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IRS RESTRUCTING: A NEW ERA FOR SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

SECOND SESSION

MAY 23, 2000

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IRS RESTRUCTURING: A NEW ERA FOR SMALL BUSINESS

TUESDAY, MAY 23, 2000

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The Committee met, pursuant to notice, at 10 a.m., in room SR–428A, Russell Senate Office Building, the Honorable Christopher S. Bond (Chairman of the Committee) presiding.

Present: Senator Bond.

OPENING STATEMENT OF THE HONORABLE CHRISTOPHER S. BOND, CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS, AND A UNITED STATES SENATOR FROM MISSOURI

Chairman BOND. Good morning, the Committee on Small Business is called to order.

My colleague and Ranking Member, Senator Kerry, has another commitment. His staff informs me that he will be joining us shortly. But since we said we were going to start at 10, we will get on with it right now.

As many of you know, this week is Small Business Week, and I believe it to be very important for the Committee to focus its attention today on one of the most pervasive and continuing issues confronting small-business owners, and that is their interaction with the Internal Revenue Service. Over the past 2 years, the IRS has been taking some major steps to streamline that interaction, which I hope will take some of the frustration and fear out of America's entrepreneurs.

Today, the Committee will examine the progress that the IRS is making on its modernization efforts. In particular, we will be looking at the new IRS division dedicated to small-business and self-employed taxpayers in this country. To bring us up to date on the agency's work in this area, it is my pleasure to welcome IRS Commissioner Charles Rossotti back to the Committee this morning. Welcome, Mr. Commissioner.

Nearly 2 years ago, Congress passed sweeping legislation, with strong support of the Administration and the IRS, to rebalance the focus of the Internal Revenue Service. Broadly speaking, the purpose of the 1998 Internal Revenue Service Restructuring and Reform Act was to transform one of the Nation's most feared enforcement agencies. Our goal was for the IRS to become an agency that balances the taxpayers' needs for outstanding service with the agency's duty to collect tax revenues in a fair and uniform manner. As a strong supporter of that legislation, I am pleased that it has

allowed Commissioner Rossotti and his team of senior managers to begin the massive effort of transforming an agency that had become such a significant part of the lives of taxpayers, and especially small-business owners.

A significant part of the IRS' transformation is expected to occur through the reorganization of the agency into four operating divisions, each dedicated to the particular needs of specific groups of taxpayers like small-business owners and the self-employed. I have asked Commissioner Rossotti to provide us with a progress report today on the new Small Business/Self-Employed (SB/SE) Division and the steps the IRS is taking to reduce the enormous tax filing and reporting burdens that small businesses face every day.

I also see that the new Commissioner of the SB/SE Division, Mr. Joe Kehoe, is here with Commissioner Rossotti today. We welcome him as well. Having tried a little bit of retirement, he found that it was not nearly as rewarding as being actively in the fight, and he has got it. I admire a man who makes irrational decisions like that for the greater public good.

A year ago I also asked the General Accounting Office to begin an examination of the IRS' plan for the new SB/SE Division. I am pleased that Cornelia Ashby, Associate Director of the GAO for Tax Policy and Administrative Issues, is here this morning to report on the GAO's findings.

I appreciate the extensive work that the GAO has done on this project, and the periodic briefings that the Committee has received over the past year. I also appreciate the IRS' extraordinary cooperation with the GAO on this project. While the GAO has identified some challenges facing the IRS, I think the examination that Ms. Ashby and her team have now completed validates the IRS' plans for the SB/SE division and helps us to see some of the benefits that the Division will have for small-business taxpayers.

It is my hope that the new SB/SE Division will contribute to the overall effort to swing the pendulum back from the heavy-handed enforcement mentality of yesteryear to one that recognizes the importance of prompt, courteous, and fair service by the IRS for America's small-business taxpayers. For too long, small-business owners and the self-employed have felt they have been treated like tax cheats simply because they run a small business.

Commissioner Rossotti and Commissioner Kehoe, I urge you in the strongest possible terms to ensure that, as the new SB/SE Division "stands up" later this year, that historic bias of "guilt by virtue of small business" will have no place in the new Division's front-line employees or its top management.

Small business owners bear incredible burdens when it comes to compliance with the overly complicated tax code, as the Committee saw in great detail at our hearing last April on tax filing and reporting burdens. With such complexity, honest mistakes will naturally occur, especially for small-business owners who often cannot afford professional tax assistance. Those taxpayers need help in avoiding mistakes and straightening them out when they occur, all in a manner that treats them as honest, upstanding citizens who are willing to pay their fair share of the taxes.

Just as the IRS does not want to be judged by its worst employees, small-business owners do not want to be branded as criminals simply because of a few *dishonest* small enterprises.

This is not to say that the IRS should look the other way when it comes to disreputable taxpayers who are trying to evade their tax liabilities. The IRS has a dual responsibility, part of which is to ensure that taxpayers who owe taxes, pay them. And I strongly support the IRS' efforts to collect taxes due in a fair and professional manner. We can hardly expect honest taxpayers to pay their fair share, if others are getting away with cheating the system.

As one who just went through the annual ritual of paying my taxes, I sure do not want to see somebody else getting away with not paying the taxes they owe, when we pay the taxes we owe.

Finally this morning, I have asked two individuals who currently serve as informal advisors to the IRS to provide the Committee with their perspective on the agency's new SB/SE Division and the steps the IRS is taking to reduce the compliance burdens on small businesses and the self-employed.

Sandra Abalos is the owner of Abalos & Associates, an accounting firm in Phoenix, Arizona. This morning, we will be testing the boundaries of the Senate's technological advancement by having Ms. Abalos join us from Phoenix via video conferencing. We look forward to her insights as a member of the IRS Electronic Tax Administration Advisory Committee on the new SB/SE Division and the efforts underway to encourage and improve electronic tax filing.

I should also note that this morning's proceedings are being broadcast on the Internet via the Committee's web page at sbc.senate.gov.

Last, but certainly not least, will be Roy Quick, Jr., a fellow Missourian, a good friend, and a principal in the Quick Tax & Accounting Services. Mr. Quick is also a member of the IRS Advisory Council, and he will give us his perspective on the new SB/SE Division, as well as some of the agency's efforts to provide taxpayer education in the pre-filing stage in order to reduce errors and provide better compliance by small-business taxpayers.

With that, Mr. Commissioner, I know that you have a very full statement that we will accept for the record, and I ask now that you summarize your testimony and begin the proceedings.

STATEMENT OF THE HONORABLE CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE, WASHINGTON, D.C.

Mr. ROSSOTTI. Thank you very much, Mr. Chairman, and thank you for having me here this morning. I think it is very helpful for you to have this hearing at this particular point in time, when we are really at the beginning of what I think is a whole new era in tax administration with respect to especially the small business community.

Of course, we are following, we think, the Restructuring and Reform Act as our road map as we embark on this huge modernization. We think that as we look across all of the parts of the taxpayer base that we serve, we really believe that the opportunities we have to improve service to the small-business taxpayer are

probably some of the best opportunities we have. Which is another way of saying we have some of the greatest room for improvement.

We believe that we must help these taxpayers and I would stress especially almost 800,000 new businesses that startup every year, to understand what is expected of them and to stay in compliance from day one.

Very much as you summarized in your opening statement, Mr. Chairman, we are stressing the balanced approach to doing this tax administration. We know that the vast majority of small-business taxpayers do want to comply with their tax obligations. And we have to help them do that every way we can, to make it as easy as possible, and especially to prevent problems before they even occur.

Of course, for that small minority who do refuse to meet their obligations, they cannot be allowed to unfairly burden the remainder, and we need to take necessary steps to bring them into compliance.

What we are trying to do is take a short-term and long-term approach to this. We know we cannot do everything at once. In the short term, we are working on new avenues of communication and new technologies to help provide quality service at convenient times. I think one of the important things we have done for hard-pressed small-business owners who do not have a lot of time, is to open our phone service 24 hours a day, 7 days a week, so that people can communicate with us when it is convenient for them.

We have also created a CD–ROM that has a great deal of information that any small-business owner could benefit from.

Chairman BOND. I imagine that is a best seller.

Mr. ROSSOTTI. It is actually a pretty good seller. I think your staff has copies of this and have been looking at it. Of course, we have all of this on the web site as well. Our small business corner on the web site, which I think is very helpful in terms of being able to assist small businesses since most small businesses now have some computer capability, gives them a chance to go to the web site and get what they need.

We are also trying, of course, to make it easier to actually file and pay taxes. On the quarterly return side, which is some of the most frequent filings, small businesses can now do that either by touch tone phone or filing online directly from their own computer.

Something new for the next filing season, which we think will be very popular with many self-employed taxpayers and small businesses, is a checkbox on the form 1040 which will basically allow people to, just by checking this box, allow their preparer or the person that prepared their return to communicate with us without having to file still another return—another form just to be able to authorize them to do that. This seems to have gotten a good response and we look forward to expanding that potentially to other forms after we test it the first time.

We are also expanding our voluntary tip compliance program, so that people can now devise their own tip agreements, in addition to the standard ones that we provide. Any industry now, where tipping is a customary practice, we think this will expand what has been already a successful program, to use voluntary agreements to encourage compliance rather than having to go in and audit things after the fact.

Those are some short-term things. We know that they only scratch the surface. We do not, in any way, claim that these are anywhere close to what we need to do to relieve the burden and to make ourselves more efficient with small-business taxpayers. But we think they are some steps.

Now of course, the other big step that we are taking, which you mentioned in your opening statement as the key focus of this hearing, is the establishment of four operating divisions as the primary units of operation in the IRS. One of the most important of those will be the Small Business and Self-Employed Division. We are still targeting to get that division operational officially as of October 1. We have much to do to make that happen but we are definitely setting that as our goal.

As you noted, Mr. Kehoe who is here with me today is the Division Commissioner. And Dale Hart, who is an experienced IRS executive, also has been sworn in as the Deputy Commissioner.

Just briefly, to outline what we are going to have in this unit, we will have three major components that actually deal with taxpayers. I think that, right off the bat, is an important statement because it is an attempt to be balanced in the very structure of the division itself.

The first one is our Taxpayer Education and Communication division, which will have not only a national office but a field staff that will operate in 86 territory offices throughout the United States. I will note that one of these will be in St. Louis, Mr. Chairman. I think that once this office is fully staffed, it will have about six times as many staff across the country as we currently have today devoted to this function. Of course, that is because we have very few devoted to this function right now.

But in the future, we will have a fully staffed, across the country set of offices. For example, in St. Louis, we would expect that they will work very closely with some of the local offices, the State of Missouri for example, in order to generate one-stop shopping with the State. We would work closely with local small business association offices, and especially something that we are working very hard on, working with the Small Business Development Centers. They are very effective educational organizations that already offer many courses for small businesses, and we want to partner with them.

In addition, the taxpayer education group will pick up the responsibility that is currently done on sort of a detail, part-time basis during our filing season to help taxpayers who have questions, either in our direct field offices or over the phone. That will also help both taxpayers and also help us avoid what is today a major problem in that we have our compliance people, our revenue agents, get off their cases in order to work on things during the filing season.

So that is a very important and, I think, one of the most important new initiatives, our Taxpayer Education and Communications organization.

The second major component will be our customer account services. Actually, it will be the part of the organization that probably most taxpayers will most interact with, because this will be the one to which you actually send in your returns, and get refunds and

payments, and deal with the normal kinds of transactions that take place every day in any business operation.

I think the key thing here is that once we get this fully established, we will then have account representatives who will be dedicated and specialized to deal with small-business and self-employed taxpayers. So they will be more capable, we hope, in fact I am certain, will be more specialized in understanding particular problems that occur with small businesses who interact with us more frequently, of course, than the individual taxpayer who sends in their return once a year.

Their job will be to make that process, which is actually the most frequent interaction process, as smooth as possible.

Of course, the third component will be our compliance organization, which will have a full field organization, as well as phone and other resources, to perform the traditional functions of examining returns and collecting overdue accounts, which is a very important function. But they will also assist in the overall strategy of developing voluntary compliance to its maximum.

Finally, one of our goals in the compliance area, which will take some new technology to enable, but which over time I think has tremendous potential. When we do intervene with the taxpayer we want to do it as quickly as possible after we find a problem. Oftentimes, in collection from small businesses, the problem is not that the customer will not pay, it is that they cannot pay because we have gotten to them so late, by that time the money is gone or they have just gotten into an intractable problem.

So one of our key goals in compliance is to speed everything up, so that if we are going to talk to a taxpayer about a problem, let us do it as quickly as possible, get it resolved, and get in and out. That is what we hear as one of the main things that our taxpayers tell us, and it is just common sense.

Those are kind of the main outlines of where we are going. I believe that if we can sustain this program, Mr. Chairman, we really can, I think, be more effective on both of the missions that you have mentioned in your statement, to provide quality service to all of the compliant taxpayers, which are the majority of them, and also to ensure fairness in the system by enforcing compliance where that is required.

We do need some resources, and I have to mention that our fiscal year 2001 budget is still up for consideration. Frankly, it is very important that we get that budget so that we will have the resources to staff some of these things that I have mentioned, and also to invest in the technology that we think is really critical in order to improve service, especially in the account area, which is where most of our small-business taxpayers really interact with us most of the time.

So with the support of Congress, in committees like your Committee and our other committees, which I am very happy to say so far has been very positive, at least so far this year, I think we can continue this tremendous transformation. And I think in the next year to 2 years really begin to seriously deliver on our commitments to improving the way tax administration works for all taxpayers, but especially for small-business and self-employed taxpayers.

Thank you very much, Mr. Chairman.
[The prepared statement of Mr. Rossotti follows:]

PREPARED TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
CHARLES O. ROSSOTTI
BEFORE THE
SENATE COMMITTEE ON SMALL BUSINESS
IMPROVING SERVICE TO SMALL BUSINESSES
MAY 23, 2000

INTRODUCTION

Mr. Chairman, using the IRS Restructuring and Reform Act of 1998 (RRA 98) as our road map, the IRS has embarked on the most comprehensive modernization of the agency and the way it serves taxpayers in almost a half century. By employing a combination of incremental short-term improvements and longer-term fundamental changes in organization and technology, we can greatly improve the way we serve the small-business taxpayer community.

The opportunities to improve service to this vital segment of our economy are enormous. For example, there are as many as one million start-up businesses each year in the United States. However, we now reach only 65,000 of them through our extremely limited education outreach program, missing an enormous window of opportunity to help these taxpayers understand what is expected of them and stay in compliance from the start. Far too often, compliance is seen as an "after-the-fact" or "back-end" solution to a problem when we should be building compliance throughout the business-life and filing cycles.

I want to stress the balanced approach we are taking on compliance. The vast majority of small business taxpayers want to comply with their tax obligations. They also know that their competitors who do not comply burden everyone who does. Through our modernization plan, we will help these compliant taxpayers understand and meet their tax reporting, filing and payment responsibilities. We want to prevent compliance problems from ever occurring, or address them as soon as possible. However, for that very small minority who simply refuse to meet their obligations and unfairly burden those who do, we will take the vigorous and necessary steps to bring them back into compliance.

SHORT-TERM IMPROVEMENTS

Mr. Chairman, our most basic goal is to help to the best of our ability small businesses and the self-employed understand their tax obligations and reduce their burden. However, before the IRS can give them the type of service they expect and deserve, we must understand what it really means to be a small businessperson, to be self-employed or to start a business. We must understand the challenges and enormous pressures they face.

As a former small businessman, I know that it seems that small business owners and entrepreneurs spend every minute of every day meeting clients, serving customers, trying to meet a payroll and to grow their businesses with limited capital. People considering going into business for themselves often do not have the time to visit every government office to find out what forms they have to file or to get a question answered or a problem resolved. The IRS is also not one of their favorite destinations.

We are building this understanding of the needs of small businesses into our current initiatives and activities geared towards this critical taxpayer group. Whether it is offering 24/7 phone service to resolve an account problem, creating a new small business CD-ROM and the Small Business Corner on our web site, or working in partnership with the Small Business Administration and other stakeholders, we are exploring new avenues of communication and exploiting new technology to provide quality service to small businesses at times and locations convenient to them.

Mr. Chairman, I would now like to discuss in detail some of our current initiatives on small business taxpayer education, service and taxpayer rights.

Web Site "Small Business Corner"

The Small Business Corner located on the IRS web site was inaugurated in January 1999 to benefit the over 23 million small business taxpayers and the 800,000 start-up businesses begun each year. We want to provide these taxpayers with easy-to-access and easy-to-understand information. This type of convenient "one-stop shopping" for assistance could provide most, if not all, of the immediate products and services that a small business needs. It also offers the potential for web-based Q&As which can help the IRS identify and address trends and systemic problems. Improved electronic access to information should also result in decreased demand for telephone and walk-in assistance.

Mr. Chairman, there is also a "hot link" from the Small Business Corner to the Committee's website. This has quickly become an important source of information and feedback on IRS' major forms and notices. As a result of this input, the IRS convened the first "Forms Forum" last year, with a second one scheduled for next month.

Small Business CD-ROM

In conjunction with the Small Business Administration, the IRS also recently produced the joint small business CD-ROM, "Small Business Resource Guide: What You Need to Know About Taxes and Other Topics." Last year's prototype CD-ROM received highly favorable reviews from small businesses and external stakeholders. As a result, the Year 2000 version of the CD-ROM is being made available free of charge, one-per-customer, by calling our toll-free number at 1-800-TAX-FORM. It can also be ordered on the IRS Web site.

The CD-ROM is an interactive multi-agency product utilizing the latest technology to provide the small business taxpayer with easy-to-access and easy-to-

understand information. The CD-ROM provides an array of helpful information for business operators, including actions to take before going into business and tax filing and reporting responsibilities when starting, expanding, closing or selling a business. In addition, it includes all of the business tax forms, publications and instructions for *e-filing*. The CD-ROM also allows users with Internet access to link to other helpful federal and state web sites.

We are working with the SBA, the Association of Small Business Development Centers and the Service Corps of Retired Executives (SCORE) to help publicize and distribute the new CD-ROM so that we can get it to the people it will help most. Combined, these organizations have over 1,500 locations, and the IRS sent each site 100 free copies of the CD-ROM to share with their small business clients. Each Member of Congress has received two copies, as well. The IRS produced nearly 500,000 of the CD-ROMs and expects to distribute all of them by this summer.

Checkbox Burden Reduction Project

Mr. Chairman, beginning in the 2001 filing season, Paid Return Preparers can use the Third Party 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. It also addresses a problem with which we have been grappling for years.

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

The leadership of the external stakeholder organizations meets annually with the IRS Commissioner and propose methods to enhance cooperation between the Agency and the practitioner community and to make filing easier. The checkbox issue has been on our collective agendas for a number of years and numerous proposals were made to address this issue. However, they proved to be unworkable for a variety of reasons, ranging from representation questions to systems, equipment and capacity issues.

The checkbox designation I am announcing today should enable practitioners to expedite the resolution of questions concerning the processing of the taxpayer's return. It should also reduce 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. Our initiative also addresses the practitioner groups' concern that this designee not be afforded post-assessment correspondence or representation.

Mr. Chairman, the IRS calculates that taxpayers will save an estimated 75,000 hours initially by not having to prepare a third party authorization disclosure form (Form

8821). Additional time will be saved because processing issues will be resolved immediately, thereby eliminating unnecessary post-filing contacts. However, we recognize that the net burden reduction, as we currently calculate it, will be less because there will be an increase in burden for reading and understanding Forms 1040 instructions for the new checkbox authority.

We further expect over a million taxpayers to use the checkbox feature in lieu of filing Form 2848 (Power of Attorney and Declaration of Representative). As a result, taxpayers will save an estimated 1.9 million hours initially by not having to prepare Form 2848. Once again, the net burden reduction will be less because we must assume there will be an increase in the burden for reading Forms1040 instructions and understanding the new checkbox authority.

The burden reduction that will result from the checkbox initiative is even greater when one considers the 9.1 million notices related to math errors and return preparation that were issued in 1999. Twenty-seven percent of these notices were related to returns prepared by paid preparers. The IRS estimates that taxpayers will save approximately 779 thousand hours by referring notices to their designees rather than responding to the IRS in writing or by telephone. Similarly, we estimate that taxpayers will save more than a million hours related to correspondence by allowing IRS to resolve issues by contacting their designees.

Simplified System for Tip Income Compliance Agreements

Last month, the IRS announced that it is simplifying its voluntary tip income compliance agreements and expanding them to all industries where tipping is customary, such as restaurants and hair salons. Also, IRS will now allow employers in the food and beverage industry to design their own agreements. Finally, the IRS will resume enhanced compliance efforts in cases of serious noncompliance at businesses where tipping is customary.

Under the TRDA (Tip Rate Determination Agreement), the IRS and the employer work together to determine the amount of tips that employees generally receive and should report. Each participating employee agrees to report tips at the appropriate rate. Under the TRAC (Tip Reporting Alternative Commitment) agreement, the employer agrees to educate employees and establish tip reporting procedures. In return, the IRS agrees not to initiate tip examinations of the employer while the agreement is in effect, nor to examine a participating employee with respect to tips. These agreements are designed to help employers and employees understand and meet their tip income reporting responsibilities.

Until now, only the gaming, food and beverage, and cosmetology and barber industries were able to make these agreements with the IRS. The IRS has simplified and shortened the TRDA and the TRAC agreements for the food and beverage industry and the TRAC agreements for the cosmetology and barber industry. In addition, the TRAC

agreement for the cosmetology and barber industry will now allow business owners with booth renters or independent contractors to participate.

The IRS has also developed a TRDA and a TRAC agreement for other industries where tipping is customary. Businesses that may wish to participate in this program include taxicab and limousine companies, airport skycap companies, and car wash operations.

In addition to the TRDA and TRAC agreements, the IRS will permit employers in the food and beverage industry to design their own programs through EmTRAC (Employer's Tip Reporting Alternative Commitment). EmTRAC will include the same employer commitments and protections as afforded under the TRAC agreement. This option will initially be offered to food and beverage employers. Later, the IRS will consider expanding this option to other industries, which would allow these employers the flexibility to develop a program that would best serve their needs.

Notice 2000-21 tells food and beverage employers how they can apply to get their EmTRAC plan approved. If the IRS approves the employer-developed plan, the employer will receive a confirmation letter from the IRS.

The above changes reflect the IRS's continued effort to use education and outreach to help taxpayers voluntarily comply with the nation's tax laws rather than solely relying on enforcement actions. We are very pleased with the cooperative efforts of participating businesses that make these agreements work so well. The IRS will accept public comments until July 7th on these changes or on other aspects of this program that will help to further improve voluntary compliance.

The IRS also announced, that effective October 1, 2000, it will resume the practice of making assessments for FICA taxes on employers only, without first determining the tip income of individual employees. These employee only assessments will be made only where there are flagrant violations of the tip reporting rules.

The IRS has had a self-imposed moratorium on making such assessments while the courts have been deciding this issue. However, three federal circuit courts of appeal have now clearly found that IRS does have the authority to assess employer FICA taxes on tip income without examining the tip records of individual employees.

Many people are willing to comply with their responsibilities for correctly reporting tip income and we have set forth a non-burdensome method for them to comply. However, there are still some people who are flagrantly willing to throw the burden on other taxpayers. We will use the power that the courts have given us to make sure that they do not unfairly burden their competitors.

IRS will also continue to examine the tips received by individual employees as appropriate. Tipped employees should make sure they keep good records to support the actual tips received.

IRS and Association of Small Business Development Center Partnership

This year, the IRS began a partnership with the Association of Small Business Development Centers (ASBDC) in a pilot program designed to improve the attendance, quality and presentation of IRS' small business workshops. The pilot is underway in Iowa, Texas, Delaware and Nevada and features four new basic business tax law training modules in a Power Point format. The workshops are being presented at SBDC locations and are proving to be popular with our small business customers. A major benefit of the partnership is that the ASBDC counselors also become more familiar about business taxes so they can provide more help to their customers. This leveraging opportunity is especially attractive since the ASBDC sees nearly 600,000 business startups annually at their 1,000 locations.

Mentor and Monitor Program

Starting a new business can be a confusing and difficult process – especially when it comes to employment taxes. The IRS is testing a new program, Mentor and Monitor (M&M), to try to make the process a little easier.

