COMPLEXITY IN ADMINISTRATION OF FEDERAL TAX LAWS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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COMPLEXITY IN ADMINISTRATION OF FEDERAL TAX LAWS

THURSDAY, JUNE 29, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:07 a.m., in room 2167, Rayburn House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Subcommittee on Oversight

FOR IMMEDIATE RELEASE Contact: (202) 225–7601
June 22, 2000
No. OV–21

Houghton Announces Hearing on Complexity in Administration of Federal Tax Laws

Congressman Amo Houghton (R–NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the Internal Revenue Service (IRS) report to Congress regarding complexity in the administration of the Federal tax laws. The hearing will take place on Thursday, June 29 , 2000, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.

The sole witness will be Charles O. Rossotti, Commissioner of the Internal Revenue Service . However, any individual or organization may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

In section 4022 of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA) (P.L. 105–206), Congress required the IRS to report annually regarding sources of complexity in the administration of the Federal tax laws.

Congress instructed the IRS to take into account the following factors in making its report: (1) frequently asked questions by taxpayers, (2) common errors made by taxpayers in filling out their tax forms, (3) areas of law that frequently result in disagreements between taxpayers and the IRS, (4) major areas in which there is no, or incomplete, published guidance, or in which the law is uncertain, (5) areas in which revenue agents make frequent errors in interpreting or applying the law, (6) the impact of recent legislation on complexity, (7) information regarding forms, including a listing of IRS forms, the time it takes taxpayers to complete and review forms, the number of taxpayers who use each form, and how the time required changed as a result of recent legislation, and (8) recommendations for reducing complexity. The report to be presented by the Commissioner is the first annual complexity report to Congress since the enactment of the RRA.

In announcing the hearing, Chairman Houghton stated: "I have long sought simplification of the Federal tax laws. I am hopeful that the Service's first complexity report will highlight the most problematic provisions and lead to possible legislation to reduce unnecessary complexity for taxpayers."

FOCUS OF THE HEARING:

The focus of the hearing will be to discuss the most complex provisions in the Internal Revenue Code as identified by the IRS and possible remedies.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label, by the close of business, Thursday, July 13, 2000 , to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'http://www.waysandmeans.house.gov'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. The hearing will come to order.

Commissioner, we are delighted to have you here.

Before I begin, I want to tell you a story. George Lyman Kittridge was a great Shakespearean scholar at Harvard and he used to stride up and down the platform. One day he fell off the platform and nobody could see him. He brushed himself off and said, "This is the first time I have ever been on the level of my audience."

[Laughter.]

Chairman HOUGHTON. We are trying to have a little more informal attitude here and I hope it will be all right with you, sir.

We are here to discuss, as most of you know, an issue that is near and dear to all our hearts, which is simplifying the Tax Code. One of the most important provisions in the IRS Restructuring and Reform Act that we passed nearly 2 years ago directed the IRS to study and report back to us on the sources of major complexity in the Code.

We get plenty of input from the Treasury and from the Joint Committee on Taxation, but who better to study this issue than you, Commissioner, and the employees at the Service who answer taxpayer questions through TeleTax, customer service call centers, the Internet, and a variety of areas? Who better than the agents who review the millions of errors in tax returns each year?

A provision we pass may make good sense in terms of fairness and equity but may be absolutely unworkable in the real world. We need your help in making the law more easy to understand.

Your first report to Congress focuses on provisions that affect individual taxpayers and small businesses. These are the taxpayers least able to fend for themselves in terms of time and resources. I hope that future reports expand beyond the specific provisions you will discuss today, and I hope that future reports will be expanded to cover other taxpayer groups as well.

You have stated in the report that reducing complexity will reduce taxpayer burden, both in time and money spent, and increase taxpayer compliance. I agree, but I would add that reducing complexity will also restore faith in the tax system. I hope that we in Congress heed the call to keep simplification in mind as we pass tax bills in the future.

I would like to yield to our ranking Democrat, my friend, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

I want to thank you for holding this hearing here today—a very important hearing—and also to welcome Commissioner Rossotti to the hearing as a witness today.

Today's hearing will address the recommendations of the Commissioner's first annual report on tax law complexity. This report was mandated by the IRS Reform and Restructuring Act of 1998. It s completion marks an important milestone in our efforts to implement the law and offers suggestions for making the tax law simpler and more equitable for all taxpayers.