M&M is part of the Redesign of the Collecting Process initiative. The program, currently being tested in Kansas, New Mexico, Oklahoma and Texas, acts early in the new business startup process. When the new businesses request an Employer Identification Number (EIN), M&M also sends:

- a simply worded letter offering assistance,
- an instructional videotape on Federal Tax Deposits with an accompanying workbook,
- an enrollment form for the Electronic Federal Tax Payment System (EFTPS),
- information on services offered by the SBA and other information a business might need to meet its tax obligations.

An M&M employee, known as a Small Business Representative (SBR), calls taxpayers who have received the special EIN mail-out, offers to answer any employment tax questions, suggests additional forms and publications the customer may find useful, and offers to enroll them in the M&M program. Once enrolled, the SBR becomes the customer's personal representative who makes monthly tax deposit reminder calls and answers questions that may have come up since the last monthly contact. When customers need assistance beyond getting employment tax questions answered, the SBR will refer them to:

- a subject-matter expert from Customer Service,
- the Automated Collection System if there is a delinquency issue involved, or
- an outside organization, such as the Small Business Development Centers sponsored by SBA.

So far, taxpayer reaction has been very positive. The Service plans to expand the pilot to existing businesses where there is some indication of prior tax delinquency. Analysis of compliance differences between test and control groups begins this summer.

Taxpayer Identification Number (TIN) Matching Program

The TIN Matching system under development will significantly decrease the number of notices requiring corrections to TINs and penalty notices for late-filed, incorrect or missing TINs. In addition, this system will encourage businesses not currently filing electronically, or required to file electronically, to convert to electronic filing so that they can use the TIN Matching system to validate their TINs before submitting them to the IRS.

The TIN matching program will provide a match of user-supplied information against IRS' files. The results provided are based on an exact match, and no validation or perfection is performed on the data. With appropriate legislative changes, the TIN-matching program will be open to all payers, employers, Electronic Return Originators, tax preparers, and other governmental entities. Requestors with the appropriate limited power of attorney will also have access.

FTD Threshold Increase

To provide additional burden relief to small businesses, the IRS also increased the threshold amount for quarterly tax deposits required on tax deposits from $500 to $1,000. This change means that almost one-third of the nation's 6.2 million small business employers will not have to deposit employment taxes, relieving them of the responsibility of making as many as 12 deposits annually. This change also reduces paperwork burden because, generally, these taxpayers used paper coupons to make these deposits.

Electronic Payments

A growing number of taxpayers are also enjoying the convenience of paying electronically. More electronic payment options (credit card and direct debit) have been made available to taxpayers this year, such as accepting debit payments through TeleFile and accepting credit cards for Forms 1040ES, estimated tax payments, and Forms 4868, extensions of time to file.

Through February 26, 2000, over 11,300 taxpayers chose the direct debit option where taxpayers can designate a checking or savings account at the time the return is filed and defer the debit until the due date of the return. Last year, 75,000 payments were made via direct debit.

Another 4,747 taxpayers used credit cards to pay their taxes. Taxpayers can charge their federal tax bill to an American Express, MasterCard, or Discover Card account by calling 1-888-2PAY-TAX (1-800-272-9829). In addition, a few software developers offer integrated *e-file* and pay combinations for individuals who want to pay their balance due with a credit card. This payment option is available to taxpayers who

purchase tax preparation software and file their returns from a personal computer. Last year, over 53,000 tax payments were made via credit card.

Electronic Federal Tax Payment System

Approximately 2.8 million businesses are now enrolled in the Hammer-award winning Electronic Federal Tax Payment System (EFTPS) that allows taxpayers to make their federal tax deposits over the telephone or using a personal computer, eliminating the need for paper deposit coupons, checks, or trips to the bank. During FY 1999, over 55 million transactions, in excess of $1.3 trillion, were made via EFTPS. Thus far in FY 2000 (through February 26, 2000), nearly 26 million transactions in excess of $610 billion were made through EFTPS.

Expansion of the Form 941 On-Line Filing Program

Since April 1998, small businesses that meet certain qualifications were able to file their Forms 941, "Employers Quarterly Federal Tax Return", using a touch-tone telephone. During FY 1999, over 915,000 quarterly employment tax returns were filed over the telephone by employers, in addition to 1,234,063 Forms 941 that were filed electronically by payroll-service providers. In Fiscal Year 2000, the IRS expects 962,200 returns to be filed over the telephone and another 1,504,100 Forms 941 to be filed electronically. Over 220,000 employers participate in the TeleFile program, in addition to approximately 320,000 employers who participate in the Form 941 *e-file* program.

IRS now offers the opportunity for employers to prepare and file their Forms 941, "Employer's Quarterly Federal Tax Return" on-line using their personal computers. The tax return information is transmitted to IRS through a third party. This program provides another option for filing Form 941 electronically, which will save time and reduce paperwork for employers.

Simplified Tax And Wage Reporting System (STAWRS)

Under STAWRS, the IRS is working with other federal agencies and states to reduce the wage and tax-reporting burden on employers through initiatives such as the Single Point Filing projects conducted in Montana and Iowa. Approximately 80 Montana employers participated in each of the four test quarters by filing one quarterly (paper) return, Form MTQ/941, with the Montana Department of Revenue.

The employers used the Form MTQ/941 to report their Montana state withholding tax, Montana unemployment insurance tax, Federal withholding tax, and Social Security and Medicare taxes. Montana extracted the Federal data, encrypted it and sent it via a secure gateway to the Tennessee Computer Center for processing. Based on the test results, Montana is planning for a phased-in implementation. It plans to offer the combined form to 5,000 additional employers each quarter until all employers in the state have the opportunity to participate. Montana is hopeful that half of their 30,000 employers will ultimately participate in combined filing.

The Iowa project was similar to the Montana project except that it involved electronic filing of the quarterly return rather than paper filing. Because of limitations with the pilot software, which was provided by the STAWRS Project Office through Iowa, only three employers participated in the pilot during the three test quarters.

PIN Pilots

Millions of individual taxpayers used Personal Identification Numbers (PINs) to file totally paperless returns this year. The use of a PIN number eliminates the need to send a paper signature *jurat* to the IRS.

Through May 11, 2000, approximately 5.4 million taxpayers have already participated in the Practitioner Signature Pilot where taxpayers choose a PIN when filing electronically through 18,000 participating practitioners. The May 11th total was more than ten times the 500,000 PINs used for all of last year.

Another 1.2 million taxpayers used e-file Customer Numbers (ECNs) to file using tax preparation software from their home computers. In December, the IRS mailed more than 11.5 million postcards with ECNs to people who did their taxes on a computer last year, whether they filed a paper or electronic return. By e-filing with the ECN, these taxpayers do not have to file any paper with the IRS. The ECN usage thus far this year already exceeds the 1999 total of 660,000.

Taxpayer Advocate

Just as important as answering the phone and providing new and better filing and payment options is ensuring that we have in place a process to resolve problems and not let then fester as sometimes, unfortunately, happened in the past. Our National Taxpayer Advocate (NTA) Service has been beefed up to tackle exactly these types of issues. We have a special hotline for the Taxpayer Advocate and the NTA Service will have an executive director responsible for the Small Business/Self- Employed and the Large and Mid-Size Operating Divisions. In addition, the NTA will be hiring in the near future a Small Business Operating Division Taxpayer Advocate. The office will be co-located with the Small Business Operating Division in New Carrollton, MD.

Taxpayer Rights

RRA 98 required the IRS to implement 71 new or modified taxpayer rights provisions, many of which were effective either on date of enactment, or within six months of it. At the same time, the IRS received recommendations from many sources about other pressing changes that were required to improve service or fix problems. These included such basic matters as availability and quality of telephone service, rewriting of notices and letters sent to taxpayers, control over inventory of assets and hundreds of other matters.

For example, since January 1999, two-hundred eighteen Treasury Inspector General for Tax Administration (TIGTA) audits and 138 GAO audits have been initiated

(both opened and closed). The 89 GAO reports that have been issued so far contained 94 recommendations and the 80 TIGTA reports proposed 375 specific recommendations. The National Taxpayer Advocate identified the top twenty problems affecting taxpayers and made recommendations as to what should be done about them. Addressing and managing these changes requires significant management attention, and many require additional resources, including information systems resources, to implement.

In this context, the first priority was implementation of the taxpayer rights provisions of RRA 98 in accord with the law. Given the short time frames, and many competing demands, our capacity to provide guidance to the public and to employees and to conduct training for the 100,000 employees affected was stretched to the limit. The initial focus was on ensuring legal compliance. In many cases, we did not know the amount of time and resources that would be needed to carry out these provisions. In FY 1999, for example, we had briefings and training on 55 RRA 98 provisions and provided a total of two million hours of training. We estimate that nearly 4,560 full time equivalent (FTE) personnel were required for the specific administrative provisions of RRA 98.

We are at the stage where we have implemented the RRA legal provisions. However, we have several years of work ahead to make them work more efficiently and with higher quality. Our immediate challenges are primarily training and management. We are continuing a high level of training in FY 2000.

I want to stress that we are wholly committed to implementing each and every taxpayer rights provision and making them work as intended, while still fulfilling our mandate to collect taxes that are due. We will get the job done and we will get it right. However, we will also make mistakes along the way and we are not yet at an acceptable level of quality, efficiency and effectiveness in the way that we are implementing some of these provisions.

To describe more concretely some of the issues we face, I would like to cover in detail our approach to one of the 71 taxpayer rights provisions: third party notices. Mr. Chairman, before I describe our efforts, let me once again thank you for calling to our attention the problems associated with the third party notices and working so hard with us to arrive at a solution.

Third Party Notice

Section 3417 concerning Third Party Notices presented implementation challenges. It requires us to give a taxpayer reasonable notice before contacting any other person with respect to the determination or collection of the taxpayer's taxes and then to periodically tell the taxpayer who has been contacted. The brevity and seeming simplicity of this statute belies its complexity. The chart at the end of my testimony shows the chronology of events in implementing Section 3417.

When we first implemented this provision, we attempted a "one size fits all" approach by sending a broadly written notice to virtually every taxpayer in our administrative stream -- a total of 25 million in all. The reaction was immediate, strong, and negative. We were told that the generic nature of the notice did not provide its recipients with any indication of why we would contact third parties to talk about their tax situations or what information we would seek from third parties. We also were told that the tone of the notice was intimidating, implying that we would talk to anyone and everyone, including neighbors, about private tax return information. The notices caused undue (and certainly unintended) anxiety for many persons.

We clearly needed to try a different approach to implement this provision, and we did. First of all, we listened very intently to the feedback we received, and solicited additional input from practitioner groups, the small business community, and other interested parties. In particular, I thank many of the Committee Members and your staffs who have worked collaboratively with us to enhance the implementation of this provision.

We knew from this input that we should provide a frame of reference for the taxpayer in the notices. For example, we should state that we are seeking unfiled returns or unpaid taxes and that we are following up on prior communications. We should alleviate concerns that we would disregard the privacy protections that are so fundamental to our tax administration system when we make these third party contacts and we should look to the taxpayer first to provide the information that we might obtain from third parties.

Not surprisingly, when we moved to address these issues, we learned that the drafting of the notices, though challenging, was not the most difficult part of administering this provision. We quickly learned that if we did not blanket all taxpayers in our pipeline with a third party notice, we had to isolate those instances where a third party contact was most likely, develop a notice appropriate for that situation, and train our employees on how to identify and handle these situations, including the reporting requirements that occur when third party contacts are made. When all was said and done, our refinements narrowed the universe of taxpayers who may receive the notice to about eight million, with slightly more than half of those notices being sent through an automated process and the remainder being sent by employees only when a third party contact is imminent. Beginning in February, we issued new notices -- about 15 in all -- that are tailored to the specific situation of the taxpayer and that address many of the concerns that we heard.

However, we still have our work cut out for us. One troubling area is how to balance the interests of third parties with the rights of taxpayers and the need for efficient tax administration. We are required to record all third party contacts and to periodically report them to the taxpayer involved, except where the contact was authorized by the taxpayer, is with respect to a criminal investigation, would jeopardize collection, or the third party expresses a fear of reprisal. We have instructed our employees to take reprisal claims by third parties at face value. We made this decision to avoid a situation, where by

virtue of our second-guessing of a claimed fear of reprisal, we make the wrong call and disclose the contact, only to have the third party suffer harm as a result.

More difficult is the situation where a third party does not claim a fear of reprisal but asks us not to record their name or provide it to the taxpayer. In this situation, the statute requires us to disclose the name of the third party to the taxpayer. The vast majority of third parties do not wish to get caught up in another person's tax dispute, but nonetheless recognize a public duty to assist law enforcement efforts. I am concerned that they undergo a great deal of anxiety when they learn that the disclosure will be made, and, as a result, become disenchanted with the tax system and their government. Though we do not track the instances where third parties ask not to be identified, I understand from reports from the field that it occurs frequently, which puts our employees in a very difficult position. This ultimately may have the effect of creating unwillingness on the part of third parties to provide any information at all to us in the normal course of business, even outside of the situations contemplated by the statute.

I can assure you that we are committed to implementing this provision in a way that is fair to all of the respective players and carries out the intent of the legislation. While we are working on some of the remaining challenges, such as the ones I have described, we have moved forward with training and implementation. We estimate that we are dedicating approximately 500-600 FTE to administer this provision.

LONG-TERM IMPROVEMENTS:
THE SMALL BUSINESS/SELF-EMPLOYED OPERATING DIVISION

Mr. Chairman, while we have made some important short-term improvements in service, they barely scratch the surface of what we need to do for America's small business taxpayers. They need and deserve service that is tailored to their circumstances and is managed by people who understand their problems and work every day to reduce their tax administration burden. I believe that this is where and how we can make the most meaningful gains to improve service to small business owners and reduce their burden.

Following Title I of the IRS Restructuring and Reform Act of 1998, the IRS is creating an organizational structure of four operating divisions that will be fully responsible for all of the tax administration needs of specific, corresponding taxpayer segments, including one devoted to small business and self-employed taxpayers.

Mr. Chairman, I stress that this change is not just moving around the organizational boxes. It is designed to put in place a structure with a management team at its core that lives and breathes small business issues every day. And that team has the authority and responsibility to improve the way the whole tax system works for small business and self-employed taxpayers, including preventing problems before they occur and reducing administrative burden.

Also critical to our efforts to better serve small business taxpayers is the complete replacement of IRS' information technology systems. We have no choice. The systems we are using today are built on a 30-year-old, fundamentally deficient foundation that cannot provide accurate up-to-date information about taxpayer accounts, nor sustain modern business practices. Moreover, implementing new technology based on revamped business practices is critical to carrying out RRA 98's mandates, and providing meaningful taxpayer burden reduction across the board.

Small Business/Self-Employed Operating Division

The Small Business/Self-Employed Division (SB/SE), containing between 37,500-40,000 IRS employees, is on schedule to become operational on October 1, 2000. Joe Kehoe and Dale Hart have been sworn is as Commissioner and Deputy Commissioners respectively of the division. Prior to accepting these leadership positions, Mr. Kehoe was Global Leader, Service Sector Consulting for PricewaterhouseCoopers and Ms. Hart was Regional Commissioner for the IRS Mid-States Region, which includes Missouri. They bring a unique blend of leadership, skills, tax expertise and business experience to these key positions. We are also actively recruiting and hiring the balance of the SB/SE leadership team.

The taxpayers served by this division include about 45 million filers who have four to 60 transactions with the IRS per year and are responsible for the nearly 44 percent of the total cash collected by the IRS. Of these, there are approximately seven million small businesses, including corporations and partnerships with assets of $5 million or less.

The challenges are particularly great for the approximately one million small businesses started each year. More than 80 percent are unaware of the tax provisions intended to assist them, and 70 percent do not know how the tax laws affect their businesses. In addition, while many small businesses face the same tax issues as large corporations, they often do not have in-house tax professionals. For this reason, 88 percent use a paid preparer to assist in tax preparation. Tax compliance issues often stem from a lack of understanding of tax law requirements, inadequate accounting practices, and resources or cash flow problems.

The SB/SE Division will also service approximately 38 million self-employed individuals and supplemental income earners. This group is similar to wage and investment taxpayers, but their tax issues are more complex. They have substantially higher income and file twice the number of forms and schedules. For example, almost 30 percent file schedules C, E, or F; this requires more time to prepare taxes, a greater reliance on paid tax preparers, and more IRS expertise.

As these businesses hire more employees, filing complexity also increases, as does reliance on technology. Approximately 65 percent of them use the Internet, and in FY 1999 approximately 19 percent of small businesses filed electronically. By 2002, the

number of self-employed and home-based businesses is expected to total 50 million, with 38 million of those utilizing personal computers to assist them in conducting business.

SB/SE will also serve a third set of taxpayers – estate and gift taxpayers, fiduciary returns, and individuals with international tax returns. For this taxpayer group, SB/SE will focus on providing top-quality, tailored service through better-trained and better-equipped employees.

The SB/SE operating division will have three major components. The first is Taxpayer Education and Communication (TEC) that will serve the pre-filing needs of SB/SE customers. TEC will educate and inform SB/SE taxpayers and representatives about their tax obligations by developing educational products and services focused on customer needs and by providing top quality pre-filing services.

I want to stress that we have built into all four operating divisions the principle of working with taxpayers before they file their returns. We want taxpayers to get it right the first time. It is faster, more efficient, better for everyone and an accepted best business practice to prevent a problem rather than solve it.

SB/SE taxpayers and practitioners have very similar education and communication needs, such as education on new tax laws and filing procedures, and awareness of emerging issues. While services and products will focus on meeting the needs of all SB/SE taxpayers, many of TEC's activities may be targeted to provide specialized information for various customer segments. Services and products existing today such as Small Business Workshops and one-on-one counseling in conjunction with the Service Corp of Retired Executives will also continue to be offered by TEC Field offices. TEC will further utilize our partnerships with major stakeholders to assist in the design, development and delivery of educational products and services.

TEC's organizational structure will be comprised of two areas, Partnership Outreach and TEC Field. Partnership Outreach will be responsible for establishing relationships with partner organizations to identify customer needs, opportunities for partnerships, and benefit-oriented products and services to improve service to SB/SE customers. Some of these potential partners include small business organizations, professional, trade and service organizations, government agencies, educational institutions, payroll and practitioner groups, and electronic business organizations. Responsibility for negotiating Voluntary Agreements on Compliance and tax matters will be centralized under the Partnership Outreach Director.

The TEC Field staff will provide taxpayer education from 86 Territory office locations across the United States. Once fully staffed, TEC Field will have about six times more employees than all of the current IRS Taxpayer Education offices. With an increased workforce of approximately 1,200 employees devoted to small business taxpayers, and with the use of leveraged partnerships with our major stakeholders, TEC will educate SB/SE customers at a level unheard of today. TEC Field staff will also

support peak filing-season initiatives including the Walk-In Program and R-Mail. They will also channel feedback on customer needs and ideas to Partnership Outreach.

To see how the TEC Field office will work, let me use St. Louis, Missouri as an example; St. Louis will be one of the TEC Area Center Headquarters. According to 1998 figures from the Small Business Administration, Missouri ranked 39th in new business starts. In 1998, approximately 14,300 new-employer firms were formed. Further, 1996 SBA information provides a snapshot of the top ten industry segments in the state. The number of existing businesses in each area include:

Hotels & Rooming Houses	45,289
Health Services	7,847
Food and Beverage Establishments	7,110
Miscellaneous Retail	5,893
Agriculture	4,490
Real Estate	4,458
Auto Dealers / Gas Stations	3,635
Food Stores	2,219
Amusement & Recreation	1,872
Local & Suburban Transportation	261

The TEC Field staff will deliver services and products that will be tailored to meet the needs of the Small Business customer with emphasis on these local market segments. They will partner with the State of Missouri to provide one-stop service. They will also partner with the local SBA office, Small Business Development Centers, and other local organizations to offer services at times and places most convenient to the customer.

Imagine how these services would help just one person thinking of starting a business. After years of working in other people's restaurants, John Smith wants to start his own establishment. Late one night, he starts the research process from his home PC. First, he accesses the SBA's web site for help. From there, John sees he can link to the IRS Small Business Corner, and discovers a multi-lingual interactive site where he can customize his questions to fit the Food and Beverage Industry perspective. He finds information on topics such as an explanation of the various types of business entities, payroll tax filing information, a business guide for the Food and Beverage industry that includes information on record keeping and related tax topics, and an on-line application process for an Employer Identification number.

After being on the website, John decides to enroll in the next Small Business Workshop that will be jointly sponsored by the IRS, SBA, and state agencies. At the workshop, he meets the local Field office staff, and files away their names for future reference. Other services of which he can take advantage include receiving his personal copy of the Small Business CD-ROM, one-on-one tax counseling with the local TEC Field office staff, registering for the IRS newsletter, or *e*-mail messages and electronic payment processing for making employment tax deposits.

SB/SE's second component, Customer Account Services (CAS), is a dedicated processing, customer service and accounting organization for small businesses and self-employed taxpayers. Accounts representatives will be able to provide tax law, account resolution and payment information through different means, such as telephone, paper and electronic, which will shift in response to changing customer demands. SB/SE accounts representatives will be specifically trained to resolve both routine and complex issues affecting this taxpayer base. CAS will also promote voluntary compliance.

The CAS organization will develop strategies for: (1) processing returns and assisting taxpayers with specific tax law and account inquiries and adjustments; (2) technology implementation and information automation strategies; and (3) improving CAS services, such as toll-free, adjustments/correspondence, accounts maintenance, disclosure, refund activity, etc. It will also monitor submission and customer service patterns and trends as well as the workload and effectiveness of CAS. In this way, it can better allocate resources among electronic filing, processing and account management.

CAS will also ensure that taxpayer education and assistance is emphasized throughout its organization. In addition, it will coordinate program activities with other top-level IRS functions to: prepare guidance for IRS-wide policies, address cross-functional issues, develop strategies, and ensure consistency of approach.

The third and last SB/SE component, Compliance, focuses on post-filing operations. However, Compliance will have the dual function of performing the traditional exam and collection work and improving voluntary compliance, which is our main goal. Should we have to intervene through the collection or exam process, we want to identify and act on these problems as quickly as possible.

On a national level, Compliance will formulate both short- and long-range program strategies, policies and objectives specific to SB/SE taxpayers. It will also work in conjunction with the Taxpayer Education and Communications division to design, develop and implement programs, including pre-filing, filing and post-filing educational activities to assist these taxpayers in understanding and complying with the tax laws. In addition, it will manage issues affecting compliance across the operating divisions and work with them to develop and implement fair and consistent treatment of all taxpayers.

Compliance also has a major field function. For example, working in conjunction with the Office of Compliance Policy, it will develop compliance strategies that reflect local needs. It will also coordinate market-segment compliance strategies and alternative treatments. Moreover, it will coordinate with TEC to integrate education and outreach into its operations and work with stakeholders and industry experts to meet taxpayer needs and improve our knowledge of industry standards and practices.

CONCLUSION

I would like again to thank the Chairman and the Committee for this opportunity to discuss our short- and long-term efforts to improve service and ease the tax

administration burden faced by the Nation's small businesses. I believe we are transforming the IRS into an agency that will provide quality service to small business taxpayers and help them meet their tax obligations while ensuring that compliance is fair.

However, as I recently testified before the Appropriations Committees, to succeed in this enormous and vital program, we must have adequate budget resources in FY 2001 to address critical operational needs and to invest in new technology to support best business practices. If Congress can provide continued and assured support for IRS modernization, such as that contained in our budget request, we will be able to produce the visible, tangible and meaningful improvements that America's small business taxpayers expect and deserve. Thank you.

Chronology of Section 3417, Third Party Notice

07/22/98	**Passage of RRA 98, Section 3417 Third Party Notice**
July 1998	Convened **Executive Steering Committee** to oversee implementation of RRA 98 provisions
August 1998	**Initial coordination meeting** with representatives from all functions to discuss impact of legislation
August 1998	**Developed National Resource Center web site** to provide updated information to employees to answer questions relating to various RRA provisions. Multifunctional working group, including counsel, established to respond to 3417 issue. Approximately 300 Q&As regarding 3417 are on this site.
October 1998	**Action plan** developed by Section 3417 provision owner and approved by Executive Steering Committee. Action items included development and utilization of database for tracking contacts, creation of notice, determination of day-to-day application of provision, and assessment of training needs.
October 1998	**Working group** including counsel and function representatives established to interpret legislation and develop operational procedures.
November 1998	**Notice to taxpayers** of potential third party contacts (letter 3164) drafted and shepherded through clearance process.
November 1998	Development of **System of Records Package** for contact database
December 1998	**Letter 3164** submitted to forms and publications unit for printing
December 1998	**Developed and distributed to all heads of office interim operational procedures** for initial implementation
December 1998	**District and Service Center** Third Party Notice **coordinators** selected
December 1998	**Initial mandatory training** on interim operational procedures for all employees who make third party contacts

December 1998	Initiated **negotiations with National Treasury Employees Union (NTEU)** regarding **Memorandum of Understanding** on impact and implementation of section 3417
January 1999	Issued **revised operational procedures** to clarify application of statute and information necessary to track third party contacts
January 1999	**Instruction on revised operational procedures** provided to all employees who make third party contacts
January 1999	**Letter 3164** issued to first wave of approximately 25 million taxpayers
January 1999	Began **development of database** to track third party contacts
February 1999	Established **Executive Oversight Sub-Committee** to review impact of RRA 3417 on customers and employees and to address concerns relating to letter 3164
February1999	**External Stakeholders raised concerns** that letter 3164 was too generic and intimidating
March 1999	Chief Operations issued instructions **to letter 3164** would be used in situations where a third party review was likely
March 1999	Mandatory training an targeted use of letter 3164
March 1999	**Meeting with external partners** to identify specific issues resulting from 3417 implementation
March 1999	Issued revised **3417 operational procedures**
April 1999	Worked with **TIGTA** on preparations for 3417 review
April 1999	**Revision to letter 3164** issued for **field test** to external/internal partners
April-June 1999	Held **meetings with each function** to identify unique policy, legal and operational issues arising from 3417, such as who is the taxpayer, who is a third party, and what constitutes a contact
June 1999	Finalized report on **policy, legal and operational issues** and developed revision to letter 3164 based on meetings, field tests, and external partners
June 1999	**3417 Systems of Record** Notification published in Federal Register

July-September 1999	Conducted **focus group interviews** in all regions with employees from all functions and field tested revised letter 3164
July 1999	**Provided testimony** on status of RRA 98 implementation
July 1999	Development of **third party database** completed. **Training** of all third party contact coordinators conducted
August-September 1999	Established Detroit host site **for input of third party contact data** gathered from January 1999 through August 1999, approximately 75,000 contacts. **Provided training** to Detroit employees on review of input documents and appropriate data entry techniques.
August 1999	Provided **status update** on 3417 to representatives from the **Oversight Committee**. Briefing included a discussion on impact of implementation on taxpayers and third parties and the policies, operational and legal issues for the service.
August 1999	Finalized negotiations **with National Treasury Employees Union** and issued **Memorandum of Understanding** to all employees
September 1999	Provided **training to all employees** on Memorandum of Understanding between IRS and NTEU relating to initial implementation of 3417
September 1999	**Final revision to letter 3164** developed based on input from internal and external partners and placed in clearance.
September 1999	Provided **status update** on 3417 to representatives from the **Small Business Committee.** Briefing included a discussion on impact of implementation on taxpayers and third parties, and the policies, operational and legal issues for the service
September 1999	**Met with Treasury** representatives to discuss impact of implementation on taxpayers and third parties, and the policies, operational and legal issues for the service.
October 1999	Provided **status update** to representatives from the **Finance Committee.** Briefing included a discussion on impact of implementation on taxpayers and third parties, and the policies, operational and legal issues for the service

November 1999	**Approved revised letters 3164** forwarded for printing and distribution, effective date 2/11/2000
November 1999	**Updated Operational Procedures** to include information on the use of the new letters 3164
November 1999	Provided **training on revised procedures** and new letters 3164 to representatives from all district offices and customer service sites.
November 1999	Provided **status update** on 3417 to representatives **from IRS Advisory Committee.** Briefing included a discussion on impact of implementation on taxpayers and third parties, and the policies, operational and legal issues for the service
November 1999-January 2000	**Provided training** to all employees who make third party contacts in all functions throughout the service
January 2000	**Executive training** on RRA 3417
February 2000	Effective date for **new letters** and **revised procedures**
Short Term Goal	Issuance of Regulations on Third Party Notice

Chairman BOND. Thank you very much, Mr. Commissioner. Those are very encouraging words, and we commend you for the direction you are taking.

Before I turn to questions, though, I want to close the loop on a project that you were kind enough to help us initiate at the Committee's hearing last April on small business tax filing and recordkeeping burdens. After that hearing, as you recall, we posted on the Committee's web page the "IRS Paperwork Unpopularity Poll." For the past year, we have collected input from small-business owners on the IRS forms, instructions, and publications, letters and notices most in need of revision.

This morning, I am pleased to present you with the results of that poll. May I have the envelope, please? I always wanted to do that.

Mr. ROSSOTTI. I cannot wait to see what is coming out of that envelope.

Chairman BOND. We have preserved the anonymity of each participant. We are providing you with the complete documents and the votes cast on each type. Without reviewing the entire report, let me announce the winners.

The five most unpopular IRS forms are: No. 1, Form 1040, the U.S. Individual Income Tax Return. No surprise.

No. 2, Form 941, the Employer's Quarterly Federal Tax Return. No. 3, Form 4562, Depreciation and Amortization. No. 4, Form 940, the Employer's Annual Federal Unemployment Tax Return. And No. 5, Form 1065, U.S. Partnership Return of Income.

To give you a flavor of how candid the comments were, let me just quote from two of our participants regarding the depreciation and amortization, Form 4562. One participant wrote:

> I have a degree in accounting with honors from the University of Texas . . . and I have to read the rules on depreciation at least three times every year, and then just pray that I'm interpreting them correctly.

And on Form 941, the Employer's Quarterly Federal Tax Return, a participant noted:

> Way too confusing for anyone without a degree or a CPA. Trying to figure out if I have a credit or owe money is difficult. My monthly liability and my quarterly liability is always just a few cents different. It's a lot of useless paperwork to find I've overpaid by 12 cents.

He has the same problem I have with my checkbook.

Commissioner, your willingness to examine these forms and documents is a testament to the IRS' overall efforts to provide greater service to America's taxpayers. It is an important step forward in reducing tax filing and recordkeeping burdens that small business and the self-employed encounter every day. I look forward to working with you to reduce the filing and compliance burdens.

I thank you very much for participating with us in that poll.

Mr. ROSSOTTI. Thank you very much, Mr. Chairman. We have it right here and we will be looking at these comments very carefully. Of course, I think getting rid of the 1040 may be a little beyond our capacity.

Chairman BOND. I do not think anybody asked to get rid of it, but perhaps some of the comments can help translate it into readily understandable language.

Let me turn now to a series of questions. First, in your testimony you described the SB/SE Division's Taxpayer Education and Communication component. How will you assess whether these efforts are getting to the taxpayers, as opposed to the tax preparer, and whether they are effective?

Mr. ROSSOTTI. I think that one of the techniques that we have begun to use on evaluating all of our programs, and we will most definitely use it for these programs, the simplest way is just to ask the customer. In other words, survey the taxpayers on a regular basis. We are already doing this on many of our programs, and we are actually not only serving them but we are actually building this into the performance measures for our managers in our whole organization.

Although we have not gotten this unit established yet, I feel sure that we will do that. We have some pilot projects that have been very interesting in different parts of the country that we are going to build on, and we have already been doing some surveying of the participants.

A lot of times what you find, especially with the new business owners, is that they have a trade or a skill. I was out in California last week, and we have a program out there that is a good prototype I think of what we want to do for home-health care providers. There is quite a booming industry, people using people to come into their homes to provide help or health care for elderly people and others who need care. These people do have to get licensing, but many times they do not know anything at all about business or taxes.

Both we and the State of California, in this case, found out that they were getting behind. We were going in and auditing them or finding they had not paid something and shutting down and that was not benefiting anybody. So we developed this program in the State of California, as part of the process where they get their licensing to give them basically a fairly simple 2-hour kind of primer on what needs to be done to file and pay their taxes.

Then we went back and surveyed them and got very good responses from the participants in that kind of a program that say this is really helpful, I did not know anything about this. It really is a way to keep them where they need to be. So a very simple method of just simply asking them and seeing if they have gotten something out of it.

In the longer term, we want to actually measure the effect on compliance of these activities, which is a more difficult thing to do, but we will definitely have that as part of our longer term plan.

Chairman BOND. This Committee has taken a real interest in the plight of home-health care agencies. Last year we held hearings on it. The question is whether the Health Care Financing Administration will eliminate them, execute them before they can get around to paying their taxes. So I would say that, in this one area, you are probably not the least favorite agency of the Federal Government with which the home-health care providers have to deal.

I am sure, as you talk to home-health care people, you will encounter some of those questions. I guess, fortunately or unfortunately, that is not your problem. It is ours, and a great concern of many members of this Committee and mine.

With respect to the customer account service of the new SB/SE Division, do you have some problems with the aging technological capabilities? You mentioned in your comments the need for technology. Will it be a hurdle to overcome the technological gap to provide the kind of customer service improvements you envision?

Mr. ROSSOTTI. Unfortunately, Mr. Chairman, I have to say it is a major hurdle, especially in that area. Let me put it this way, it is an obstacle or a barrier. By that, we do not mean that we are going to just wait and do nothing until we have replaced all our technology, because that is not a good approach. We are trying to do what we can.

But just to give you a couple of examples, one of the problems we have is with just simply the timing of updating our files. Somebody calls us in and says I have paid such and such an amount, and it takes anywhere from—it could take as long as 16 days, because of the way our systems work, to actually get that transaction updated on what we call our master file.

So in the meantime, it is possible that the person could get another notice or could call in again. You get this kind of cycle that is very, very bad. A lot of the times when people, you probably get complaints from your constituents, every member virtually does, about this kind of thing. From the taxpayer's point of view, it seems inexplicable. I have already called up. I have paid. I have settled this. And then they get another letter, and then they call up again.

It is simply the fact that we have a 35-year-old system that takes up to 2½ weeks. That is a major problem.

Another problem is with the notices. We send out 180 million notices a year. Many of them go to small businesses. Many of those people complain that they cannot understand what it is. I got a complaint recently from one of your colleagues, Senator Domenici, from one of his constituents, where he said the taxpayer was furious. I got a notice that said he had not paid by 1 cent and he got a penalty for $286. It looked very much like that, if you read this notice, like that is exactly what happened.

Of course, we looked into this, and the reality was the penalty was not for the 1 cent. The 1 cent had nothing to do with it. It had to do with some late payments on a previous filing that just carried over to this notice. But the notice did not tell him anything about this. So it just looked to him like that is what the problem was.

And yet, although we are trying to fix some of these notices, we do not have, in all cases, the data in our system, in our data base, to be able to actually carry it forward, to be able to explain fully to the taxpayer what is in these notices. So it is not just a matter of rewriting them, it is the underlying computer systems.

These are just two examples. But fundamentally, we have a tax system, Mr. Chairman, that depends on computer systems that were, many of the key parts of it, actually designed and built in the 1960's and 1970's, and we are now in the 21st century. So we cannot really deliver what is expected appropriately by the taxpayers.

That, of course, is why we have our whole technology modernization program which has begun, but which is a long-term program

and which, of course, will require continued funding in order to be successful.

Chairman BOND. I can sympathize with the fellow that had the notice. One of my first encounters with the IRS some 35 years ago when I was called in to the office because they claimed I had not paid the quarterly taxes I owed. I brought in the canceled check stubs, and I sat down with a gentleman who had not had his coffee that morning, he was not really awake. And I said here is our problem. You say I have not paid, but here is the canceled check that you deposited.

He said let me go talk to my supervisor. So he came back after 10 minutes, and he said, "Well, we are willing to compromise this." That is when I lost it. I said, "No, no, no, I paid it. We are not compromising anything."

I hope that that is long gone, but I know that my first experience set my teeth on edge a bit, so I think that is important, as well.

In the testimony, you note that the third component of the SB/SE Division will be a traditional compliance function. As I indicated, I support that in order to ensure that the system is fair, the taxes owed are collected. Because of the complexity of the tax code, however, would you consider implementing a program under which penalties for first time taxpayer errors in mitigating circumstances are waived?

Mr. ROSSOTTI. As a matter of fact we do have, of course, the authority to abate penalties. The most common case where that occurs is the first time somebody has had to make, for example, a tax deposit. We actually have a program in effect right now, which we just fairly recently implemented within the last couple of years, where we automatically waive the penalties.

I did find out that we were not, however, until very recently, notifying the taxpayer that they had this problem and that we had waived the penalty. So therefore, they were in the position where they could have done it a second time and gotten the penalty. This was an interesting finding.

So we have got a system now where we at least send the taxpayer a letter when that happens to tell them look, you did not do this and we waived the penalty because obviously it was your first time, just to let them know what they are supposed to do the second time. I think that is a better system.

So I agree with you, in many cases, we should do that. As a matter of fact, we have that program in the case of the tax deposits program. We certainly would look at that as a key criteria for abating penalties in any other situation where it was a first-time filer.

We are not really trying to use penalties to penalize people, except where it is really a legitimate issue. It is just part of the tax system. We do have, fortunately, the authority in most cases to waive the penalties if it is justified.

Chairman BOND. When can we tell small businesses they could expect to start seeing some substantive changes in the kind of assistance the IRS provides and/or the way it provides the information, as you describe in your testimony?

Mr. ROSSOTTI. Well, I think we could claim that, at a limited level, it has already begun, it has already happened. We have not waited until we have the new division started up.

I mention some of the things, that is why I mentioned them in my testimony. I will not repeat them again, but the 24-hour phone service, the web site, the other forms of communication.

And I think more generally, just our whole mission, our more balanced focus of how we want to administer the tax system, I think has had considerable effect in the way our employees—which have responded to this very well—deal with taxpayers. We have had a considerable focus on training and balance measurement of performance, for example.

So those things have already happened. I think that there are some other things in the pipeline for next season, next filing season. I mentioned the checkbox. And we will begin, we hope, to specialize some of the phone service a little bit more.

So I think that we have already done some things. We will have more things next year. I think over the following 2 years, 2001 and 2002, we will have then at least a major part of our organization in place. Assuming we can get the funding we requested for the staffing and the technology, we can then put in place some of these new initiatives that we have requested.

So I think we have seen some improvement already, and I think there has been some feedback from our taxpayers to that effect. I hope it will accelerate over the next 2 years.

Chairman BOND. Mr. Commissioner, as I said, there are several of my fellow Committee members who wanted to come. Obviously, they have been held up. We will leave the record open for questions that I have, which we will submit in writing. We will ask staff to prepare, by the end of this week, any questions that they have for you.

We very much appreciate your willingness to come and be with us today. We will be hearing from the GAO next, and others, but I know your time is very busy so we appreciate your being with us. Commissioner Kehoe thank you for joining us, as well as the rest of your staff. We look forward to continuing to work with you and expect very good things from the SB/SE Division.

Thank you very much for being with us today.

Mr. ROSSOTTI. Thank you very much, Mr. Chairman.

Chairman BOND. Our next panel is Ms. Cornelia Ashby, Associate Director for Tax Policy and Administration Issues at the General Accounting Office. Ms. Ashby, it is a real pleasure to have you with us.

I am also pleased this morning to release the study that the GAO undertook at my request on the IRS' efforts to construct a model that will estimate the tax burdens imposed on America's taxpayers. This first stage of this model focuses on taxpayers with wage and investment income and is expected to assess the pre-filing, filing, and post-filing burdens that taxpayers encounter.

While this part of the model does not directly affect small-business owners and the self-employed, it will be the basis for what we anticipate will be the next stage, a burden model covering small-business taxpayers.

I applaud the IRS for attempting to update its antiquated burden-estimation process, and I greatly appreciate the GAO's review and evaluation of the IRS' efforts as the agency works toward a

model that will accurately assess the enormous tax compliance burdens borne by small-business owners in America.

With that, Ms. Ashby, we will make your full statement and this other information part of the record. We thank you for your excellent assistance, and welcome you here today.

STATEMENT OF CORNELIA M. ASHBY, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.; ACCOMPAINED BY KIRK R. BOYER, SENIOR EVALUATOR, KANSAS CITY FIELD OFFICE, AND JAMES A. WOZNY, ASSISTANT DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION

Ms. ASHBY. Thank you, Mr. Chairman.

We are pleased to be here today to discuss factors that have complicated small businesses' efforts to comply with Federal tax laws and IRS' efforts to provide better service to this important group of taxpayers. James Wozny and Kirk Boyer are accompanying me today.

The IRS Restructuring and Reform Act of 1998 required IRS to place greater emphasis on meeting taxpayers' needs and to establish new operating units to serve groups of taxpayers with similar needs. In response, IRS is reorganizing into four operating divisions. No. 1, the Small Business/Self-Employed Operating Division will serve small corporations, partnerships, farmers and other self-employed individuals, a group that we will refer to as "small businesses."

Our remarks are based on results of the two studies that have been mentioned this morning that the Committee asked us to do, one on the extent to which the IRS' plans for SB/SE address factors that have complicated past interactions between small businesses and the IRS; and another on the IRS' new taxpayer burden estimation models.

The first study is ongoing and our remarks today are based on preliminary results. We have completed the second study and you have just released our report.

In summary, factors that have complicated interactions between small businesses and the IRS relate to the potential for non-compliance among small businesses, the way the IRS has structured its organization and allocated its resources, and the reluctance of small businesses to go to the IRS for help. Although the IRS' plans for SB/SE address these complicating factors, the IRS will face several challenges as it implements those plans.

First, I will discuss the complicating factors. According to the IRS, small businesses are more likely than other taxpayers to have compliance problems. IRS data show, for example, that small businesses tend to have more collection cases involving withheld employment taxes than do larger businesses. Complexity, in combination with the resources available for dealing with that complexity, may account for some small business non-compliance.

While small businesses, like larger ones, encounter complex tax issues and are subject to multiple layers of filing, reporting, and deposit requirements, they do not always have the kinds of re-

sources on a continual basis that they need to understand and deal with those issues and requirements.

Other factors that may contribute to a small business's potential for non-compliance are cash-flow limitations and the fact that business income, unlike wage and investment income, is generally not subject to withholding or some form of third party reporting.

Because the IRS is organized and allocates its resources along geographic and functional lines, it is designed to handle a wide range of issues pertaining to all taxpayers with little or no focus on specific taxpayer segments, such as small businesses. As a result, the IRS does not have any easy means of accessing comprehensive information about small-business taxpayer accounts. This can inhibit its ability to identify and resolve tax-compliance problems of small businesses.

Further, the IRS has historically allocated most of its resources to correcting problems rather than preventing them. This emphasis is especially problematic for small businesses that need assistance up front and that, absent help, are at a high risk of going out of business if problems arise.

The results of our survey of a stratified random sample of 1,000 small businesses representing a study population of 398,105 small businesses nationwide showed that many small businesses were unaware of key IRS services or knew of the services but did not use them. Many expressed negative feelings about their past interactions with the IRS. Small business owners participating in IRS focus groups indicated that they had limited familiarity with or use for IRS' products and services because they relied on tax practitioners.

Small business representatives told us that small businesses would rather rely on tax practitioners because they are too busy, they do not trust the IRS, or the IRS' services are not conveniently offered.

IRS' plans for SB/SE indicate that it will address the factors we identified as complicating interactions between the IRS and small businesses by dedicating an operating division to small businesses, determining the characteristics and needs of that population, shifting more resources to prevention, partnering with tax practitioners and other organizations from which small businesses are likely to seek help, and by customizing its products and services to meet the needs of small businesses.

The IRS should be in a better position to provide small businesses improved customer service. However, it will not be easy for the IRS to implement its plans for SB/SE. The IRS and the new division must confront several challenges.

First, SB/SE will serve a large and diverse population, the members of which can migrate between operating divisions as their circumstances change from year to year. The diversity of the small business population will require the SB/SE staff to specialize in a wide range of tax issues and deal with a wide range of taxpayer needs.

In addition, SB/SE is expected to do examination and collection work for other operating divisions. These responsibilities could stretch the capabilities of management and staff of SB/SE and di-

lute its taxpayer focus. Taxpayer migration also poses a challenge to the taxpayer focus intended by the reorganization.

Antiquated information systems and a shortage of staff with needed skills will also challenge SB/SE. Antiquated computer systems have long hindered the IRS' efforts to manage operations and serve taxpayers, and improvements are critical to SB/SE's overall success. A shortage of staff with needed skills can also adversely affect SB/SE's ability to deliver new programs and services.

For example, SB/SE intends to improve taxpayer education and assistance through research and analysis of taxpayer characteristics and behavior. However, according to the IRS, it does not have enough employees who possess the requisite skills such as market research, forecasting, and trend analysis.

SB/SE, like the rest of the IRS, is challenged to develop an integrated performance management system that creates incentives for employee behavior that support organizational goals. Although the IRS has clearly made progress in implementing new performance measures, it does not have a measure for voluntary compliance. The absence of such a measure could hinder SB/SE more than other operating divisions because the SB/SE population generally has a greater potential for non-compliance.

A second critical aspect of performance management is an employee evaluation system that reflects the organization's mission. The IRS recognizes that, with respect to SB/SE, a successful blend of customer service and compliance activities will require not only a substantial shift in employees' skills and abilities but also a significant change in employees' attitudes and behavior. A change that is dependent on employees being able to see a clearer connection between their day-to-day activities, their performance evaluations, and the overall organization's goals.

Finally, in closing, let me briefly address another area of interest to the Committee, the IRS' efforts to estimate compliance burden on taxpayers. Besides measuring voluntary compliance, it is also important that the IRS be able to measure compliance burden. To do that, the IRS is pursuing a multi-phase strategy. Initially, the IRS is focusing on the design and implementation of models for estimating the Federal income tax compliance burden on taxpayers who are served by the new Wage and Investment Income Operating Division. The conceptual definition of compliance burden developed for that group, and the theoretical framework for measuring that burden are supposed to build the foundation for developing burden estimates for other taxpayer groups, including small businesses.

The IRS has begun to implement its strategy by contracting for the development of two models that, when combined, should provide more reliable estimates of W&I taxpayers' Federal income tax compliance burden than current methodology. The models are also designed to provide the IRS with a greater capacity to analyze the impact of tax law and administrative changes on that burden. As with all such modeling, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

Mr. Chairman, this concludes my statement. We would be glad to answer any questions you have.

[The prepared statement of Ms. Ashby follows:]

United States General Accounting Office

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Testimony

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TAX ADMINISTRATION

IRS' Efforts to Serve Small Business Taxpayers

Statement of Cornelia M. Ashby
Associate Director, Tax Policy and Administration Issues
General Government Division

GAO/T-GGD-00-138

Statement

Tax Administration: IRS' Efforts to Serve Small Business Taxpayers

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the factors that complicate small businesses' efforts to comply with the tax laws and the Internal Revenue Service's (IRS) efforts to provide better service to this important group of taxpayers. According to IRS, there are about 40 million small businesses and self-employed taxpayers in the United States who are responsible for remitting nearly half of the taxes collected by IRS.

Congress, in the IRS Restructuring and Reform Act of 1998, mandated that IRS place more emphasis on providing better service to taxpayers. In response, IRS has undertaken a long-term effort to modernize itself, including reorganizing into four operating divisions, each of which is to focus on a particular group of taxpayers. One division, the Small Business and Self-Employed Operating Division (SB/SE) is to serve small corporations and partnerships, farmers, and other self-employed individuals—a group that we will call "small businesses". One of SB/SE's major challenges will be to help relieve the compliance burden, including the time and other costs of complying, that federal tax rules place on small businesses.