Aside from this report, there are many other proposals before this Committee to reduce complexity in the tax law. Mr. Neal, from Massachusetts and a member of our Committee, has proposed legislation to substitute a simpler method for the alternative minimum tax. With several of my colleagues on this Committee, I have introduced a bill to simplify the capital gains tax.

I am certain that this Committee can work together to consider these various proposals. I hope we can work in a bipartisan manner, which has been the tradition of this Committee, to pass legislation this year that will further the goal of reducing complexity in the Tax Code.

Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you, Mr. Coyne.

Mr. Commissioner?

STATEMENT OF HON. CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE

Commissioner ROSSOTTI. Thank you very much, Mr. Chairman. It is great to be able to see straight across like this. I appreciate that very much.

[Laughter.]

Commissioner ROSSOTTI. I appreciate the opportunity to testify before the Committee on this first annual report on tax law complexity.

I think you have pointed out many times, Mr. Chairman, that the Tax Code has continued to grow in complexity. In fact, over the last 14 years since the 1986 legislation, there have been about 9,500 changes to the Tax Code. Of course, we know there are number of factors that contribute to the complexity. These include a desire to provide tax cuts while limiting revenue losses, a desire to achieve fairness in the tax system, and finally a general growth of complexity in the global economy.

Many of the taxpayers, tax practitioners, and other people that we spoke to when writing and compiling this report have emphasized that sometimes even seemingly small changes to the Code can have serious consequences for taxpayers and the IRS, especially if there are frequent changes and if there is short lead time to implement these changes due to the effective dates of the provision.

Whenever a tax law changes, the IRS must ensure that our systems, training, and employee tools are current and reflect the most current legislation. We must also issue guidance and tax forms covering the changes in time for the taxpayers to file in the next filing season. It is especially problematic when these changes come late in the calendar year when forms and publications for the next filing season may have already been designed.

So I think, Mr. Chairman, before we get to specific provisions, it is worth noting that one of the most helpful things the Congress can do is to provide the IRS with adequate time prior to the statutory effective dates when changes go into effect. I do want to say that the taxwriting Committees over the last year have been really receptive to many of our recommendations in this regard. This was particularly true when we were going through the Y2K Program. In fact, I doubt that we would have been successful with the Y2K Program had we not had a good relationship in working out these effective dates.

I just want to put that on the agenda as a general problem and a general issue that we need to work with the taxwriting Committees on in the future.

With respect our report, which you have seen, it really had three objectives, one replying specifically to the request in RRA 98. We have tried to provide information on such things such as frequently asked taxpayer questions, areas where taxpayers have difficulty in complying with the Tax Code, and missing or incomplete guidance.

Second, the report does describe how we selected and analyzed certain specific areas of the Code for further scrutiny in this particular report. With no pun intended, Mr. Chairman, analyzing the entire Code would have been too complex to do the first time. So instead, we tried to look at the complexity from a taxpayer's point of view. After consulting with numerous experts and others who have looked at this and analyzing our own data, we chose to focus on three particular areas of the Code that in particular affect a large number of taxpayers.

For each of the three areas we selected—filing and dependent definitions, alternative minimum tax for individuals, and estimated taxes—we tried to analyze why those provisions are considered very complex. And then we provided a number of options the Congress might want to consider that would reduce complexity.

I do need to stress, Mr. Chairman, that the options in our report are not recommendations in the full sense as they do not take into account revenue impact or the distribution of revenue, which would have to be considered in any legislation.

But just to note the first one of these—and the one that really affects the most taxpayers—can be seen on this chart over here on the left. This one deals with the first set of provisions of the Code that have to do with definitions of filing status, dependent exemptions, and various tax credits. These tend to go together.

As you can see, there are six different kinds of elections or credits the taxpayers have the option to elect, such as head of household, or filing status, dependent exemptions, and various credits, including the earned income credit and the child credit. These are six different areas. And then across the top there are five different kinds of tests that are applied in the Tax Code to determine eligibility or the status of these elections.

As you can see, some apply in some cases and some apply in other cases. But in addition to that, of course, there are different definitions under these tests. Even where it appears to be the same, such as the age limit, there are different definitions. For example, there is no general age test for dependents or for the education credit. However, for the dependent child care credit, it is limited to qualifying individuals under the age of 13. The child tax credit is limited to those under 17. The EITC applies to qualifying children under 19. And the kiddie tax is under 14. And actually, there are more complications than that.

This illustrates some of the confusing aspects of the varying definitions.