Our remarks today are based on the results of two studies the Committee asked us to do—one on the extent to which IRS' plans for SB/SE address factors that have complicated past interactions between small businesses and IRS and another on IRS' new taxpayer burden estimation models. The first study is ongoing, and our remarks today are based on preliminary results. We have completed the second study, and our report is being released today.[1]

In summary, several factors have complicated the interactions between small businesses and IRS. First, small businesses are more likely than other taxpayers to have compliance problems, which is not surprising given the complex tax issues and requirements that a small business can face and the fact that small businesses do not always have the kind of resources needed to understand and deal with those issues and requirements. Second, IRS' organizational structure and its focus on correction rather than prevention have hampered its ability to meet the needs of small businesses. Third, small businesses are often reluctant to seek help from IRS, which could be due in part to past negative experiences.

[1] Tax Administration: IRS Is Working to Improve Its Estimates of Compliance Burden (GAO/GGD-00-11, May 22, 2000).

Although IRS' plans for SB/SE address these complicating factors, such things as the diversity of the small business population, IRS' antiquated computer systems, a shortage of staff with needed skills, and the need for an integrated performance management system will challenge IRS as it implements those plans.

One aspect of performance management involves development of an appropriate set of performance measures, and one important measure is compliance burden. IRS is pursuing a multi-phased approach in developing new methods for estimating that burden. With the help of a contractor, IRS is developing models that, when compared with IRS' current methodology, are designed to produce more comprehensive estimates of federal income tax compliance burdens and to provide IRS with a greater capacity to analyze the impact of tax law and administrative changes on those burdens. However, as with all models, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

Various Factors Complicate the Interactions Between Small Businesses and IRS

From responses to our survey of small businesses[7] and the results of interviews with IRS officials and representatives of the small business community, we identified several factors that complicate the interactions between small businesses and IRS. Those factors relate to (1) the potential for noncompliance among small businesses, (2) the way IRS has structured its organization and allocated its resources, and (3) the reluctance of small businesses to go to IRS for help.

Small Businesses Have a Greater Potential for Noncompliance

According to IRS, small businesses are more likely than other taxpayers to have compliance problems. IRS data show, for example, that small businesses tend to have more collection cases involving withheld employment taxes than do larger businesses.

Complexity was the most commonly mentioned reason why small businesses might have trouble complying. Small businesses, like larger businesses, can encounter such complex tax issues as employment taxes and depreciation and are subject to multiple layers of filing, reporting, and

[7] We sent a survey to a stratified random sample of 1,000 small businesses representing a study population of 398,105 small businesses nationwide. We identified the study population from the membership list of the National Federation of Independent Businesses (NFIB). After considering a number of national organizations that represent small businesses, we chose NFIB because its membership was the largest and included members from a wide range of business sectors. We reached a general consensus regarding this choice with cognizant officials from IRS, the Small Business Administration, and a number of other membership organizations that represent small businesses. Fifty-five percent of the small businesses responded to our survey. The results of our survey can only be generalized to the population of NFIB members.

deposit requirements. However, small businesses do not always have the kind of resources on a continual basis that they need to understand and deal with those issues and requirements.

Other factors mentioned as contributing to a small business' potential for noncompliance were (1) the fact that business income, unlike wages and investment income, is generally not subject to withholding or some form of information reporting and (2) cash flow limitations. It is generally recognized that compliance is highest when taxes have been withheld (as is the case with wages) or when a third party (such as a bank or mutual fund) reports payments (such as interest and dividends) to IRS. Cash flow limitations can cause a small business to become delinquent in making required tax payments or in remitting taxes that have been withheld from employees.

IRS Has Not Operated in a Way That Best Enables It to Serve Small Businesses

IRS' ability to meet the needs of small businesses has been hampered in the past by its organizational structure and its focus on problem correction versus prevention.

Under IRS' current organizational structure, authority for serving taxpayers and administering the tax code is decentralized to 33 districts and 10 service centers, each of which is organized along functional lines, such as collection, examination, and taxpayer service. Because IRS allocates its resources, such as staff and information systems, along geographic and functional lines, it is designed to handle a wide range of issues pertaining to all taxpayers—from individuals whose sole income is from wages to multi-national corporations—with little or no focus on specific taxpayer segments, such as small businesses. For example, IRS has dozens of discrete databases that are function specific and are designed to reflect transactions at different points in the life of a return or information report—from receipt to disposition. As a consequence, IRS does not have any easy means to access comprehensive information about small business taxpayer accounts, which can inhibit its ability to identify and resolve tax compliance problems of small businesses.

IRS has also historically allocated most of its resources to correcting problems after they occur rather than preventing problems from occurring. According to IRS, it allocates about 11 percent of its budget for customer education and assistance (i.e., problem prevention) compared to 72 percent for compliance (i.e., problem correction). The other 17 percent is allocated to customer account services. This emphasis on correction versus prevention can be especially problemmatic for small businesses that need assistance up front and that, absent that help, are at a high risk

of going out of business if problems arise. In other words, by the time IRS determines that a small business has a compliance problem and sets out to correct the problem, it may be too late.

Small Businesses Are Often Reluctant to Go to IRS for Help

Small business representatives told us that small businesses are often reluctant to go to IRS for help. In that regard, our survey results showed that many small businesses (1) were either unaware of key IRS services or knew of the services but did not use them and (2) expressed negative feelings about their past interactions with IRS.

Many Small Businesses Were Unaware of Key IRS Services and Many Who Knew of the Services Did Not Use Them

IRS has certain services, such as outreach seminars and a small business corner on its World Wide Web site on the Internet, that it has developed specifically for small businesses. However, our survey indicated that many small businesses are unaware of those services and many others who know of the services do not use them.

For example, of the 398,105 small businesses in our survey population, an estimated 52 percent were not aware of IRS' outreach seminars, and an estimated 38 percent were aware of the seminars but had not used that service. Likewise, an estimated 58 percent of our survey population were not aware of the small business corner on IRS' Internet site, while another 31 percent were aware of that service but had not used it.

Small business owners participating in IRS focus groups indicated that they had limited familiarity with or use for IRS' products and services because they relied on tax practitioners.[3] Small business representatives told us that small businesses would rather rely on tax practitioners because they are too busy, they do not trust IRS, or IRS' services are not conveniently offered. For example, one small business owner responding to our survey commented that certain IRS services, such as walk-in sites and outreach seminars, are not available in small towns and that it would be helpful if there was more information available on IRS' Internet site. Another small business owner commented that he would personally find it difficult to contact any source other than a local tax preparer for information because of fear of an audit. He further suggested that IRS needs to change the image that it treats small businesses as tax cheats.

[3] According to IRS, between 80 and 88 percent of small businesses rely on tax practitioners to prepare their returns.

Small Businesses Had Mixed Feelings About Their Past Interactions With IRS

Small businesses can have a variety of interactions with IRS ranging from general written advice, such as that provided through tax publications, to more personalized service, such as that provided over the telephone or at walk-in sites, to enforcement actions, such as audits. Negative reactions of small businesses to any such interactions in the past can complicate their future relationships with IRS.

Our survey included several questions about small businesses' interactions with IRS over the past 5 years, including their level of satisfaction or dissatisfaction with several aspects of IRS' service. More small businesses in our study population were satisfied with the overall quality of IRS' service than were dissatisfied. However, when asked about selected interactions with IRS, small businesses had mixed feelings. For example, when asked about the availability of forms and publications or IRS' timeliness in issuing refunds, many more businesses commented positively than negatively. The opposite was true, however, when they were asked about such things as the understandability of forms, publications, and notices; the accessibility of IRS' telephone assistance; and the levying of penalties.

Several respondents who expressed dissatisfaction with certain aspects of IRS' service provided narrative comments to explain their feelings. For example, one respondent commented that IRS' instructions have too much fine print and not enough plain English. Two additional examples follow:

"when I do finally get a phone call through, I [dislike] all of the menus that you go through and the passing from one person to another when you finally do get to talk with a human. I also despise the noncaring, uninterested attitude that I usually get from IRS employees."

"The frustrating thing about [IRS] is they send you a notice about tax discrepancies, you answer and about a month later you get another notice. You answer again and then you get a notice telling you this is your final notice. They need to have a person assigned to your tax problem so you could call them and work it out. It seems most of the time the person sending you the notice never sees your replies."

Some small business owners and representatives said that, although IRS can improve its services, dissatisfaction with IRS is often misplaced. For example, one small business representative said that many small businesses that are dissatisfied with IRS have likely had little experience with IRS and are really expressing their dissatisfaction with the complex tax code.

Reorganization May Enable IRS to Address Factors That Have Complicated Its Interaction With Small Businesses, But Implementation Will Not Be Easy

IRS is implementing a major reorganization that is to, among other things, structure the agency around four primary customer segments and operating divisions. One of those operating divisions—SB/SE—is to focus on taxpayer education and assistance, specialized account services, and revamped compliance efforts tailored to small businesses.

The various changes discussed in IRS' plans for the new organization indicate that it will be taking steps to address those factors that have been identified as complicating the interaction between IRS and small businesses. Although the new organization may not be able to do much to reduce the complexity facing small businesses, it should be able to help businesses better deal with those complexities and increase taxpayer satisfaction. By dedicating an operating division to small businesses, increasing its knowledge base on the characteristics and needs of the population, and customizing its products and services to meet those needs, IRS intends to shed the limitations of its historic structure and improve its customer focus.

Under the new organization, IRS also intends to shift the allocation of its resources to help small businesses meet their tax requirements. For example, IRS currently allocates few resources toward problem prevention activities, such as taxpayer education and assistance, compared to problem correction (e.g., enforcement) activities. IRS recognizes the need for a greater focus on education and assistance and intends to increase the number of staff dedicated to small business education and communication from fewer than 100 in its current organization to about 1,300 in SB/SE.

Although IRS intends to increase its taxpayer education efforts, it recognizes that many small businesses are reluctant to go to IRS for help. To increase the effectiveness of its efforts, IRS intends to provide needed information by partnering with tax practitioners and other outside organizations from which small businesses are less reluctant to seek help and by focusing attention on those small businesses most in need of help, such as start-up businesses.

IRS also intends to improve overall compliance among small businesses through a revamped compliance strategy that integrates its traditional enforcement activities (exam and collection), while blending in a mixture of education and outreach services, using a risk-based approach. For example, IRS' current collection process is a "one-size fits all" approach that treats all taxpayers alike. Under its new approach, IRS intends to segment small businesses with collection issues by risk. A low risk small business would most likely receive a blend of education and enforcement

activities, while a high-risk small business might receive aggressive enforcement action. The goal of this approach is to intervene as early and quickly as possible to address small business compliance issues. Specific details about this new approach, such as the criteria that will be used in assessing risk, have yet to be developed.

All of this assumes that the various changes discussed in IRS' plans come to fruition. However, implementing the new operating division will not be easy. Some of IRS' plans, such as those related to partnering, might not take long to implement. Others, such as those related to risk-based enforcement, could take much longer.

Besides time, there are several other challenges that the new operating division and IRS must confront. For example, the size and diversity of the taxpayer population for which the new operating division will be responsible could stretch the capabilities of management and staff and dilute the division's customer focus. The new division also will be (1) hindered in its ability to deliver new programs and services by antiquated information systems and a shortage of staff with needed skills and (2) challenged, as is all of IRS, to develop an integrated performance management system that creates incentives for employee behavior that supports organizational goals.

Challenges to SB/SE's Taxpayer Focus

Although creation of SB/SE should facilitate a sharper focus on the needs and problems of small businesses than is possible under the current organization, the division will be challenged by the need to (1) serve a large and diverse population and (2) devise effective procedures for dealing with taxpayers who migrate between operating divisions.

According to IRS, the approximately 40 million taxpayers to be served by SB/SE include about 6.2 million small partnerships and corporations; 19.3 million partially or fully self-employed individuals;[4] 13 million individual filers with supplemental income or business expenses;[5] and 1.2 million non-small business taxpayers who are considered specialty tax filers.[6] Compared to SB/SE, (1) the Wage and Investment Income Operating

[4] According to IRS, as many as one-half of self-employed filers receive the vast majority of their income from wages, not business-related enterprises, and should be considered "incidental" business filers. Nevertheless, these filers are included in IRS' definition of small business and in the population to be served by SB/SE.

[5] Supplemental income earners are wage earners who file a Form 1040 with a Schedule E for rental, royalty, or other supplemental income. Wage earners with business expenses file a Form 1040 with a Form 2106 attached.

[6] Specialty tax filers include international filers and filers of fiduciary, excise, and estate tax returns.

Division is to serve a larger but less diverse customer segment (about 116 million taxpayers who only have wage and investment income) and (2) the Large and Mid-size Business Operating Division is to serve a smaller and less diverse population (about 210,000 corporations and partnerships with assets of more than $5 million).

The diversity of the small business population will require that SB/SE staff specialize in a wide range of tax issues and deal with a wide range of taxpayer needs. For example, the needs of wage earners who also operate small, one-person businesses from their homes can vary significantly from corporations that employ 100 persons and have gross receipts in excess of $1 million.

Besides handling the workload for its own diverse population, SB/SE is also expected do work for other operating divisions. For example, SB/SE is to conduct certain audit and collection activities for the Wage and Investment Income Operating Division. These additional responsibilities could stretch the capabilities of management and staff in SB/SE and dilute its taxpayer focus.

Taxpayer migration also poses a challenge to the taxpayer focus intended by the reorganization. Migration refers to scenarios under which a taxpayer might qualify as a small business one year but not the next, or vice versa. These scenarios could cause taxpayers to change operating divisions from year to year under the new organization. For example, according to IRS data, about 2.2 million individuals who had filed for tax year 1995 as pure wage earners (i.e., the kind of taxpayer for which the Wage and Investment Income Division is to be responsible) filed for tax year 1996 as sole proprietors (i.e., SB/SE-type taxpayers) and 1.7 million individuals who had filed as sole proprietors for tax year 1995 filed as pure wage earners for tax year 1996. Similarly, a corporation or partnership could have more than $5 million in assets one year (and thus be part of the population to be served by the Large and Mid-size Business Operating Division) and $5 million or less in assets the following year (which would make it part of SB/SE).

IRS acknowledges that taxpayer migration could present account management problems for SB/SE and other operating divisions. Specifically, this issue could lead to disparate treatment of taxpayers and hamper IRS' ability to provide end-to-end accountability because the responsibility for managing a migrating taxpayer's account could shift from one operating division to another. IRS is working on plans to put processes in place to allow for greater interaction between the account

management units within the operating divisions to properly manage and serve migrating taxpayers.

Challenges to SB/SE's Ability to Deliver New Programs and Services

SB/SE will also be challenged to deliver the various new programs and services discussed earlier. In general, the division's challenges derive from (1) antiquated computer systems and (2) a shortage of staff with needed skills.

IRS' antiquated computer systems have long hindered agency efforts to manage operations and better serve taxpayers. IRS has struggled with systems modernization for years, and we have made numerous recommendations to correct management and technical weaknesses that jeopardized the modernization process.[7] Although IRS has made progress in addressing our recommendations, it has yet to fully implement them. More specifically, IRS needs to fully implement key controls that are needed to effectively guide and constrain modernization initiatives. These controls include (1) completing a blueprint for modernization; (2) implementing a "systems life cycle" process, including development of business cases, to manage system investments; and (3) establishing a fully operational management structure to oversee systems modernization. Without systems improvements, IRS managers will continue to have a difficult time monitoring and managing program outcomes—including identifying taxpayer needs and evaluating the effectiveness of programs to meet those needs.

Improvements to IRS' information systems are critical to SB/SE's overall success. IRS acknowledges, for example, that small business taxpayer education and communication initiatives depend on substantial investments in computer hardware and software and that major systems changes will be required to support a risk-based compliance strategy.

A shortage of staff with needed skills can also adversely affect SB/SE's ability to deliver new programs and services. For example, the operating division intends to improve taxpayer education and assistance through research and analysis of taxpayer characteristics and behavior. However, according to IRS, it does not have enough employees who possess the requisite skills, such as market research, forecasting, and trend analysis. Such limitations could delay the operating division's ability to develop and deliver specialized education and assistance to small businesses.

[7] Tax Systems Modernization: Management and Technical Weaknesses Must Be Corrected If Modernization Is To Succeed (GAO/AIMD-95-156, July 26, 1995) and Tax Systems Modernization: Blueprint Is a Good Start But Not Yet Sufficiently Complete to Build or Acquire Systems (GAO/AIMD/GGD-98-54, Feb. 24, 1998).

SB/SE and IRS Will Be Challenged to Develop and Implement a Performance Management System

A coherent organization and management structure dedicated to small businesses will not significantly improve service to taxpayers without a performance management system that aligns employee, program, and strategic performance measures and creates incentives for behavior that supports agency goals. IRS has made some headway in this area as it develops a new set of performance measures balancing customer satisfaction, employee satisfaction, and business results and updates its employee evaluation system.

Although IRS has clearly made progress in implementing new performance measures, it is missing a key indicator for voluntary compliance. Such a measure is essential for a number of reasons. Regularly measuring progress in voluntary compliance is important to guage whether IRS is accomplishing a key aspect of its mission. Also, the information about taxpayers that would be generated in measuring voluntary compliance may help IRS identify the characteristics of taxpayers who have difficulty understanding and meeting their tax responsibilities. Finally, the data IRS would develop as part of any voluntary compliance measurement effort may allow IRS to better direct its enforcement resources to those taxpayers that willfully flaunt the tax laws, thus reducing the burden on compliant taxpayers. The absence of a measure of voluntary compliance could hinder SB/SE more than other operating divisions because, as already mentioned, the SB/SE population generally has a greater potential for noncompliance. IRS recognizes that it needs a reliable and meaningful measure of voluntary compliance and is working with a contractor to determine how to measure compliance with the least burden on taxpayers. However, that effort is still in its early stages.

A second critical aspect of performance management is an employee evaluation system that reflects the organization's mission. As mentioned earlier, SB/SE intends to refocus its compliance capabilities to provide a mix of education and outreach along with an integration of examination and collection—IRS' traditional compliance activities. IRS recognizes that a successful blend of customer service and compliance activities will require not only a substantial shift in employees' skills and abilities but also a significant change in employee attitude and behavior. IRS recognizes that to achieve this shift and a more balanced mix of customer service and traditional compliance activities, employees must have a clearer line of sight between their day-to-day activities, their resulting performance evaluations, and the agency's broader goals. IRS is exploring several different approaches for revising its employee evaluation system to make the relationship between employee performance and agency performance more transparent.

IRS Is Pursuing a Multi-phased Approach in Developing New Burden Estimation Methods

Besides measuring voluntary compliance, as discussed earlier, it is also important that IRS be able to measure compliance burden. To do that, IRS is pursuing a multi-phased strategy. Initially, IRS is focusing on taxpayers who are to be served by the new Wage and Investment Income Operating Division (W&I)—those taxpayers who derive all of their income from wages, pensions, interest, dividends, and capital gains. In subsequent phases, IRS plans to develop estimates for other taxpayer groups, such as small businesses and the self-employed and large and mid-sized businesses.

IRS' incremental approach is intended to mitigate the risks associated with developing a new methodology for estimating compliance burden. The approach should give IRS and its contractors an opportunity to incorporate lessons learned from early phases of the process into later efforts. It also gives IRS the flexibility to significantly modify or terminate the overall development process or its relationship with a particular contractor. IRS' Office of Program Evaluation and Risk Analysis is responsible for overseeing the contractor's work.

The first phase of the development process focuses on the design and implementation of models for estimating the federal income tax compliance burden of W&I taxpayers. This taxpayer group was selected for the initial phase because it accounts for a large share of IRS' overall compliance burden and because its burden may be the easiest to estimate. The conceptual definition of compliance burden developed for this group, along with the theoretical framework for measuring that burden, are supposed to build a foundation for developing burden estimates for other taxpayer groups.

The timing of later phases will depend on resource availability and the accumulation of experience. IRS expects to contract out later this year for a study that would develop a methodology for estimating the time and money that self-employed individuals spend preparing and filing their federal income tax returns. The agency also expects to begin work on employment taxes later this year and on small corporate taxpayer burden in calendar year 2001.

New Estimation Models for W&I Taxpayers Are in Development

IRS has begun to implement its strategy by contracting for the development of two models that, when combined, should provide more reliable estimates of W&I taxpayers' prefiling, filing, and postfiling compliance burdens. Compared with IRS' current methodology, these models are designed to produce more comprehensive estimates of federal income tax compliance burdens and to provide IRS with a greater capacity

to analyze the impact of tax law and administrative changes on those burdens. As with all such modeling, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

PricewaterhouseCoopers, the contractor engaged to assist IRS in the initial phase of its strategy, began work on the modeling effort in September 1998. The first model, which is to estimate prefiling and filing burdens is expected to be delivered to IRS in May 2001. A second model, which is to estimate postfiling burdens, also is expected to be designed by then, but the operational model is to be delivered at a later date. The cumulative cost of this initial effort is expected to reach approximately $5 million by the end of fiscal year 2001. Expenditures for later years have not yet been determined.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions you or other Members of the Committee might have.

Contact and Acknowledgements

For further information regarding this testimony, please contact Cornelia M. Ashby at (202) 512- 9110. Individuals making key contributions to this testimony included David Attianese, Kirk Boyer, Stuart Kaufman, Daniel Lynch, Marvin McGill, Yong Meador, Anne Rhodes-Kline, Samuel Scrutchins, Margarita Vallazza, and James Wozny.

United States General Accounting Office

GAO

Report to the Chairman
Committee on Small Business
U.S. Senate

May 2000

TAX ADMINISTRATION

IRS Is Working to Improve Its Estimates of Compliance Burden

GAO/GGD-00-11

United States General Accounting Office
Washington, D.C. 20548

General Government Division

B-283788

May 22, 2000

The Honorable Christopher S. Bond
Chairman, Committee on Small Business
United States Senate

Dear Mr. Chairman:

Taxpayers spend considerable time and money complying with the federal income tax rules. While much of this compliance burden is attributable to the tax code, another portion can be linked to Internal Revenue Service (IRS) actions. Reliable estimates of the burdens imposed by such compliance could assist Congress in reducing those burdens, and assist IRS in developing measures of its own performance, making better informed resource allocation decisions within the agency, and meeting reporting requirements under the Paperwork Reduction Act. We have reported that the estimation model that IRS currently uses for compliance burden ignores important components of burden and has limited capabilities for analyzing the determinants of burden.[1]

You asked us to report on the status of IRS' efforts to improve its estimates of taxpayer compliance burden. Accordingly, in this report, our objectives were to (1) describe IRS' overall strategy to improve its methodology for estimating compliance burden, (2) describe what IRS has done to begin implementing its overall strategy and how IRS expects this to improve its methodology, and (3) determine whether IRS expects that its new methodology will be able to measure the burden associated with the complex tax rules identified in IRS' forthcoming first annual report on tax complexity.[2]

Results in Brief

To improve its methodology for estimating compliance burden for all types of federal taxpayers, IRS is pursuing a multiphased strategy. Initially, IRS is focusing on taxpayers who have only wage and investment (W&I) income because they bear a large portion of the overall compliance burden and because their burden may be easiest to estimate. Later phases would develop estimates for other taxpayer groups, such as small businesses and the self-employed and large and medium-sized businesses. This

[1]Small Business Tax Compliance Burden (GAO/GGD-99-96R, May 5, 1999).

[2]This report was mandated by the IRS Restructuring and Reform Act of 1998 (P.L. 105-206, July 22, 1998).

incremental strategy should give IRS and its contractors the flexibility to incorporate lessons learned from early phases of the process into later efforts.

IRS has begun to implement its strategy by contracting for the development of two models that, when combined, should provide more reliable estimates of W&I taxpayers' prefiling, filing, and postfiling compliance burdens. Compared with IRS' current methodology, these models are designed to produce more comprehensive estimates of federal income tax compliance burdens and to provide IRS with a greater capacity to analyze the impact of tax law and administrative changes on those burdens. As with all such modeling, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

IRS expects that one of the new models, covering prefiling and filing activities, will provide some assistance in estimating burdens associated with the complex rules identified in IRS' forthcoming first annual report on tax complexity.[5] For some rules, the model may be able to show both the number of W&I taxpayers affected and the approximate size of their burdens. For other rules, IRS expects that the model will only be able to show the potential number of taxpayers affected. The other model, which is to estimate postfiling burden, is in the early design stage, and its capabilities have not yet been determined.

IRS reviewed a draft of this report and agrees with the content.

Background

IRS has been seeking to improve its compliance burden estimation methodology for several reasons. First, it would like a tool to assist policymakers in understanding the sources of burden and evaluating options for reducing that burden. Second, IRS would like to know how its own programs and activities affect compliance burden. This information could be used to develop additional performance goals and measures for reducing burden and would assist managers in targeting resources and developing new programs. Third, the 1995 amendments to the Paperwork Reduction Act of 1980 and the 1993 Government Performance and Results Act (GPRA) impose new reporting requirements that IRS' existing methodology was not designed to meet.

[5]The IRS report will focus on the Alternative Minimum Tax (AMT) for individuals, the variety of definitions that taxpayers must learn in order to determine their filing status and eligibility to claim dependents and credits, and the estimated tax rules.

IRS' current model for estimating taxpayer compliance burden, developed by Arthur D. Little, Inc. (ADL), was considered a substantial improvement over the agency's previous methodology when it was first introduced in the 1980s. However, IRS and other observers have identified several significant shortcomings of the model that limit its usefulness and accuracy. Two important limitations of the model are that it ignores significant components of burden, as well as important determinants of burden.[4]

The ADL model was designed to meet reporting requirements arising from the Paperwork Reduction Act. Pursuant to that act, the Office of Management and Budget (OMB) established the annual Information Collection Budget and required federal agencies to provide estimates of the paperwork burdens that they impose on the public.[5] The definition of burden that the ADL model uses to meet this reporting requirement includes the estimated time costs (burden hours) imposed by information collections but excludes costs associated with tax planning and postfiling activities, such as preparing for an audit. It also excludes most monetary expenses. For example, paid preparer fees were converted into an equivalent time amount, but expenditures on books, software, and delivery services were excluded. Amendments to the Paperwork Reduction Act in 1995 now require IRS and other agencies to include these monetary expenses in their burden estimates. IRS would like to use an even broader definition of compliance burden—including the tax planning and postfiling burdens—when developing performance measures under GPRA or when evaluating the effects of changes in tax laws and administrative practices.

Past reviews of the ADL model have criticized the approach that it uses to update estimates of compliance burden from year to year as simplistic.[6] These reviews noted that the model does not account for changes in important determinants of burden, such as tax preparation technology and taxpayers' education and experience. These shortcomings limit the

[4]See appendix I for more detail on these and other limitations of the model.

[5]The Information Collection Budget is the means by which the federal government, through OMB, measures and controls the number of hours individuals, businesses, state and local governments, and others must spend complying with federal reporting requirements. The Information Collection Budget is prepared annually based upon the prior fiscal year's experience and current estimates of the "burden hours" imposed by individual forms, surveys, and other information collections.

[6]See, e.g., IRS, "Report of the Taxpayer Burden Study Group: Roadmap for a New Measure and Pilot Study for Individual Non-Business Taxpayers," Request for Proposal (Aug. 19, 1998); Marsha Blumenthal, Burden Reduction Research and Analysis, report submitted to the Analysis and Studies Division, IRS (May 1996); and Henry Beale, untitled draft report on Arthur D. Little Compliance Burden Model, submitted to the Analysis and Studies Division, IRS (1996).

model's usefulness as an analytical tool and raise concerns about the accuracy of its estimates.

In August 1998, an IRS study group identified the type of burden estimation model that the agency would like to have.[7] Ideally, the model would be able to

- estimate the burden associated with all prefiling, filing, and postfiling activities undertaken to comply with federal income, estate and gift, employment, and excise tax rules;
- disaggregate total compliance burden by type of tax, taxpayer, and activity;
- disaggregate burden by origin of compliance requirements (tax laws, regulations, and administrative procedures);
- estimate changes in burden associated with potential tax law changes;
- function in an integrated manner, allowing users to see how certain tax changes affect multiple taxpayer groups;
- disaggregate burden by IRS function (e.g., submission processing and customer service) for burdens associated with the requirements of, and taxpayer interactions with, those functions;
- estimate the impact on taxpayer burden of alternative enforcement programs and techniques providing customer service;
- provide different types of estimates for different purposes (e.g., the estimates required for the Information Collection Budget are different from those that IRS would use for performance measurement under GPRA);
- estimate burden in terms of dollars as well as time; and
- incorporate new data with sufficient ease so that the model, itself, would not have to be replaced in the near future.

Scope and Methodology

To address the first two objectives of this report we interviewed IRS officials about their ongoing and planned efforts to develop new burden estimation methodologies. We also reviewed extensive documentation prepared by IRS' contractor PricewaterhouseCoopers (PwC), which described (1) the objectives of the new compliance burden estimation models; (2) the conceptual and operational designs of the model covering prefiling and filing burdens and the conceptual design of the model for postfiling burdens; and (3) research that PwC completed to inform its design decisions. We did not evaluate the effectiveness or appropriateness of the designs for the new models. We also reviewed documentation relating to the ADL model, as well as existing evaluations of that model by

[7] IRS, "Report of the Taxpayer Burden Study Group."

IRS and external analysts, in order to identify differences between that model and the new models.

To address the third objective we obtained information from IRS about the expected content of their forthcoming complexity report. We reviewed PwC's description of how it expects the new prefiling/filing burden model will operate and inferred how that model could be used to estimate the burden associated with certain aspects of the tax rules discussed in IRS' report. We confirmed with IRS officials that our understanding of how the model could be used with respect to these complex rules was consistent with IRS' expectations of the model's capabilities.

We conducted our review from July 1999 through April 2000 in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Commissioner of IRS. His comments are discussed near the end of this letter and are reproduced in appendix III.

IRS Is Pursuing a Multiphased Approach in Developing New Burden Estimation Methods

To accomplish its goal of improving its methodology for estimating compliance burden for all types of federal taxpayers, IRS is pursuing a multiphased strategy. Initially, IRS is focusing on taxpayers who have only W&I income. Later phases would develop estimates for other taxpayer groups, such as small businesses and the self-employed and large and medium-sized businesses.

IRS' incremental approach is intended to mitigate the risks associated with developing a new methodology for estimating compliance burden. The approach should give IRS and its contractors an opportunity to incorporate lessons learned from early phases of the process into later efforts. It also should give IRS the flexibility to significantly modify or terminate the overall development process or its relationship with a particular contractor. IRS' Office of Program Evaluation and Risk Analysis is responsible for overseeing the contractor's work.

The first phase of the development process focuses on the design and implementation of models for estimating the federal income tax compliance burden of W&I taxpayers—those that derive all of their income from wages, pensions, interest, dividends, and capital gains. This taxpayer group was selected for the initial phase because it accounts for a large share of IRS' overall compliance burden and because its burden may be the easiest to estimate. The conceptual definition of compliance burden developed for this group, along with the theoretical framework for

measuring that burden, are intended to build a foundation for developing burden estimates for other taxpayer groups.

In subsequent phases, estimation methodologies are to be developed for other segments of the taxpayer population, such as small businesses and self-employed taxpayers and large and medium-sized businesses. The timing of these later phases will depend on resource availability and the accumulation of experience. IRS expects to contract out later this year for a study that would develop a methodology for estimating the time and money that self-employed individuals spend preparing and filing their federal income tax returns. The agency also expects to begin work on employment taxes later this year and on small corporate taxpayer burden in calendar year 2001.

New Estimation Models for W&I Taxpayers Are in Development

IRS has begun to implement its strategy by contracting for the development of two models that, when combined, are to estimate W&I taxpayers' prefiling, filing, and postfiling compliance burdens. Compared with IRS' current methodology, these models are designed to produce more comprehensive estimates of federal income tax compliance burdens and to provide IRS with a greater capacity to analyze the impact of tax law and administrative changes on those burdens. As with all such modeling, the specific capabilities and precision of the new models will depend on the quality of the underlying data.

IRS' Contractor Has Begun Developing Two Models

PricewaterhouseCoopers, the contractor engaged to assist IRS in the initial phase of its strategy, has begun to develop two models covering W&I taxpayers—one for estimating the prefiling and filing burdens, the other for estimating the postfiling burdens of those taxpayers. This work began in September 1998. The model for estimating prefiling and filing burdens is expected to be delivered to IRS in May 2001. The postfiling burden model also is expected to be designed by then, but the operational model is to be delivered at a later date. Before delivering either model, PwC is to provide IRS with paperwork burden estimates for this taxpayer group, using the new methodology, for the agency's Information Collection Budget due in December 2000. The cumulative cost of this initial effort is expected to reach approximately $5 million by the end of fiscal year 2001. Expenditures for later years have not yet been determined.

The New Models Are Intended to Produce More Comprehensive Estimates of Burden

The two models are intended to produce more comprehensive estimates of burden by including all of the time costs covered by the ADL model, plus time spent on tax planning and postfiling activities. They are also to estimate the monetary expenditures associated with federal income tax compliance, such as the purchase of books and software, which are not covered by the ADL model.[8]

PwC said it used focus groups of taxpayers and tax preparers to identify a lengthy list of activities and costs involved in the prefiling and filing stages of the tax compliance process. It has grouped these activities and costs into six broad categories: recordkeeping, gathering tax materials, using IRS services, tax planning, form completion, and form submission. The initial plan for the postfiling burden model is also to group activities and burdens into six categories: recordkeeping and retrieval, gathering tax materials, using IRS services, form completion and form submission, using a paid professional, and interviewing.[9]

The definition of compliance burden for both models excludes any activities or costs associated with

- the basic financial planning and recordkeeping that individuals might do even if there were no income tax,
- requirements imposed by federal taxes other than the income tax,
- requirements imposed by state or local taxes,
- criminal tax investigations, and
- Tax Court proceedings.

According to PwC, its models will not distinguish between "required" and "voluntary" compliance activities because there is no clear benchmark of "required" activities against which to measure "voluntary" tax minimizing activities. PwC noted that, although the expenditure of time and money spent on tax minimizing activities, such as itemizing deductions, is voluntary,[10] some taxpayers would incur the cost of higher taxes if they did not make those expenditures.

[8]Neither of the new models is to estimate the costs of employers, banks, and other third parties that are required to provide information returns to individual taxpayers. Those costs are to be included when the total tax compliance costs of those entities are estimated at a later date.

[9]Even though some of the category names are the same for the two models, the activities covered by the two models do not overlap. For the postfiling model, e.g., "form completion and submission" covers only submissions that may have to be made after the initial filing of the taxpayer's return.

[10]Taxpayers have the option of claiming the standard deduction, which is less burdensome than itemizing.

The New Models Are Also Intended to Provide IRS With Increased Analytical Capabilities

The two new estimation models are intended to provide IRS with increased capabilities to analyze burden, disaggregated by type of taxpayer activity. In addition, the prefiling/filing burden model, which is further along in development, is intended to enable IRS to analyze the effects of changes in tax laws, IRS programs and services, and other important determinants of burden.

PwC determined that, to meet IRS' analytical requirements, its prefiling/filing burden model would have to take into account the influences of many significant determinants of burden that the ADL model ignores. PwC said it relied on its focus groups of taxpayers and interviews with tax preparers to identify important determinants of burden and to gain a better understanding of the complex relationships between these determinants and burden. The insights obtained through the focus groups and interviews have guided PwC's model design, data gathering, and model construction efforts.

PwC conceives the tax compliance process as a series of decisions made by taxpayers that result in a variety of activities, each of which imposes some burden. For example, a taxpayer incurs additional recordkeeping and reporting burdens if he or she chooses to itemize deductions from income, rather than claim the standard deduction. These taxpayer decisions and activities are influenced by such factors as tax system characteristics (e.g., specific recordkeeping and reporting requirements), demographic characteristics (e.g., age, income, and tax-filing experience of individual taxpayers), and others (e.g., tax preparation and filing technologies).

One important insight from the focus groups was that, in most cases, the activities a taxpayer engages in change little from year to year. Another important insight was that the most significant changes in compliance activities are due to life changes (e.g., marriage or birth of dependents), changes in financial situation (e.g., the purchase of a house), and changes in the tax code. According to PwC, changes in these factors have particularly significant effects on compliance burden when they lead taxpayers to change their basic approach to tax preparation. This is due to the fact that the types of activities taxpayers engage in vary significantly, depending on whether they prepare their return by hand, use tax preparation computer software, or hire a professional to prepare their tax return. PwC also determined that the more experience taxpayers gain in filling out returns, the less of a burden it becomes. PwC expects that models that account for these determinants of burden will provide IRS with analytical capabilities it does not possess now.

Realizing the Increased Capabilities Depends on Complicated Data Collection and Analysis

There are three phases in the construction and operation of the prefiling/filing burden model, all of which must be successfully completed for IRS to realize the increased analytical capabilities it is seeking. First, data must be collected that describe taxpayer characteristics, decisions, activities, and burdens. Second, statistical techniques must be used to estimate the relationships between key outcomes, such as taxpayer decisions and compliance burden levels, and their determinants. Finally, the estimated relationships must be applied to data from a representative sample of taxpayers in order to simulate taxpayer decisions and the resulting level of burden.

Data Collection Will Be Challenging

PwC intends to meet many of its data requirements by relying upon existing IRS administrative and research data files. It also hopes to make use of demographic and personal finance data that the Census Bureau and other government agencies collect from samples of households. However, PwC and IRS have decided that they need to survey a representative sample of taxpayers in order to collect information on the compliance burdens those taxpayers incur. Each telephone interview is expected to cover up to 92 questions and last approximately 20 minutes, depending on the characteristics of the respondent. Data from this survey are to be directly merged with data from IRS' computer files for these same taxpayers. In addition, statistical imputation techniques[11] are to be used to supplement the data record for each taxpayer with information that is not available from IRS files (such as information on the taxpayer's educational background and spending behavior).

The data collection and analysis tasks that PwC must accomplish are ambitious for several reasons. First, the taxpayers surveyed by PwC will be relying on their memories to estimate the amounts of time and money they spent preparing their 1999 tax returns. Second, for each of these taxpayers, PwC will have to be able to collect or impute accurate data on the numerous determinants of their compliance burdens, including the specific tax rules that apply to them. Third, PwC will have to estimate statistical equations that accurately isolate the individual effect that specific tax rules have on the compliance burdens of specific types of W&I taxpayers. While the data collection and analysis tasks are ambitious, PwC believes that the

[11]Imputation techniques are commonly used to combine data from separate sources when it is not possible to use a common identifier, such as a Social Security Number, to ensure that the data being linked from each source pertain to the same individual. One could use, e.g., detailed data from a survey to estimate a regression equation showing the relationship between variables, such as income and area of residence on the one hand, and level of education on the other. With the estimate of this relationship, one could then "impute" the level of education of individuals represented in a different database, as long as the second database contained data on income and area of residence.

available data will enable it to estimate equations that improve upon IRS' current methodology.

The data most critical to the modeling effort—those relating to the time and money that taxpayers spend complying with tax rules—are subject to measurement error of an unknown degree. The accuracy of the burden data that PwC collects in its survey will depend, in part, on each respondent's ability to understand the definition of burden used in the model. PwC recognizes that there are limits to the amount of guidance it can provide to respondents during a survey.[12] For example, it does not intend to provide guidance on how to separate the travel time attributable to purchasing tax software from the time attributable to other errands completed during a multipurpose shopping trip. Individual respondents will decide for themselves whether all, or only a portion, of the time spent on the trip should be considered a burden.

The accuracy of the burden data that PwC collects will also be limited by recall bias on the part of respondents. The focus groups that PwC conducted reconfirmed findings from earlier focus groups conducted by ADL that taxpayers are not able to recall the amount of time they spent on tax compliance very accurately. ADL provided further evidence of this problem when it used two different methods to collect burden estimates from taxpayers—a mail survey and a diary study (in which taxpayers kept logs of their activities as they prepared their returns). On average, compliance time estimates made by respondents to ADL's mail survey were 78 percent greater than the estimates made by participants in its diary study (see app. I). PwC recommended a telephone survey for collecting its burden data because that approach usually yields a higher response rate than a mail survey and allows interviewers to clarify questions. However, PwC acknowledges that telephone surveys do not permit taxpayers to consult documents when responding and that respondents' recall may not be as accurate as in a diary study.[13]

The accuracy of the model's underlying data for several important determinants of burden, such as taxpayers' education level and experience in completing returns, will depend on the precision of PwC's imputation techniques. Although PwC intends to collect information on some of these

[12]PwC has drafted a questionnaire to be used in a telephone and mail survey of taxpayers. Appendix II summarizes the instructions from that questionnaire.

[13]PwC intends to send an advance letter to respondents, telling them the general nature of the questions they will be asked. PwC also intends to mail a written version of the questionnaire to taxpayers for whom they cannot find telephone numbers.

determinants in its taxpayer survey, it will have to impute values for them in the model's production file that is to be updated each year.

IRS and PwC recognize the limitations of the data on burden and its determinants that will be used in the model. They have concluded that their plans represent a cost-effective approach for collecting the data needed to improve IRS' burden estimation methodology.

Numerous Equations Describing Taxpayers' Decisions and Burden Must Be Estimated

Once this initial database is constructed, PwC plans to use statistical techniques to estimate equations that describe the important relationships needed for making simulations. One set of equations is to show how the decisions that each taxpayer makes during the tax compliance process are related to specific factors, such as that taxpayer's age and education, the particular forms that the taxpayer must complete, and the costs of alternative preparation methods. Another set of equations is to show how the amount of burden that a taxpayer bears is related to specific characteristics of that taxpayer and the particular compliance requirements that the taxpayer faces. These relationships are to be estimated separately for each of the six categories of burden (recordkeeping, form completion, etc.).

If the estimation efforts are successful, the relationships described in both sets of equations should enable IRS to regularly update its model using data on taxpayer characteristics that it already collects every year (or that can be imputed from other available sources). IRS should not need to collect new data on burden for each update of this "production" data file.[14]

To estimate the aggregate prefiling and filing compliance burden for tax years after 1999, IRS will need to update the model's data file to reflect changes in the taxpayer population and enter information about any tax law changes made since 1999. The model is to then process this information in several stages. First, it is to simulate the effect that the law changes have on the compliance requirements faced by each taxpayer represented in the data file. Second, the model is to simulate taxpayer decisions to determine if the changes in the tax laws, or changes in taxpayers' circumstances from one year to the next, would cause any of

[14]The core of the production data file is to consist of detailed data that IRS' Statistics of Income Division collects annually from a large sample of individual tax returns.

the taxpayers to change their preparation or submission methods.[15] Finally, the model is to take this updated information on tax requirements and compliance methods for each taxpayer and, by applying the relationships from the previously estimated equations, estimate the time and money that each taxpayer spent on each of the six categories of burden activities.[16]

The Prefiling/Filing Burden Model, by Itself, Will Not Provide Everything IRS Was Seeking

While IRS expects the new prefiling/filing burden model to improve its burden estimation capabilities, the model, by itself, will not provide all of the capabilities that IRS was originally seeking. It will not disaggregate burden by specific IRS function (e.g., submission processing and customer service), nor will it disaggregate burden by origin of compliance requirement (tax law vs. administrative procedure). The model is supposed to be able to accommodate these capabilities at a future date, but it will be up to IRS to determine how these disaggregations would be done.

In addition, PwC is not expected to statistically estimate the effect that each and every tax rule has on the average burdens of W&I taxpayers. However, even in cases where PwC has not statistically estimated the average burden of a particular tax rule, the model may be able to identify how many and what types of W&I taxpayers are affected by the rule. IRS could then use some independent method, such as a targeted research project, to estimate the change in the average amount of burden that a specific change in the tax rule would cause. By combining this estimate with the information on the number of taxpayers affected, IRS would be able to estimate the aggregate burden change that would result from the tax rule change. At this time, PwC does not know for how many, or which, tax rules it will be able to make specific statistical estimates.

[15]Although the model is to simulate changes in compliance-related behavior, as currently designed, it would not, by itself, simulate other types of behavioral changes that affect aggregate burden. For example, it would not simulate how an increase in documentation requirements for charitable contributions would affect the number of taxpayers who claim deductions for such contributions. The model, however, is to allow users to make "off-model" estimates of those behavioral changes and then adjust the data in the model to capture the effects of such changes.

[16]If appropriate data become available, the model would have the capability to translate time spent by taxpayers into a monetary cost. The methodology for monetizing taxpayer time is to be based on forthcoming guidance from OMB. A PwC subcontractor has drafted a "white paper" on monetizing compliance burden that summarizes existing research and identifies best practices. OMB is to review that paper before developing its guidance. OMB has also solicited input to its guidance from the broader public.

Fundamental Decisions on the Design of the Postfiling Model Remain to Be Made

The primary functional requirements of the postfiling burden model are the ability to

- estimate the change in burden due to changing factors, such as the number of audits IRS undertakes;
- disaggregate burden estimates by postfiling segment[17] and by taxpayer activity; and
- link to the prefiling/filing burden model.

Fundamental decisions remain to be made regarding the operational design of the postfiling model. A report that presents PwC's broad conceptual design for the model notes that PwC and IRS need to agree on specific interpretations of the general requirements that were set by the contract's scope of work. The report also indicates that the ultimate functionality of the model may be constrained by the limitations of IRS' data systems. For example, IRS has no database that tracks the activities of individual taxpayers throughout the entire postfiling process. This may prevent the model from determining if the burdens that taxpayers experience in one segment of the postfiling process are influenced by their experiences in a preceding segment.

The New Models Could Assist IRS in Estimating the Burdens Associated With Some Aspects of Complex Tax Rules

The prefiling/filing burden model may assist IRS in estimating burdens associated with some aspects of the complex rules identified in IRS' forthcoming report on tax complexity. That report will devote detailed attention to three areas of concern for W&I taxpayers: the Alternative Minimum Tax for individuals, the variety of definitions that taxpayers must learn in order to determine filing status and eligibility to claim dependents and credits, and the estimated tax rules.[18] The data that the contractor plans to collect for the prefiling/filing burden model will provide it with the opportunity to directly estimate the burdens associated with some, but not all, aspects of those complex rules. IRS has not yet decided whether the postfiling model should have any ability to estimate burdens associated with specific tax rules.

The current list of variables that PwC intends to incorporate in its statistical equations includes many that relate to the complex tax rules

[17] PwC proposes to divide the postfiling process into five segments: clarification (relating to IRS requests for further information), collection, audit, appeals, and amendment (relating to the filing of amended returns).

[18] IRS selected these three areas after reviewing over 40 reports and testimonies published since 1989 and meeting with both internal and external stakeholders interested in tax complexity/simplification.

covered in the Commissioner's report. Among these are variables that indicate[19]

- whether taxpayers spent any time dealing with the AMT form, even if they ultimately did not have to submit it;
- whether taxpayers who did file the AMT form filled in selected lines on that form;
- which filing status, dependents, and credits taxpayers actually claimed; and
- whether taxpayers paid estimated taxes and estimated tax penalties.

The availability of data for these variables may enable PwC to make estimates, such as the average amount of time that the existence of the AMT adds to the total compliance time of different groups of W&I taxpayers. In those cases where PwC is able to estimate average burden effects, the model should be able to use that information, along with information on the number of taxpayers affected by the tax rules in question, to estimate the aggregate burdens attributable to those rule. However, as previously noted, PwC is not expected to directly estimate the average burden effect of every aspect of these complex tax rules. For some rules, IRS expects that the model will only be able to show the number of taxpayers affected.

Agency Comments and Our Evaluation

We received written comments from the Commissioner of IRS in a letter dated May 3, 2000. In his letter, the Commissioner agreed with the contents of our report and emphasized two points that we had mentioned: (1) in contrast to the ADL model, the new model will incorporate tax preparation method as a key determinant of burden, and (2) IRS expects to be able to keep the new model up to date without unduly burdening itself or taxpayers.

In addition to the written comments, IRS provided technical comments on the report, which we incorporated where appropriate. The Commissioner's letter is reproduced in appendix III.

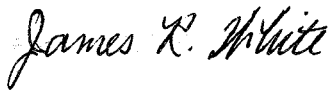
As agreed with your office, unless you announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. We will then send copies to Senator William V. Roth, Jr., Chairman, and Senator Daniel P. Moynihan, Ranking Minority Member, Senate Committee on Finance; Senator John F. Kerry, Ranking Minority Member,

[19]PwC notes that its list of variables is "dynamic" and that some will be dropped and new ones added as the development of the model proceeds.

Committee on Small Business; Representative Bill Archer, Chairman, and Representative Charles B. Rangel, Ranking Minority Member, House Committee on Ways and Means; the Honorable Lawrence H. Summers, Secretary of the Treasury; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will also make copies available to others on request.

Please contact me or James A. Wozny at (202) 512-9110 if you have any questions. Marvin G. McGill and Margarita Vallazza made key contributions to this report.

Sincerely yours,



James R. White
Director, Tax Policy and
Administration Issues

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Abbreviations

ADL	Arthur D. Little, Inc.
AMT	Alternative Minimum Tax
GPRA	Government Performance and Results Act of 1993
IRS	Internal Revenue Service
OMB	Office of Management and Budget
PwC	PricewaterhouseCoopers
W&I	Wage and investment income

Limitations of the Arthur D. Little Model

IRS and Other Reviewers Have Identified a Number of Limitations

To measure the paperwork dimension of compliance burden, IRS sponsored a study in 1984 that has been the basis of its burden estimation methodology since that time. Arthur D. Little, Inc. (ADL), an IRS contractor, released the results of the paperwork burden study in 1988. Since then, IRS and other reviewers of ADL's paperwork burden estimation model have criticized it for number of reasons.[1] The reported limitations of the model and its estimates can be categorized into four areas: (1) the age of the underlying survey data, (2) the exclusion of certain components of burden, (3) the model's simplistic treatment of the determinants of burden, and (4) the questionable statistical validity and poor documentation of the estimates.

Underlying Data Are Outdated

Several reviewers of the ADL model, including IRS, have criticized the age of the burden model's survey data. They have observed that the survey data reflect 1983 information and lack relevance to today's tax environment because of the many significant changes in tax law and tax preparation technologies that have taken place since then.

Reviewers have also expressed concern over the accuracy of the burden estimates taxpayers provided when they were surveyed. To obtain the information about burden, ADL used two collection methods—a mail and a diary study. The burden estimates yielded by the two methods varied significantly. On average, diary respondents' estimated burden, by return, was 8.32 hours, while mail survey respondents' estimated burden was 14.82 hours—78 percent higher. ADL could not determine which estimate was more accurate, so it decided to use the average of the two estimates.[2]

Certain Components of Burden Are Excluded

Past reviewers have noted that the definition of burden used in the ADL model excludes important components of burden. The ADL model does includes the time costs (burden hours) imposed by information collections but excludes costs associated with tax planning and postfiling activities, such as preparing for an audit. It also excludes most monetary expenses. For example, paid preparer fees are converted into an equivalent time

[1] IRS, "Report of the Taxpayer Burden Study Group: Roadmap for a New Measure and Pilot Study for Individual Non-Business Taxpayers," Request for Proposal (Aug. 19, 1998); Henry Beale, Report on Arthur D. Little Taxpayer Compliance Burden Model, untitled draft report submitted to the Analysis and Studies Division, IRS (1996); Marsha Blumenthal, Burden Reduction Research and Analysis, Report submitted to the Analysis and Studies Division, IRS (May 1996); PricewaterhouseCoopers, Compliance Burden Literature Review, draft report submitted to IRS (June 16, 1999).

[2] ADL made this correction by multiplying the burden estimates that would have been obtained if it had relied exclusively on the mail survey results by 0.78. The corrected estimate equals the average of the two estimates that would have been obtained by using the diary results and the mail survey results separately.

amount, but expenditures on books, software, and delivery services are excluded.

The Determinants of Burden Are Simplistically Incorporated

The ADL model has been criticized for the simplistic nature of the equations it uses to represent the relationship between burden and its determinants. In its report, ADL acknowledged the simplicity of its equations but explained that IRS decided it would be operationally infeasible to use more detailed and precise models.

One past reviewer noted that the only determinants of burden used in the final model were measures of return size (numbers of forms and attachments), form size (number of words or number of line items), the number of references to the tax code in forms and instructions, and the number of line items requiring records.[3] As a consequence, many important determinants were omitted from the model. For example, the model does not allow for alternative filing methods, such as electronic filing software programs, and it also does not differentiate levels of burden between simple and complex types of forms. The model does not differentiate burden between simple and complex line items on a form, and it does not separate burden within the form and identify parts of the form that represent the greatest burden. In some cases the model erroneously estimates the impact of efforts to simplify forms, instructions, or procedures. For instance, if new lines are added to a form's worksheet to simplify computations, the ADL model reports an increase in burden.

The Statistical Validity of the Model Has Been Questioned

Reviewers have also called into question the statistical validity of the model. IRS indicates that errors were made in the sample weighting techniques. In addition, the model's methodology was poorly documented. IRS noted that the ADL burden estimates are inconsistent because they yield results that assign unrealistically high levels of burden to certain forms (e.g., Form 4789, Currency Transaction Report, and Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business). At the same time, IRS noted that the ADL burden estimates for many other forms did not include the amount of time taken to mail them, even though those forms had to be mailed to IRS. Researchers have also questioned the validity of the business burden estimates because the ADL model yields an estimate of burden greater than that found in the survey data on which the model is based.

[3]Beale, Report on Arthur D. Little Taxpayer Compliance Burden Model.

Details on the Definition of Burden to Be Used in the PwC Survey

Draft Questionnaire on Prefiling/Filing Burden

PwC has drafted the questionnaire that it plans to use to gather information on prefiling and filing from a sample of wage and investment taxpayers. This appendix summarizes the parts of the questionnaire that instruct respondents on the types of costs to include in their estimates of compliance burden and ask respondents to estimate the specific components of their burden. The full draft questionnaire includes over 90 questions. In addition to the questions listed below, the questionnaire asks respondents for selective demographic information that is not available from IRS files and information on tax preparation practices. Additional questions are designed, in part, to prompt respondents' memories about other activities that they may have undertaken in preparing their tax returns.[1]

Recordkeeping

The recordkeeping category includes maintaining documents needed as proof of income or expenses for federal income tax purposes. Relevant documents include receipts, W-2 forms, and 1099 statements of interest or dividends. Time and money spent balancing checkbooks, paying bills, or keeping records for state or local tax purposes are not to be included. The draft questions include the following:

- How much time did you personally spend on recordkeeping activities related to your 1999 federal income tax return? Include
  - Time spent retrieving and organizing your records in preparation for completing your return.
  - All the time spent on activities you did related to your federal income tax return even if you also needed the information for other purposes.
- How much time, if any, did your spouse, relatives, or friends spend in assisting you with these recordkeeping activities?
- How much money, if any, did you spend on these recordkeeping activities? Include
  - Expenses such as overnight delivery fees, appraisal costs, and faxing or copying fees.

  Do not include

- The cost of any accounting software, such as Quicken, unless you use it only for federal income tax record keeping purposes.
- Any costs associated with helping someone else.

[1]Examples of such questions are: "Did you maintain any documentation related to the household employee tax?" and "Did you attend any classes, seminars, or workshops primarily to complete your tax return last year?"

Gathering Tax Materials	The gathering tax materials category covers time and money spent gathering materials needed to complete the taxpayer's federal income tax return or for tax planning purposes. These materials may include any tax forms, tax-related publications, books, or guides collected from IRS or other sources and tax preparation software or 1999 upgrade. Some of the draft questions are the following: • How much time did you spend gathering the materials we just discussed? • How much time, if any, did your spouse, relatives, or friends spend in gathering your materials? • How much money, if any, did you spend obtaining the materials we just discussed?
Using IRS Services	The using IRS services category covers the time and money spent using services, such as the Toll-Free Tax Assistance telephone line, Walk-in Customer Assistance site, Volunteer Income Tax Assistance site, Tax Counseling for the Elderly, IRS Web site, or Tele-Tax Telephone line. Some questions for taxpayers include the following: • In total, how much time did you spend using these IRS services, including the time reaching an assistor, being put on hold, waiting, and using these services? • How much time, if any, did your spouse, relatives, or friends spend using these IRS services related to your return, including the time reaching an assistor, being put on hold, waiting, and using these services? • Of the [time amount], how much time was spent actually using the service after waiting to see someone or holding on the telephone? • How much money, if any, did you spend, using these IRS services?
Paid Professionals	The paid professional category covers time and money spent by taxpayers when consulting with professionals for tax planning purposes or to prepare and complete their tax returns, including the time spent finding and selecting the professional. It does not include time spent obtaining general investment advice that was not directly related to the taxpayer's federal income tax; nor does it include costs for consulting on someone else's behalf. The category includes the professionals' fees for consultation and services, such as overnight delivery fees, appraisal costs, and faxing and copying. Some draft and survey questions are the following: • How much time did you spend consulting with paid professionals? • How much time, if any, did your spouse, relatives, or friends spend consulting with paid professionals about your federal income taxes? • How much did you pay the professionals with whom you consulted?

- Was any of the [dollar amount] paid in order to file your return electronically?
- How much did you spend to file your return electronically?
- Was any of the [dollar amount] paid in order to receive an accelerated or instant refund?
- How much did you spend to get an accelerated refund?
- Was any of the [dollar amount] paid in order to complete your state or local tax return?
- How much did you spend to get the state or local tax return completed?

Tax Planning

The tax planning category covers the time and money spent considering the federal income tax implications of activities, such as contributing to an Individual Retirement Account, including withdrawals and distributions; participating in a 401(k) plan or other employer-sponsored retirement plan; taking advantage of tax-exempt or tax-preferred investments; realizing capital gains or capital losses on any investments; exercising stock options; and planning charitable contributions. A few of the draft questions are the following:

- How much time did you spend on federal income tax planning activities?
- How much time (in hours or minutes), if any, did your spouse, relatives, or friends spend in activities related to federal income tax planning for your federal income taxes?
- How much money, if any, did you spend on these activities, including the cost of classes, seminars, or workshops attended for tax planning purposes? Do not include the costs of a paid professional or costs related to tax planning for someone else.

Form Completion

The form completion category covers the time and money spent completing forms, whether they were submitted or not; consulting instructions, publications, or other materials while filling out forms; or completing your federal income tax and related returns. It also includes the time reviewing and checking the returns no matter how they were prepared and completing nonreturn forms such as the W-4 and 1040ES. The category may also include the time spent filing for an extension or installing or updating tax preparation software.

The form completion category does not include time submitting the returns; preparing state, local, or someone else's tax returns; or recordkeeping. It also does not include the costs of a paid professional or costs related to completing someone else's return. Draft questions include the following:

	• How much time did you spend completing your 1999 federal income tax return? • How much time if any, did your spouse, relatives, or friends spend completing your 1999 federal income tax return? • How much time did you spend on forms or worksheets that you did not submit? • How much money, if any, did you spend to complete your 1999 federal income tax return?
Form Submission	The form submission category may include photocopying and mailing charges and cost of electronic filing, including service fees. Draft questions include the following: • How long did it take you, your spouse, relatives, or friends to submit your return [and complete the form 8453], including the time spent photocopying and assembling your return? • How much money did you spend to submit your return?

Appendix III

Comments From the Internal Revenue Service

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

May 3, 2000

Mr. James White
U.S. General Accounting Office
Room 1T47
441 G Street, NW
Washington, DC 20548

Dear Mr. White:

Thank you for the opportunity to comment on the General Accounting Office's (GAO) draft report on the status of the Internal Revenue Service (IRS) efforts to improve its estimates of taxpayer compliance burden. We agree with the information in the report and are pleased that GAO shares our view that better estimates of taxpayer burden are important to both the Congress and the IRS.

There are two points discussed briefly in the report that I would like to further emphasize: the new burden estimation model's ability to differentiate taxpayer burden by how the return is prepared and our intent to improve the model and the data supporting it over time. In addition, we have provided a few technical comments directly to your staff.

First, the burden estimation methodology the IRS currently uses does not consider how the return is prepared in calculating burden. This is a problem because taxpayers are increasingly using tax preparation software and paid preparers, the costs of which are not included in the current model. The method of preparing the return affects not only total taxpayer burden but also how the burden is split between time and dollar costs. Consequently, one of the key variables in the new model is how the return is prepared.

Second, as we develop the new model it must be capable of making estimates in the future without needing to completely redo the data supporting the model. A more complete model will help us manage costs of updating the model and reduce the burden placed on taxpayers from our data collection efforts. For certain specific issues and activities, such as the Alternative Minimum Tax or tax

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planning, we will conduct targeted burden studies to enhance our understanding of where and how burden is generated and to support burden reduction efforts.

I look forward to working with you in the future on this important effort.

Sincerely,

Charles O. Rossotti

Chairman BOND. Thank you very much, Ms. Ashby.

Recognizing that most small businesses use tax preparers and that there seems to be a reluctance on the part of small business to go to the IRS for help, what do you think the IRS' role should be in providing help to small-business taxpayers?

Ms. ASHBY. We think, and the IRS in its plans seems to recognize this, that one avenue to help small businesses is to go to tax preparers, to use them as a resource, by first of all making sure the tax preparers understand what the requirements are and using them and partnering with them in getting the word to small-business owners and managers.

Chairman BOND. I can see some happy tax preparers. I know they will be glad for that.

To what extent are there small businesses these days who still try to do it on their own, and do not use tax preparers?

Ms. ASHBY. I will let my colleague, Mr. Boyer, who is more familiar with the results of our survey, answer, but overwhelmingly I think we found that most small businesses do use tax preparers.

Mr. BOYER. Yes, sir. Based on our survey results, we found that 94 percent of small businesses use tax preparers of one sort or another. That does lead, as Ms. Ashby said, to a great challenge of communicating or providing up-front input for the taxpayers, when so many of them go through tax preparers.

Chairman BOND. I would say that 6 percent is either very brave and very well-informed, or brave and . . . anyhow.

Ms. ASHBY. I wanted to make the point that while there is a higher-percentage usage of tax preparers to prepare tax returns, small businesses really need advice at other times during the year. They lack the availability of continual resources as they are planning their activities to put themselves in the best position tax-wise, and as they are doing the things they need to do during the course of a year to be prepared for that year-end filing. That is where small businesses have difficulty.

Chairman BOND. Your testimony mentions several challenges facing the IRS as it implements its new operating division. Which of these challenges do you think will be most difficult to overcome? And how do you see them dealing with those challenges?

Ms. ASHBY. I think the most difficult challenge will be the computer systems.

Chairman BOND. Getting back to the technology side of it.

Ms. ASHBY. Yes, as the Commissioner explained to us. He is right, the IRS cannot wait until those systems are sufficiently improved in order to do something. The IRS has to operate with what it currently has.

But the difficulties involve, for one thing, identifying who small businesses are in order to be able to look at their characteristics and assess their needs. Right now, with the two master files, the individual master file and the business master file, some small businesses are in one, some are in another. They are intermingled with other types of taxpayers. So that, in and of itself, provides difficulty in terms of doing some of the things that the IRS would like to do in the future.

And then, as the Commissioner stated, the problem with delays in posting transactions, and inaccuracies in the records themselves

are a problem throughout the IRS and for anything it encounters or anything it tries to do.

Chairman BOND. That is very helpful to know. I do not happen to serve on the Treasury Postal Subcommittee anymore, but we will be communicating to Chairman Campbell the information that both you and the Commissioner provided us.

A final question, sort of a broader goal, what do you see, in addition to the computer issue, as being the principal risk to the success of the IRS efforts to develop the improved burden estimation models? Is there anything that they could be doing that they are not, that could minimize those risks?

Ms. ASHBY. I am going to let Mr. Wozny answer that, and I will just say, as I mentioned in my short statement and as we state further in our longer official statement, the underlying data that is the basis for the statistical equations that are used in the model are the most problematic. But I will let Mr. Wozny say more.

Mr. WOZNY. Right, and the most difficult data to come by are the information on the burden itself. The IRS, and its contractor, have decided to try to obtain that data through a survey. Past efforts have indicated that taxpayers have limited ability to recall the burdens very precisely.

But the contractor is expert in conducting mail surveys and they will be trying to increase the response rate and to provide guidance to taxpayers in order to prompt their memory on the burdens.

Chairman BOND. I would have to say they probably have the fisherman's veracity problem, because that 12-inch bass that you release today is 16 inches long by tomorrow. And next week you are telling everybody how you threw a 20-inch bass back. So I can imagine that there are some difficulties in concluding that.

As I said earlier, we will keep the record open. We may have some further questions, and I invite my fellow Committee members and their staffs to submit their questions for the record by the end of this week. We thank you very much for your good work. As always, the General Accounting Office is most helpful to us in obtaining an independent review in order to confirm or amplify the information that we have received.

Ms. Ashby, Mr. Wozny, Mr. Boyer, thank you very much for being with us today.

Ms. ASHBY. Thank you, Mr. Chairman.

Chairman BOND. Now, Ms. Abalos, can you hear me?

Ms. ABALOS. Yes, I can. Can you hear me?

Chairman BOND. Yes, the wonders of modern technology come through, and we are very pleased that you can be with us today. We also will have, at the table, Mr. Roy Quick. We thank you both very much for joining us today, for taking the time to come and be with us through the means of modern technology.

As I indicated before, we will invite Ms. Abalos to summarize her testimony, and we will include the full written testimony in the record. Ms. Abalos, we invite you to make your comments.

STATEMENT OF SANDRA A. ABALOS, CPA, PRESIDENT, ABALOS & ASSOCIATES, P.C., PHOENIX, ARIZONA

Ms. ABALOS. Thank you so much for providing the opportunity to give testimony via the teleconference. I did not hear the opening remarks, but the sound seems to be fine now.

Taxation and all the issues surrounding tax compliance is one of the difficult aspects of running a small business. Compliance becomes not an issue of intent, but it becomes an issue of education, awareness and resources.

Historically, the relationship between the Internal Revenue Service and the small business community could be likened to "swimming with the sharks". This fear factor approach, however, fosters an "us against them" mentality that has produced really less than desirable results.

I have reviewed the mission and organizational structure of the Small Business/Self-Employed Operating Division of the IRS and I must say that I am very encouraged by the concentrated customer service focus of the SB/SE Operating Division. I think the IRS is to be commended for their efforts in identifying the distinct market segments of the taxpaying community and then developing an organizational structure that will provide meaningful customer service and support.

I am particularly interested in the organizational segment named, Taxpayer Education and Communication Organization, the TEC. This is described as a "customer-focused organization that routinely solicits information concerning the needs and characteristics of its customers and implements programs based on the information received." Within the TEC structure is the TEC Partnership Management arm that will interface with certain user groups. The TEC Partnership Management will proactively partner with Government agencies, small business organizations, practitioner groups, and other professional and volunteer organizations.

The ETAAC, Electronic Tax Administration Advisory Committee, prepares an annual report to Congress, which is forthcoming. It is due at the end of June. In considering a strategy to increasing electronic filing participation within the business community, we included "Community Alliance Initiatives" within the report.

I happened to author this section of the ETAAC report and I included it in full in my written testimony. The report describes a formal working relationship between the IRS and the respective user groups very similar to what is envisioned in the TEC partnership management initiative.

I had envisioned this working relationship between the small business community and the IRS before really reviewing the express directives of the IRS SB/SE Operating Division. Thus, I was really excited to see this concept in the structure.

The community alliance initiatives of the ETAAC report reads in part:

The electronic filing goals established by Congress require considerable participation from a broad spectrum of taxpayers and tax practitioners. The simple wage and interest type of returns account for the majority of electronically filed returns to date. The future growth and success of electronic filing will largely depend on the increased participation of the tax preparer community and the sanction of the small business community.

The tax preparer community is extremely diverse in tax practice procedures and in client profiles. For some preparers, electronic filing provides efficiencies and incentives. For other preparers, electronic filing presents a burden. There are tremendous opportunities for tax preparer associations to provide constructive input, opinion, and direction into electronic filing process and procedures as they specifically relate to divergent preparer practices and taxpayer profiles.

The small business community, on the other hand, is very sensitive to the change, complexity and cost. A seemingly simple initiative will emerge as a compliance nightmare within the small business community. The advance input and endorsement of the small business community will ensure a successful program.

When I am sitting in the ETAAC meetings, just as an example, one of the Committee members said, "Gosh, the small business community had a cow with EFTPS. We do not get it." Well, had I been on the Committee at that time, I could have told you exactly what the cow was going to be about and perhaps prevented some of that from happening.

The TEC Partnership Management Division is the vehicle to produce such results. The IRS needs to identify and resolve the barriers to electronic filing during the process development phase, rather than reacting to an outcry after the program rolls out.

In our ETAAC meeting of March 1, 2000 we heard from Sherill Fields regarding the current State of business e-file. The issues and barriers impeding business e-file, as she presented, are substantial and material. One of the issues was limited research has been conducted on business products and customers. In listening to the well structured presentation on the business e-file program, I could not help but feel like the IRS is building a bad field of dreams. I even said that at the meeting. I told her, you can build it, but they will not come. Electronic filing will be a success if it is embraced voluntarily due to ease of use and appropriate user incentives.

Congress established an e-filing goal of 80 percent by the year 2007. My single request, on behalf of the small business community, is that the electronic filing be successful as a viable option and not be made into another Government mandate.

The IRS SB/SE Operating Division mission statement talks the talk of a new partnership and relationship building with the small business community. Now they need to walk the walk. Because done right, electronic filing will flourish.

I sincerely appreciate the opportunity to testify and I would welcome any questions that you may have.

[The prepared statement of Ms. Abalos follows:]

Testimony of

SANDRA A. ABALOS, CPA

of

ABALOS & ASSOCIATES, P.C.

before the

United States Senate Committee on Small Business

on

IRS Small Business/Self-employed Division

May 23, 2000

The Honorable Christopher S. Bond, Chair
U.S. Senate Committee on Small Business
428A Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Bond and Members of the Committee:

I testify today as a member of the IRS Electronic Tax Administration Advisory Committee on behalf of the small business community. I am a Certified Public Accountant, hold a Masters degree in accounting with an emphasis in taxation, and own a public accounting firm with nine employees. I began my own small business upon graduation from college over 20 years ago. Our practice emphasis and expertise is with small business and small business tax matters.

Taxation and all the issues surrounding tax compliance is one of the most difficult aspects of running a small business. The tax compliance aspect is generally well beyond the comprehension of the small business owner. It is almost inevitable they will unintentionally be out of tax compliance in some manner at some time during their business life. This is a frightening prospect for the Small Business Community. Compliance becomes not an issue of intent, it becomes an issue of education, awareness, and resources. Historically, the relationship between the Internal Revenue Service and the Small Business Community could be likened to "swimming with the sharks".

I have reviewed the mission and organizational structure of the new Small Business/Self-Employed (SB/SE) Operating Division of the IRS. I am very encouraged by the concentrated customer service focus of the SB/SE Operating Division. I am especially pleased with the mission statement, "to effectively meet the needs of the most diverse group of taxpayers and to help them comply; to help them solve their compliance issues, while ensuring overall fairness to all taxpayers." The description of taxpayer characteristics states, "small businesses require specialized service from the IRS, with greater emphasis on working with small businesses and their representatives to educate and develop less burdensome and more practical means of complying." The IRS is to be commended for their efforts in identifying the distinct market segments of the taxpaying community and developing an organizational structure that will provide meaningful customer service and support. The IRS Modernization Initiative is an entirely new approach to doing business, which has the ability to convert the "role of the shark" to a user-friendly dolphin.

With that being said, however, the real work begins. The blueprint has been developed for a new working relationship between the Small Business Community and the Internal Revenue Service. I am particularly interested in the process-based organizational segment named, Taxpayer Education and Communication Organization (TEC). The TEC is described as a "customer-focused organization that routinely solicits information concerning the needs and characteristics of its customers and implements programs based on the information received." Within the TEC structure is a TEC Partnership Management arm that will interface with certain user groups. The TEC Partnership Management will "proactively partner with government agencies, small business organization, practitioner groups and other professional and volunteer organizations. These partnerships will improve our ability to provide: non-traditional sites for serving customers resulting in convenient and comprehensive levels of service, more channels to reach customers, and an audience for us to share ideas, understand our customers and receive feedback on our progress. These partners will be leveraged as an additional resource from which assistance can be provided. In this way, TEC will be able to reach a larger number of taxpayers with a relatively small permanent staff of IRS employees"

This vision for the TEC Partnership Management incorporates a very important component in the continued development and implementation of electronic filing. The ETAAC has identified five critical challenges the IRS must overcome to meet its electronic tax administration objectives and goals. In our forthcoming annual report to Congress, the fifth critical challenge is as follows:

> "Forming strategic alliances with businesses, federal government agencies, states, and other organizations to facilitate and promote the growth of electronic tax administration."

In considering a strategy to increasing electronic filing participation within the business community, the Alliance Subcommittee has included "Community Alliance Initiatives" within the forthcoming annual report to Congress. I authored this section of the ETAAC report and feel it is important to include it in this written testimony to the Senate Committee on Small Business. I envisioned this working relationship between the small business community and the Internal Revenue Service before reviewing the express directives of the IRS SB/SE Operating Division.

7.6 Community Alliance Initiatives

"The electronic filing goals established by Congress require considerable participation from a broad spectrum of taxpayers and tax practitioners. The simple wage and interest type returns account for the majority of electronically filed returns to date. The future growth and success of electronic filing will largely depend on the increased participation of the tax preparer community and the sanction of the small business community.

The tax preparer community is extremely diverse in tax practice procedures and client profile. For some preparers, electronic filing provides efficiencies and incentives. For other preparers, electronic filing presents a burden. There are tremendous opportunities for tax preparer associations to provide constructive input, opinion, and direction into electronic filing process and procedures as they specifically relate to divergent preparer practices and taxpayer profiles.

The small business community, on the other hand, is very sensitive to change, complexity and cost. A seemingly simple initiative will emerge as a compliance nightmare within the small business community. The advance input and endorsement of the small business community will insure a successful program. Furthermore, it will provide public assurance the developments of the business electronic filing capabilities are resources well directed.

The ETAAC recommends the formation of two community alliance coalitions or consortiums for the express purpose of working with the practitioner and small business communities via organized agencies and associations who have a vested interest in electronic filing. IRS appointed directors would organize and facilitate the exchange among a consortium of organizations in an effort to obtain valuable input and develop alliances with the IRS. The small business community consortium should include representatives from organizations such as the National Federation of Independent Business, the National Association of Women Business Owners, the National Association of Self-Employed and National Small Business United. The tax preparer community consortium should include participation from organizations such as the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the National Association of Tax Practitioners, and the National Society of Accountants. In addition, a representative member of ETAAC should participate in each alliance consortium.

The ETAAC envisions the tax preparer and small business community consortiums as being the liaison link between the IRS and the organization participants. Anticipated results of consortium communications include:

- Identify and eliminate the roadblocks associated with electronic filing.
- Implement awards/incentives program to encourage new and continued participation.
- Identify and suggest areas of program improvement and application.
- Coordinate electronic filing initiatives with respective state and local agencies.
- Communicate e-filing initiatives through the consortium organizations.
- Conduct surveys to obtain direct participant feedback regarding e-filing.

The ETAAC believes a community alliance approach to working with the practitioner and business community will go far in advancing electronic filing participation. The participating organizations will applaud such an opportunity for input and direction. Government and community working together will give e-filing strength, momentum, and credibility. Simply being "part of the process" encourages participation and ownership. The endorsement of these organizations will go far in increasing e-filing confidence and participation.

> The consortium directors should be employees of the IRS and will be a critical component in the success of such an initiative. The position requires strong public relations and facilitation skills. The business objectives of this position should be specifically defined and appropriate performance measures incorporated. ETAAC believes the public relations outreach and communicated goodwill via the consortium organizations will produce increased e-filing participation well beyond any public relations campaign communicated directly from the IRS."

It appears the TEC Partnership Management division is the vehicle to produce such results and establish a working relationship between the IRS and the Small Business Community. The IRS needs to identify and resolve the barriers to electronic filing during the process development phase rather than react to an outcry when the program is rolled out. Government is too removed from the day to day workings of the small business community to fully understand the challenges. There is much to be learned from past business programs so that future electronic filing initiatives are with minimum burden and controversy. For instance, the IRS should reflect on and understand the response to mandatory payment of business taxes through the EFTPS program.

In our ETAAC meeting held March 1, 2000 we heard from Sherrill Fields regarding the current state of business e-file. The issues and barriers impeding business e-file as she presented are substantial and material. One of the issues were, "limited research has been conducted on business products and customers." In listening to the well structured presentation on the business e-file program I couldn't help but feel like the IRS is building a "bad field of dreams". You can build it, but they will not come. Electronic filing will be a success if it is embraced voluntarily due to ease of use and appropriate user incentives. Congress established an e-filing goal of 80% by the year 2007. My single request on behalf of the small business community is that electronic filing be successful as a viable option and not be made into another Government mandate. The IRS SB/SE Operating Division mission statement talks the talk of a new partnership and relationship building with the Small Business Community, now they need to walk the walk. Done right, electronic filing will flourish.

I sincerely appreciate the opportunity to testify and welcome any questions you may have.

Respectfully,

Sandra A. Abalos, CPA
ETAAC member

Chairman BOND. Thank you very much, Ms. Abalos.

You already answered the first question I was going to ask, whether the 80 percent should be a goal or a mandate. I have long taken the position that if this electronic filing is the best thing since sliced bread, then we ought to be able to sell it to small business as sliced bread and not make it a mandate.

I will come back to you with questions, but first I want to have the testimony of our other witness, and we will have an opportunity for you to listen to his testimony. If you wish to make any comments on each other's testimony, that always makes it fun.

Now I will turn to our good friend Roy Quick, EA, Principal, Quick Tax and Accounting Service of St. Louis, Missouri. Roy, welcome, glad to have you back

STATEMENT OF ROY M. QUICK, JR., EA, PRINCIPAL, QUICK TAX & ACCOUNTING SERVICE, ST. LOUIS, MISSOURI

Mr. QUICK. Thank you very much, Mr. Chairman.

My name is Roy Quick, I am an enrolled agent and a principal in Quick Tax & Accounting Service, a private, home-based tax and accounting service located in St. Louis County, Missouri. I am also a member of the IRS Commissioner's advisory Council, or IRSAC, since November of last year. I am pleased to present this testimony on the IRS modernization effort.

First of all, let me say that I am very glad to see a change in the way the IRS does business by way of involving "outsiders" in the strategic planning process. A few examples of this are the consulting firm of Booz-Allen & Hamilton, a contractor to the IRS, invited the White House Conference on Small Business tax chairs to review the strategic planning process in the initial phases of the design and modernization.

Commissioner Rossotti has selected seven members of his 15 member advisory council who have small business experience. In addition to the IRSAC, other specialized advisory councils with interested stakeholders have been formed, for example the ETAAC that Sandy serves on.

Two other initiatives that are a sign of the "new IRS" are the establishment of "problem solving days" and the Electronic Tax Administration road shows. The problem solving days bring together representatives from the IRS and taxpayers with unresolved problems to try and find common solutions. Also, a representative from the Taxpayer's Advocates Office is available at these locations to assist taxpayers with still unresolved problems. At a recent problem solving day in St. Louis, which was held on a Saturday, the IRS and the Missouri Department of Revenue joined forces for a one-stop shop.

Electronic Tax Administration road shows that I mentioned are designed to educate and encourage the practitioner community to embrace electronic filing. Key elements of these shows are the availability of national office personnel to speak on topics of interest to the practitioner community and also the vendor displays on products that the practitioners would be able to use.

You have heard from previous witnesses regarding the different operating divisions, so I will not go into detail here, except to say that this diverse group of small-business and self-employed tax-

payers will have interaction with the service during the pre-filing, filing, and post-filing phases. It is estimated they will have between 4 and 60 contacts per year.

Taxpayer Education and Communication, or the TEC, will handle the pre-filing function. The three key functions within TEC are research and product development, partnership outreach, and taxpayer education. The strategy behind the establishment of TEC, which I think is excellent, is to assist taxpayers initially to avoid or reduce problems and burden in the filing and post-filing phases. Basically, if you solve a problem on the front or educate the taxpayer on the front end, you will not have problems later on.

If this strategy is successful, it should reduce the overall costs of tax administration. Therefore, it is critical to the reorganization effort that the TEC be fully staffed and fully funded as soon as possible.

The IRS has developed two products that should be key in the delivery of taxpayer education. The first product is the IRS web site. Taxpayers are able to obtain up to date information and forms by accessing www.irs.gov on a 24/7 basis. According to Commissioner Rossotti, there have been over 1 billion hits to this web site. The Service has done a good job in developing this web site, but the addition of a hypertext search engine would make it far more useful. With the addition of this tool, one could search for information on regulations and forms of a particular topic of interest.

The second product of interest in the taxpayer education is the small business resource CD that was mentioned earlier. This computer program covers the life cycle of a small business from prestartup to closing a business. The product was developed jointly by the IRS and the SBA. I understand that it is being distributed to all the Small Business Development Centers across the country. The contents of this CD, however, should be on the IRS web site, as well as in all the public libraries for access.

This type of partnership or strategic alliance is another function of TEC. I am encouraged by the effort to work with the various stakeholder groups. The IRS, practitioner groups, trade organizations, educational institutions, and other Government agencies have so much to gain by being partners in tax administration.

At the same time, the Service is looking to provide taxpayer education to the small business community, this same community may not be looking to the Service as the best source of information. The figure I had was over 80 percent of small business tax returns are prepared by a tax professional. I was interested to hear Mr. Boyer's figure this morning, as well.

Chairman BOND. Even better news.

Mr. QUICK. For the same reason that I do not fix my own car, a lot of people do not prepare their own taxes. It is not the highest and best use of my time. Therefore, outreach to the professional community and trade groups is essential.

One area of concern in taxpayer education is the ability of the IRS to educate taxpayers. The Service has many technically proficient employees, well versed on tax law and procedures, but these same employees may not possess the necessary skills to be a good teacher.

I would suggest the possibility of pairing knowledgeable IRS personnel with trained educators to develop suitable training materials. It may be necessary to look outside the Service for adjunct faculty. Sufficient funding needs to be available to accommodate this reality.

Another area of concern is the ability of the Service to retrain some of its examination and collection personnel and their perception of small business. Most earners are very hard working and law-abiding taxpayers willing to pay their fair share of taxes but not a penny more. In light of today's complex tax code, there is a big difference between an honest mistake and tax fraud. This trust building will take time on both sides of the table.

In talking with other IRSAC members, there are some concerns about the intradivisional and cross-divisional communications. This was a valid complaint in the old IRS. The design teams are trying to address this issue and I will be interested to see their results.

It is important to remember that this reorganization is a work in progress and no doubt there will be a few glitches, as there are in any private sector corporate reorganization. The ability of the Service to correct these problems in a timely manner, and the success of the TEC function, will greatly enhance the success of the entire process.

One final message that I would like to suggest to Congress is that they ensure adequate funding is available for this reorganization effort, specifically in the information systems area.

While admittedly, the Service has not always spent technology dollars wisely in the past, I believe the IRS is on the right track in upgrading their—for lack of a better word—mature systems and technology. The installation of new equipment and the establishment of integrated real-time information systems will take several years to accomplish. However, once in place, these systems should enable the IRS to deliver timely and accurate customer service that the American people deserve.

Thank you for the opportunity to present this testimony, and I would be pleased to answer any questions.

[The prepared statement of Mr. Quick follows:]

Quick Tax & Accounting Service

Testimony of
Roy M. Quick, Jr., EA
before the
Senate Committee on Small Business
Washington, DC
May 23, 2000

Good Morning Chairman Bond and fellow committee members. My name is Roy Quick and I am an Enrolled Agent and a Principal in Quick Tax & Accounting Service, a private home based tax and accounting service located in St. Louis County, Missouri. In addition, I have been serving as a member of the Internal Revenue Service Commissioner's Advisory Council (IRSAC) since November 1999. I am pleased to present this testimony on the IRS modernization effort.

First of all let me say that I am very pleased to see a change in the Internal Revenue Service by way of involving "outsiders" in the strategic planning process. Here are a few examples. The consulting firm of Booz-Allen & Hamilton, a contractor to the IRS, sought comments from the White House Conference on Small Business Tax Issue Chairs on the initial restructuring phase. Commissioner Charles Rossotti has selected seven members of his fifteen member advisory council who have small business experience. In addition to the IRSAC other specialized advisory councils with interested stakeholders have been formed. The Information Reporting Advisory Council (IRPAC) and the Electronic Tax Administration Advisory Council (ETAAC) were formed to solve problems in their respective areas and reduce taxpayer burden.

Two other initiatives that are a sign of the "new IRS" are the establishment of "Problem Solving Days" and the Electronic Tax Administration "road shows". The Problem Solving Days bring together representatives from the IRS and taxpayers with unresolved problems to try to find solutions. Also, a representative from the Taxpayer Advocate's office is available at these locations to assist taxpayers with still unsolved problems. Our personal experience with the Taxpayer Advocate's office has been exceptional in resolving a longstanding problem. A recent problem solving day was held in St. Louis jointly with the IRS and the Missouri Department of Revenue for a "one stop shop." The Electronic Tax Administration shows are designed to educate and encourage the practitioner community to embrace electronic filing. Key elements of these shows are the availability of national office personnel to speak on topics of interest to the practitioner community and the vendor displays.

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The Internal Revenue Service in an effort to meet the needs of the American taxpayer has reorganized itself into four distinct operating divisions: Wage and Investment Income (W&I), Small Business/Self-Employed (SB/SE), Large and Mid-sized Business (L&MSB), and Tax Exempt/Governmental Entities (TE/GE). The idea of structuring operating divisions along customer lines and eliminating the previous "stovepipe" organization revolving around functions such as examinations or collections, shows sound planning. This testimony will concern only the Small Business/Self-Employed operating division which serves a very diverse group of approximately 45 million taxpayers including:

- Small businesses (part-time, start-ups)
- Small businesses without employees (service providers, contractors)
- Small businesses with employees
- Taxpayers with rental property
- Taxpayers with a farming business
- Taxpayers with employee business expenses
- Individuals investing in small businesses (S-Corps, partnerships)
- Corporations, S-Corporations & Partnerships with assets under $5 Million

This diverse group of taxpayers will have interaction with the service during the pre-filing (education), filing (submitting forms), and post-filing (compliance) phases. It is estimated they will have 4-60 contacts per year.

Taxpayer Education and Communication (TEC) will handle the pre-filing function. The three key functions within TEC are Research and Product Development, Partnership Outreach, and Taxpayer Education. The strategy behind the establishment of TEC is to assist taxpayers initially to avoid or reduce problems and burden in the filing and post-filing phases. If this strategy is successful, it should reduce the overall cost of tax administration. Therefore it is critical to the reorganization effort that TEC be fully staffed and fully funded as soon as possible.

The IRS has developed two products that should be key in the delivery of taxpayer education. The first product is the IRS Web Site. Taxpayers are able to obtain up to date information and forms by accessing www.irs.gov. According to Commissioner Charles Rossotti there have been over one billion hits to this web site. Of particular interest to small business owners is the "Small Business Corner", "What's Hot", "Employment Taxes", and the "Forms and Publications" sections. The site can be accessed 24/7, so it is convenient for everyone who has access to the Internet. The Service has done a good job in developing this web site, but the addition of a hypertext search engine would make it far more useful. With the addition of this tool, one can search for information, regulations and forms on a particular topic of interest. Let me give you an example of a typical question. If a business purchases a piece of equipment, should they capitalize and use depreciation or could they expense it? The search engine would point out all the publications and forms where this topic would be covered to reach a decision.

The second product of interest in taxpayer education is the Small Business Resource Guide CD. This computer program covers the life cycle of a small business from pre-startup to closing a business. The program was developed jointly by the IRS and the Small Business Administration. The second version of the program was just recently released. I understand that it is being distributed to all of the Small Business Development Centers across the country. Individual small businesses can request a free copy by calling 1-800-TAX-FORM or by

requesting one through the IRS web site. The contents of this CD should be on the IRS Web Site as well as in all the public libraries across the country. The Service presently provides a set of commonly used forms to most libraries now. Those without a computer would be able to go to their local library to gain access to this valuable tool.

This type of partnership or strategic alliance is another function of TEC. I am encouraged by the effort to work with various stakeholder groups. The IRS, Practitioner Groups, Trade Organizations, Educational Institutions and other Government Agencies have much to gain by being partners in tax administration. At the same time the Service is looking to provide taxpayer education to the small business community, this same community may not be looking to the Service for the best source of information. Over 80% of small business tax returns are prepared by a tax professional. Therefore outreach to the professional community and trade groups is essential. The IRS needs to assist the tax professional and trade organizations in ways to educate the "record-keeper" in the small business.

One area of concern in taxpayer education is the ability of the IRS to "educate" taxpayers. The Service has many technically proficient employees well versed on tax law and procedures, but these same employees may not possess the necessary skills to be a good teacher. I would suggest the possibility of pairing knowledgeable IRS personnel with trained educators to develop suitable training materials. It may be necessary to look outside the service for "adjunct faculty." Sufficient funding needs to be available to accommodate this reality. This will increase the ability of the training material and class time to be technically accurate and educationally friendly

Another area of concern is the ability of the Service to "retrain" some of its examination and collection personnel in their perception of small business. Not all small business owners cheat on their taxes and not all small business owners are wealthy. Most are very hard working and law abiding taxpayers willing to pay their fair share of taxes but not a penny more. In light of today's complex tax code, there is a big difference between an honest mistake and tax fraud. Small business owners should not be presumed guilty any more than the IRS should be judged by some of their rogue employees. This trust building will take time on both sides of the table.

In talking with other IRSAC members there are some concerns about intra-divisional and cross-divisional communications. This was a valid complaint in the "old IRS". The design teams are trying to address this issue and I will be interested to see their results. Here are some examples of possible problems:

- A Schedule C filer (SB/SE) might have a problem with an erroneous 1099 form or a problem with capital gains (W&I). Will the IRS be able to handle this type of problem transparently to the taxpayer or will he/she get the runaround?

- Taxpayers selected for an examination need to be treated equally across the country. Results should not vary significantly across the country for similar taxpayers with uniform audit guides and proper supervision. A small business in Las Vegas or Houston should receive the same treatment as they do in St. Louis or Baltimore.

It is important to remember that this reorganization is a "work in progress" and no doubt there will be a few glitches as there are in any private sector corporate reorganization. The ability of the Service to correct these problems in a timely manner and the success of the Taxpayer Education and Communication function will enhance the success of the entire process.

One final message I would like to suggest that Congress insure that adequate funding is available for this reorganization effort, specifically in the information systems area. While admittedly the Service has not always spent technology dollars wisely in the past, I believe the IRS is on the right track in upgrading their mature systems and technology. Commissioner Rossotti has used the analogy of upgrading the IRS systems is like "trying to change the engines on a jet plane while flying at 30,000 feet." No easy task! The installation of new equipment and the establishment of integrated real-time information systems will take several years to accomplish. However, once in place these systems should enable the IRS to deliver timely and accurate customer service that the American people deserve.

Thank you for the opportunity to present this testimony and I would be happy to answer any questions.

Chairman BOND. Thank you very much, Roy. You answered my second question, about how they can improve the education and outreach effort by saying they need to get somebody who knows how to be an educator.

Let me turn back to Ms. Abalos.

Ms. Abalos, are there any barriers that will prevent small business from electronically filing their taxes? Can you explain how this electronic filing could be a burden on small businesses?

Ms. ABALOS. This year was the first year that our practice offered electronic filing for customers. They had two questions, every time they came around, two questions regarding electronic filing. What does it cost? And how does it benefit me?

The answer was it costs more because it takes us more time to file the return electronically. This year, just to get some familiarity with the process, I provided that service to my clients free of additional charge. But then honestly, for our practice profile, there was no benefit.

A CPA practice does not do the run-of-the-mill H&R Block type returns where somebody comes in and presents their information and they sit there and have a return done, sign the 8453 and be off and it is finished. We gather information. Sometimes there is additional information that comes in. And when we finish that return and send it out, we want to be completed with it.

So there was even additional time and correspondence back and forth with the client and the practitioner in getting the signed signature forms and so forth.

With the business community, there is even an additional barrier. This is just an example of where I cannot imagine that the Internal Revenue Service would understand these kinds of barriers or identify them because they are not practicing in the mode we are.

I will give you a perfect example. In filing most of the business returns, depreciation is a big component of the tax return, and it is very, very complex. We do not use the depreciation part of our software. The software package that would file the returns electronically has a depreciation component. We do not use that in computing the depreciation for our business clients.

We have a separate package that is a full-blown depreciation package that we can use year-round in doing planning or preparing financial statements and so forth. And that is how we do the depreciation part or component of the return.

That prints a physical paper, 4562, which we include with the paper business return. So just as an example, how would that work in electronic filing? How would you capture this data that is on a separate, independent, software package into the e-file return when we do not do it that way?

So it is just an example of it taking more time and there not being an offsetting benefit to either the small business community or the practitioner community. Does that answer the question?

Chairman BOND. That is a very good point. If it takes longer and costs more, that is a problem. I can certainly understand how your clients need to use this information throughout the year. And unless technologically we can figure out a way to move from one program into the other, it does sound like a real burden.

One other question I have, Ms. Abalos. In the Commissioner's testimony, he notes the IRS has expanded the online filing program for Form 941, the Employer's Quarterly Federal Tax Return. Have you had any experience with this program and its potential benefits or downsides for a small firm?

Ms. ABALOS. Most small businesses do not prepare their own payroll tax reports. I will tell you that as a CPA practitioner, and I have probably 200 small business accounts. I represent a wide array of the small business community. We do not prepare them anymore, either. I do not even do my own payroll tax reports.

We have out-sourced that function to a payroll service provider. No. 1, they do it faster. And again, they do it at less cost and that provides us with a real benefit.

So the electronic filing of the 941s, I see that as a real benefit for the payroll service providers like Paychex or ADP, those are two of the bigger ones here in Arizona. I really do not see the small business community benefiting from a direct 941 e-file because they are not preparing their 941s to begin with.

Chairman BOND. Thank you, Ms. Abalos.

Mr. Quick, would you like to comment on any of those items before we move on to questions?

Mr. QUICK. Certainly, Mr. Chairman. We do electronic filing for all of our clients. The only impediment we have found with electronic filing is that not all the forms are acceptable. There are certain forms that some of our clients have that cannot be filed electronically.

One advantage that we have with the electronic filing is that returns go in error free. There is an error checking mechanism to make sure that the returns go in without any errors. It cross-checks Social Security numbers, which is one of the prime errors on paper filed returns. It eliminates all math errors. The Service gets the return error free and the taxpayer gets an acknowledgement or a receipt that the Service got their return and they know that it has been accepted.

Our clients, even the ones with balances due, have been filed electronically and they seem to enjoy it. It does create some additional data entry for us but we feel that it is worth it.

Chairman BOND. How would you assess the IRS efforts to include the Taxpayer Advocate in the new SB/SE Division? And what has been your experience as a practitioner with the Advocate?

Mr. QUICK. My experience with the Advocate's office has been excellent. I cannot say enough for Val Oveson and his staff. The Taxpayer Advocate will have, or there will be a Taxpayer Advocate's representative in each of the SB/SE territories.

The one experience we had, which I cannot go into great detail due to client privacy, but they were able to solve a long-standing problem in a matter of a day with the service center.

Chairman BOND. That probably sets a record.

In closing the formal questions, first Mr. Quick, if you could tell the IRS one thing to do in the new SB/SE Division, what would be the most important one?

Mr. QUICK. My feeling on this, Senator, is that most small-business owners are law-abiding tax paying citizens and willing to pay their fair share. I would ask that they be not presumed guilty

by virtue of being small-business owners, and that the IRS live up to its mission statement.

Chairman BOND. Thank you very much, Mr. Quick.

Ms. Abalos.

Ms. ABALOS. I would ask that they formally activate that TEC Partnership arm and let us help you. We are doing the work here in the trenches and we can provide constructive input that will help this process. So before you develop something and roll it out, take our comments, consider them, and act on them, just like this directive says.

Chairman BOND. Those are all very worthwhile, very useful comments. We sincerely appreciate your testimony. We are delighted to have the practical view from the tax preparers for small business on how this is working, can work, and should work.

Before I conclude, once again I want to express my thanks to Commissioner Rossotti as well as, to Ms. Ashby and her team at the GAO, and especially our witnesses serving small business. Your insights and efforts on behalf of small business are greatly appreciated, and we urge everybody to continue their hard work for small business and the self-employed.

As we have heard this morning, the IRS' new Small Business/Self-Employed Division is expected to stand up on October 1 of this year. I extend my support, encouragement, good wishes, and sympathy to Joe Kehoe and his deputy, Dale Hart, as they undertake the enormous task of getting this critically important division off the ground.

While I think there have been great efforts that have gone into planning, the real work will begin when the new division becomes operational. To ensure the IRS improvements in small business service do not stop in the planning stages, I will be asking the GAO to undertake a new evaluation of the SB/SE Division and report back to the Committee next year on the changes, and I am confident improvements, that the agency has made for taxpayers in this incredibly important sector of our economy.

I thank all of our participants. The record will remain open for 2 weeks for those of you who are watching this, either here in the room or by means of our web site, we do invite further comments. I think there have been many good ideas that have been aired today and we would welcome comments, either supportive or adding a different perspective, that will enable us to share with the IRS suggestions that may be most helpful.

With that, I thank all participants.

The hearing is adjourned.

[Whereupon, at 11:17 a.m., the Committee was adjourned.]

APPENDIX MATERIAL SUBMITTED

STATEMENT BY PAUL COVERDELL
Committee on Small Business
Hearing entitled
"IRS Restructuring: A New Era for Small Business"
Tuesday, May 23, 2000

Mr. Chairman, I appreciate your leadership in holding this hearing on the effect of the IRS reform on small businesses, and I welcome the witnesses taking time to be a part of these proceedings. As we all know, the new programs and procedures discussed here today were, for the most part, made possible by the IRS Reform and Restructuring Act of 1998. Today, we will learn of the progress made by the IRS in an area that is in desperate need of modernization–the agency's services and actions toward small businesses.

The creation of the Small Business/Self-Employed Operating Division within the IRS will hopefully do much to ease the tax preparation burden placed upon our small business community. I am pleased to hear that this division is scheduled to begin operation on October 1, 2000.

Over the years, Congress created numerous federal programs designed specifically to aid small businesses. I believe many of these could be employed to help make small businesses aware of changes to IRS structure and procedures. Specifically, I encourage the IRS to continue its partnership with the Association of Small Business Development Centers (SBDCs) in developing business tax law training programs. It is good to hear of the success four pilot programs underway in Delaware, Iowa, Nevada, and Texas.

Again, I thank our witnesses for their input today and the Chairman for his leadership on this critical issue.

STATEMENT BY JOHN F. KERRY, RANKING MEMBER
Committee on Small Business
Hearing entitled
"IRS Restructuring: A New Era for Small Business"
Tuesday, May 23, 2000

Good morning and welcome to the Committee's hearing on IRS Restructuring: A New Era for Small Business. I would like to thank Chairman Bond for holding this hearing. I am pleased that the Internal Revenue Service and its reorganization is the subject of this hearing, especially since it seems as if the agency is heading in the right direction for small business. This is good news for small businesses, and a welcome and worthy topic, especially during Small Business Week. I would like to thank the small business owners testifying before the Committee this morning who have taken time out of their busy schedules to be with us this morning, and I would also like to thank the General Accounting Office and Commissioner Rossotti for making themselves available as well.

Tax issues have always been important to the small business community. We are all familiar with the stories of the "old IRS," stories that made small business owners cringe at the prospect of getting a call of any sort from the agency. The General Accounting Office report released today talks of some of these fears. One does not even have to read the report to get a taste of the "old IRS," all one has to do is look at the section headings: "Various Factors Complicate the Interactions Between Small Businesses and the IRS;" "Small Businesses Have a Greater Potential for Noncompliance;" "IRS has not Operated in a Way That Best Enables It to Serve Small Businesses;" and so on.

However, the focus of this hearing is about the new IRS - an agency that is reorganizing itself in a manner that should improve the way it deals with its small business clients. The GAO report outlines the initiatives that the agency has undertaken in a positive light, but does caution that the agency needs additional staff and resources to accomplish its goals.

I am pleased to note that the two small business people testifying before this Committee today endorse the way that the IRS is reorganizing itself. They are approaching the new IRS with optimism. According to the written statement of one witness (Roy Quick) who represents small business concerns, "the idea of structuring operating divisions around customer lines and eliminating the previous 'stovepipe' organization revolving around functions such as examinations or collections, shows sound planning." I think a great deal of credit should go to Commissioner Rossotti, his staff, and in fact, his entire reorganization team for undergoing efforts to position the IRS as an agency that is a more friendly, helpful, customer service-oriented entity.

The Internal Revenue Service has reorganized into four major divisions, one of which is the small business/self employed (SB/SE) division. I appreciate the goals and mission statement of this group: "to effectively meet the needs of the most diverse group of taxpayers and to help

them comply; to help them solve their compliance issues while ensuring overall fairness to all taxpayers." I am also glad that one of the 16 area headquarters offices will be located in Boston.

The SB/SE division will cover about 45 million taxpayers. Of this total, about 33 million are either full or partially self-employed, about 7 million are small businesses with assets of $5 million or less. This group consists of small businesses that are part-time or start-up firms; small businesses without employees such as service providers or contractors; small businesses with employees; taxpayers with rental property, a farming business, or employee business expenses; individuals investing in small business; and corporations, s-corporations, and partnerships with assets under $5 million.

The SB/SE division will be also divided into three segments. According to the agency, the Taxpayer Education and Communication (TEC) group will be customer-service oriented and solicit information from taxpayers and external stakeholders about customer needs. The customer account services (CAS) group will assist taxpayers in submitting timely tax returns and paying the right amount of tax. Finally, the compliance office will directed towards problem prevention and early intervention to increase overall compliance.

I think that this plan is a very good one, and I am pleased that the IRS seems to be concentrating its efforts in this new division on outreach and solving complex tax issues before they become interest and penalties on unpaid tax.

As a strong supporter of the Small Business Administration's programs and its resource partners, I am pleased to see in Commissioner Rossotti's testimony that the "new IRS" has a partnership with the Association of Small Business Development Centers in a pilot program designed to improve the attendance, quality, and presentation of the agency's small business workshops.

Unfortunately, I will not be able to stay to hear all of the testimony today, but I know that Damon Dozier of my Committee staff will stay throughout the entire proceedings, and keep me informed of everything discussed. Again, I thank you all for coming today, and I also thank the Chairman for holding this hearing.

STATEMENT BY OLYMPIA J. SNOWE
Committee on Small Business
Hearing entitled
"IRS Restructuring: A New Era for Small Business"
Tuesday, May 23, 2000

Thank you Mr. Chairman. I would like to thank you for holding this hearing on this very important issue.

I would like to welcome our guests this morning. I am pleased that you are with us to discuss this important issue. I would note that there are many key issues for small businesses as the new century dawns. The challenges facing the small business community are great -- none greater, however, than the burden of taxes on small businesses.

We clearly need a tax system that is simpler and more fair. It is simply unconscionable to ask small businesses to spend so many hours -- and so many dollars -- in order to comply with a tax code that is literally out of control.

As we mark Small Business Week, I think this is something that every small business owner, and, in fact, all Americans, can relate to. The burden of high tax rates and an overly-complex and intrusive tax code is something that we must address.

The time and money that small businesses spend on efforts to comply with the tax code makes it more and more difficult to grow a small business and create jobs. American business spends an estimated 3.4 billion hours on tax filings each year. According to the NFIB, this is the equivalent of a staff of 3 million people working full time, year-round, to file business taxes. I would submit that this is not the kind of job creation our federal small business policy envisions.

When the income tax code was established in 1913, the implementing legislation was less than 100 pages long. As we embark on a new millennium, the tax code comprises 14 volumes – over 11,000 pages, weighing over 35 pounds. The regulations that accompany the tax code comprise 19 volumes, also totaling over 11,000 pages. The IRS publishes over 400 forms and more than 100 instruction publications accompanying these forms.

When considering that there are 555 million words in the tax code, 480 different tax forms, and IRS employees give the wrong answers to taxpayers 30 percent of the time, it's no wonder the experts can't even agree on what a taxpayer owes.

As a Senator from Maine, a state with a historical record of self-reliance and small business enterprise, I am extremely interested in ways that this Committee can highlight the concerns of small businesses with respect to tax issues. In order to promote small business development and growth and job creation, we must put the federal tax system back on the drawing board. I am particularly concerned about the unique challenges facing small businesses that must comply with a tax code that is really designed for large businesses. I think most small business owners would tell you that tax preparation is something that is faced on a virtually constant basis.

We cannot overstate the significance of small business on the national economy. So to turn the other way while small businesses are being strangled by taxes and tax filing burdens would be to abdicate our responsibilities as advocates for the small business community. We must work together to help foster small business entrepreneurship and encourage job creation. I hope we can explore some of the options today.

In 1997, a series of hearings were held in the Senate Finance Committee that provided a chilling reminder of how government power can run amok: tax files were used for information on boyfriends of IRS employees. IRS managers were trained that it was permissible to lie or mislead the public, and IRS employees were told it was permissible to use these tactics to accomplish the goals and missions of the agency.

While comprehensive tax reform may only be right around the corner -- and there is even growing talk of sunsetting the tax code – the Congress did take a major step toward ending the abuse of our nation's citizens by the Internal Revenue Service this past year.

Specifically, by overwhelming, bipartisan votes in the House and Senate, the Congress passed -- and the President signed into law --IRS reform legislation that instituted a new IRS governance board dominated by private-sector tax and management experts; established new taxpayer rights; shifted the burden of proof

for wrongdoing from the taxpayer to the tax collector in tax court; streamlined congressional oversight of the IRS; and set up new controls over Congress' ability to further complicate the tax code.

With the passage of the IRS reform legislation during the 105th Congress, I think we are headed in the right direction. But we must do more.
In order to foster growth and job creation, we must make the tax system less complex and more fair. Small business should not have to live in fear of the federal government or the IRS.

I have always been a strong supporter of the small business community, and will continue to work to protect and promote the interests of small businesses. I look forward to hearing the testimony from our panels.

Again, thank you, Mr. Chairman.

Post-hearing Questions posed by Senator Christopher S. Bond, Chairman
Senate Committee on Small Business
To the Honorable Charles O. Rossotti, Commissioner
Internal Revenue service, Washington, D.C.
Hearing entitled
"IRS Restructuring: A New Era for Small Business"
May 23, 2000

1. The GAO's testimony talks about a shortage of staff with the skills needed to implement some of IRS's planned changes effectively. What does IRS plan to do to fill that skills gap?

The Internal Revenue Service depends on its human capital to accomplish its vital mission. However, as we begin to fully implement our Modernization Blueprint, our workforce is in a state of flux. Even as employees are being realigned to new positions and organizations, the Service's workforce has become severely imbalanced in a number of critical characteristics, such as age and skill mix. These imbalances, particularly as they relate to Modernization, potentially degrade our ability to meet business requirements over the long term.

These challenges require a comprehensive, strategic approach to managing the Service's human resources. That approach has four main components: transition, renewal, development, and performance, each of which is briefly summarized below.

- **Transition**. Under the terms of a landmark Restructuring Agreement with the National Treasury Employees Union, we have developed a comprehensive People Transition Strategy that non-competitively realigns over 90% of our current employees to jobs in our new organization. In addition, we have begun to implement an executive and senior management realignment strategy that employs a merit-based, competitive process to fill our 1600+ top leadership positions. Those employees and managers that do not realign will be (a) offered early/regular retirement, with separation incentive pay (VSIP), to leave the IRS; or (b) assigned to interim positions in our new Divisions until retrained and/or permanently placed. As those buyouts and placements are effected, additional full-time equivalents (FTEs) will be freed up to support critical workforce renewal efforts.

- **Renewal**. The imbalances noted at the outset also require a sustained workforce renewal effort, and the Service's FY 2001 budget proposes increased FTEs to support that effort. These resources, along with those freed up by our transition strategy, will be allocated to Divisions in accordance with a strategic hiring plan that identifies critical needs as part of an overall personnel requirements system. That plan and system are currently under development under the aegis of the Strategic Recruiting Executive Council,

championed by a Division Commissioner and chaired by a senior executive. That group will oversee an aggressive college recruiting campaign and reinvigorated intern and cooperative education programs. The Council is also overseeing the development of a sophisticated recruiting campaign employing state-of-the-art labor market research, print and electronic (that is, Web-based) media outreach, a cadre of trained IRS recruiters, and a sustained campus presence to attract high quality degreed candidates.

- **Development.** In the future, the Service will depend even more heavily on employees that are technically proficient and well led. Both require substantial investments in training and development -- at least at the level of current funding. However, we must also make qualitative improvements in the way training is developed and delivered. In this regard, the IRS needs to completely redesign its learning and education system to reflect its new organization structure, devolving responsibility for technical training to its Divisions while strengthening its corporate leadership development activities to insure an adequate "pipeline" of high quality candidates for our top jobs. And in order to meet the demand for more and better training, the Service must also continue its efforts to identify and validate mission-critical technical and leadership competencies and occupational career paths, exploit new technologies (such as Web-based distance learning), and establish strategic partnerships with universities and other education providers to expand capacity.

- **Performance.** The Service's strategic goals implicitly require our employees and managers to demonstrate a new set of values and behaviors that build upon, and complement, those that have served the IRS so well. If those values and behaviors are to become part of the Service's organizational culture, they must be reinforced and rewarded in a systematic way. To this end, we have implemented a new performance appraisal system that aligns executive and managerial performance standards with our organizational Balanced Measures System (BMS) and establishes individualized annual performance contracts that are linked directly to business objectives. In addition, we are set to implement a new paybanding system for senior managers, and a new pilot bonus system for key senior leadership positions, that will link executive and managerial compensation more directly to performance. These initiatives must be tested and expanded. In addition, the Service must complete the current effort to align bargaining unit employee performance standards with BMS, and undertake more comprehensive pay and performance management reforms in partnership with NTEU.

2. We have heard that IRS employees are worried about where they will end up as result of the agency's reorganization. What is the IRS doing to communicate with its employees about their individual jobs and prevent the talented employees from leaving the agency because they don't know what job they will ultimately have?

Our people are the Service's most important asset, and as we proceed to implement the Modernization Blueprint, we must do everything we can to insure that they are realigned to our new organizational structure with a minimum of disruption and distraction in their working lives. We are confident that this will be the case for the vast majority of our employees, over 95% of our current workforce will simply be reassigned to continuing positions in our new Divisions at their current posts of duty, with no impact whatsoever on their grades and pay. However, as a result of that realignment, we will not be able to place a relatively small number of employees in permanent positions right away. These employees, Transition Employees or Transition Managers, will not suffer any adverse impact in this regard. Moreover, the Service is absolutely committed to insuring the speedy placement of these employees, as well as to providing them with a comprehensive "safety net" of options, to include retraining and early retirement, that will help their transition.

The Service's Modernization Blueprint describes the locations and staffing levels required by our new organization structure, as approved by the Modernization Executive Steering Committee (ESC). For the most part, that Blueprint provides for almost all of our employees and front-line managers to simply "follow their work" into the new organization. In this regard, the ESC has determined that all front-line employees in technical tax positions -- to include all GS-512 Revenue Agents; GS-592 Tax Examiners; GS-962 Contact (Customer Service) Representatives; and GS-1169 Revenue Officers -- will be reassigned "in place" to the Service's new organization structure, with no change in grade or post of duty. Similarly, all employees in GS-334 Computer Specialist and GS-1811 Criminal Investigator positions will also be realigned in place. All other employees have been matched against specific Blueprint requirements, post of duty by post of duty.

Where, in any given post of duty, there are more bargaining unit (BU) employees in a particular occupation series and/or grade than there are BU positions in that series and/or grade required by the Blueprint. Those BU employees will be assigned to available positions in order of seniority, as determined by IRS Entry-on-Duty (EoD) date. Non-bargaining unit (NBU) employees will also be assigned to available NBU positions according to seniority, but as determined by Service Computation Date (SCD). Those BU and NBU employees who remain at the conclusion of that process will be designated as Transition Employees and receive written notice to that effect. Similarly, where there are employees in a particular occupation series and/or grade who have no corresponding position in the Blueprint, those employees will also be designated as Transition Employees and receive written notice to that effect. This process applies to both BU and NBU employees, as well as most first-level supervisors. However, it does not apply to new GS-14 and 15 Senior Manager positions, which are being filled by competition. Those current GS-14 and 15 mid- and top-level managers who do not apply (or who are not selected) for these Senior Manager positions will be placed in a transition status at the conclusion of that competitive process.

In an effort to get as much information to the broadest audience, Strategic Human Resources has instituted an IRS Intranet page specifically for "Transition Employees and Their Managers" http://www.dss.swro.swr.irs.gov/acss/web/shr/transition.html. This site is continually marketed on the IRWeb Home Page which is the default home page for all IRS employees, and on the Modernization Home Page, the site which houses all modernization information for all employees. We anticipate that Agency Wide Shared Services (AWSS) will add their information on this same page. There have been several Servicewide Interactive Video Teletraining (IVT) broadcasts, with corresponding rebroadcasts, on modernization topics. NTEU has been not only on the IVT but involved in the design of the production.

We believe that with the comprehensive safety net of policies and services described above, no IRS employee need to fear for his or her job - and as a result, all of us can continue to serve the American taxpayer without interruption. To that end, we will continue to look for ways to improve that safety net, and to share any and all additional information that may affect them in this time of transition.

3. According to IRS' plans, SB/SE will be doing work for other divisions in addition to its own work. How will IRS ensure that SB/SE is appropriately meeting the needs of the other divisions without adversely affecting its ability to meet its own needs and the needs of small businesses and the self-employed?

The SB/SE organization will work closely with other divisions to continually assess the effectiveness of its efforts to serve the needs of those divisions as well as continue to serve effectively the needs of the small business and self-employed taxpayers. We will employ incremental short-term improvements and long-term fundamental changes in our organization and technology that greatly improve service to all our customers. Additionally, we will have balanced measures that focus on customer satisfaction, employee satisfaction, and business results.

4. The GAO's testimony talks about "migrating taxpayers" – those whose changing filing status from one year to the next would move them from one operating division to another. What controls does IRS plan to put in place to ensure that these taxpayers are not adversely affected by their "migration"?

Most taxpayers will continue to file their returns with the same centers that they file with today. We will be centralizing the filing of business returns to two centers over time. As we begin to move into our new organizational structure, we will make every effort to minimize the impact on taxpayers whose filing status changes from one year to the next.

5. It appears that the IRS is making good progress on developing a burden-estimation model for wage and investment taxpayers. Do you anticipate that it will be more difficult to develop a burden estimation methodology for SB/SE taxpayers? Do you anticipate having to use a much different approach than the one you are following for the wage and investment taxpayers?

IRS is currently developing the methodology for estimating burden for SB/SE taxpayers. Because the forms and concerns more closely mirror those of wage and investment individuals, we are separating the Self Employed taxpayers (those filing Schedules C, E, and F) from the Small Business taxpayers (those filing Forms 1120 and 1065) for our analyses.

Various associations of tax preparers and private companies are working in partnership with us to help us ascertain the burden incurred by taxpayers who use these services. In addition, we are contracting with Pricewaterhouse Coopers to survey self-employed taxpayers who prepare their own taxes. The questionnaire is expected to be similar, but not identical, to the survey of wage and investment taxpayers. It will focus on the same taxpayer activities and taxpayer groups, i.e., those who self prepare their returns, use software, or paid preparers.

6. How will IRS and Taxpayers benefit from the development of a new burden estimation methodology?

The burden estimation model will allow IRS to identify where in the tax stream the taxpayers are incurring the largest burden as measured by time spent and out-of-pocket costs. IRS can, then, target its burden reduction efforts. In future years, IRS will have a benchmark with which it can judge the effectiveness of its programs.

IRS is required by Congress to report annually on the paperwork burden imposed on taxpayers in meeting their Federal tax obligations. The new model will not only provide current information, but also it is being designed so that IRS can make annual estimates in the future without doing an expensive taxpayer survey. This will save taxpayers' money, as well as taxpayers' time in responding to surveys.

7. When will IRS begin to use the new wage and investment burden estimation model?

The model is expected to be completed in summer 2001, and will be used to meet the Paperwork Reduction Act requirements for burden estimates for FY2001.

8. Would it be possible for the IRS to include a search engine on its website to assist taxpayers in finding the information they need quickly and efficiently?

IRS has always had a search engine on its website – since January 1, 1996.

9. Is it possible for the IRS to put the contents of the small business CD-ROM on its website in order to make it more accessible to small business owners?

We could load most of the information from the CD to our Digital Daily Web site. However, there is not an adequate business case for doing so. All the information on the CD already exists on the Digital Daily but is laid out a bit differently. As you know, IRS have a "Small Business Corner" section of our "Tax Info for Business" section that presents information of interest to business. Posting the information from the CD in an area of the web site that preserves the look and feel of the CD would only serve to confuse our customers about where to go to find information for Small Business. With as much information as we present on the Digital Daily, keeping the site easy to navigate and making it easy to find information is already a huge challenge. Adding the CD as a separate source of information would only increase the challenge.

In addition, some of the video / sound / and CGI might not translate well to the web. Bandwidth would be a big problem for the video and Flash graphics. The Small Business Resource Guide CD was designed as a CD to provide information to those who either do not have access to the web or who do not have the time to conduct the research needed to find their Government regulatory requirements. It takes advantage of the Web by focusing the customers attention on the topics of specific interest through a set of indexes unique to the content on the CD. Indexing only the information for Small Business, on the Digital Daily with the same level of detail as used on the CD would add confusion to the Web site by adding another 5 separate indexes. This is a special product designed for a special purpose and is not designed for the Web.

10. Would it be possible for the IRS to send a copy of the CD-ROM to public libraries throughout the country?

Yes, IRS could send copies of the CD to libraries throughout the country. We would need an address list to make it happen and enough copies of the CD. Currently we do not know how many libraries are involved, however IRS have already distributed approximately 15,000 copies to the participants of our Banks Post Offices and Libraries program. The BPOL Program consists mostly of libraries and some of them are libraries at colleges and universities. Currently,

we have somewhere in the neighborhood of 200,000 CDs either in inventory or being produced. (This includes a recent order for approximately 97,000 copies).

11. The GAO's testimony noted that many small business owners and self-employed are unaware of the pre-filing services that the IRS currently makes available. Would you consider using public service announcements or other forms of advertising to publicize such services better in the future?

We will continue to use many forms of communication to reach the small business owners and self-employed. We know that many people considering going into business do not have the time to visit government offices to get answers to their questions or find out what forms that they have to file. We will explore new avenues of communication and new forms of technology to provide top quality service to small businesses at convenient times and locations.

The Small Business Corner located on our IRS web site since January 1999 is an example of how we are beginning to provide small business taxpayers with easy-to-access and easy-to-understand information. And in conjunction with the Small Business Administration, the IRS produced a joint small business CD-ROM that provides an array of helpful information for businesses, such as actions to take before starting a business, tax filing and reporting responsibilities.

12. One of our private-sector witnesses, Ms. Sandrs Abalos, suggested that the IRS form two consortiums, one made up of small business organizations and other of tax practitioner groups, to work with the IRS on formulating electronic filing strategies that are effective and efficient for small businesses and IRS. Would you consider implementing such a recommendation?

Yes. We will consider the feasibility of establishing such consortiums in conjunction with similar recommendations that we expect to be in the Electronic Tax Administration Advisory Committee's (ETAAC) June Report to Congress. As required by the IRS Restructuring and Reform Act of 1998, the ETAAC was established to provide guidance regarding the development and implementation of a strategic plan for Electronic Tax Administration (ETA). It is comprised of representatives from various groups including tax practitioners and preparers, transmitters of electronic returns, tax software developers, small and large businesses, employers and payroll service providers, individual taxpayers, state governments, and financial industry members. ETA also receives input from small business organizations and other tax practitioner groups through the Public Liaison's Office which holds periodic forums with interested stakeholders.

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