Based on our analysis, we developed a number of options to be considered that would reduce the complexity associated with these inconsistent definitions, such as adopting one definition of the relationship test for dependents and qualifying individuals for tax credits, including the EIC.

The second area that we covered was the alternative minimum tax. This, of course, was created to see that no taxpayer who had substantial economic income avoids a tax liability through the use of exclusions, deductions, and credits. This is a complex provision that has not been indexed for inflation. We estimate that about 27 percent of the taxpayers who now pay the AMT have less than $100,000 in adjusted gross income. If it is not changed by 2005, we would have about 6.3 million AMT payers compared to a little over 1 million today.

Based on our analysis, we developed a number of options that could alleviate AMT complexity. These include calculating the AMT using information that is already on the tax return and possibly repealing the provisions related to married filing separate taxpayers.

The third area, briefly, is the complexity of the taxpayer encountering meeting their estimated tax obligations. Mr. Chairman, as you know, this provision particularly affects self-employed and small business taxpayers, a rapidly growing segment. Some of the options that could be considered here for simplifying would be to make the estimated tax periods standardized and would in each case equal to one-quarter, and perhaps make the filing data 15 days after the end of each calendar quarter. Another possibility would be to keep the safe harbor provisions constant. They have been changing quite rapidly.

I know that is a very brief summary, but I just wanted to mention the three areas that we have covered. We recognize that this does not cover all the areas of complexity by any means, but we hope it is a start in covering some of the more troublesome areas related to Tax Code complexity and providing some options that could be used to reduce undue and unnecessary complexity.

Thank you very much, Mr. Chairman. I would be glad to answer questions.

[The prepared statement follows:]

Statement of Hon. Charles O. Rossotti, Commissioner, Internal Revenue Service

INTRODUCTION

Mr. Chairman, I welcome this opportunity to testify before the Subcommittee on Oversight on the Internal Revenue Service's first annual report to Congress on tax law complexity. The IRS Restructuring and Reform Act of 1998 (RRA 98) requires the Commissioner of Internal Revenue to report annually to the House Ways and Means Committee and Senate Finance Committee on areas of complexity in the Internal Revenue Code (Code). My testimony will summarize the report's major findings.

Background

Few issues have generated as much discussion in recent years as Tax Code complexity. Executive and legislative branch policymakers, as well as taxpayers, have been vocal about the burden that complexity places on taxpayers as they seek to meet their tax obligations, and on the Internal Revenue Service as it works to administer the Code.

Mr. Chairman, many circumstances contribute to the Code's complexity. Complexity is added both knowingly and inadvertently as (1) tax laws are changed, (2) legislative tradeoffs among different policy objectives are made, and (3) the economy and society as a whole become more complex.

The Code's complexity becomes even more burdensome to taxpayers and the IRS when the Code changes frequently or when changes are made effective shortly in the future or retroactively. One of the largest problems that the IRS encounters is short or retroactive effective dates for changes in the tax law. Mr. Chairman, the single most helpful thing Congress can do in this regard is to provide the IRS with adequate time prior to the date statutory changes go into effect. I am pleased to say that the tax writing committees have been receptive to our recommendation in this regard, particularly with respect to provisions that might have jeopardized our Y2K program.

Reducing complexity can alleviate taxpayer burden by cutting the time and costs taxpayers face in meeting their tax obligations, and increase compliance by making those same obligations easier to understand and meet. Reducing complexity will also make it easier for IRS' employees to do their jobs of providing services to taxpayers and enforcing the law.

The IRS tax law complexity report has three objectives. First, to the extent available, the report provides the specific information requested in RRA 98, including frequently-asked taxpayer questions, areas where taxpayers have difficulty in complying with the Code, and missing or incomplete guidance.

Second, it describes how these specific areas of the Code that were analyzed for inclusion in this report were selected. Third, the report analyzes where complexity occurs, and possible options for reducing complexity in filing definitions, the non-corporate or individual Alternative Minimum Tax (AMT), and estimated taxes.

The short-term goal is to respond to the immediate issues suggested in the legislation; the long-term goal is to provide a systematic examination of complexity in tax administration that correlates with both taxpayer burden and taxpayer compliance issues.

Tax Law Complexity: Best Seen Through Both Burden and Compliance

While complexity, burden and compliance are key integrated concepts in tax administration, each is also a stand-alone issue. Burden results from taxpayers spending time and money trying to understand and meet their filing, reporting and payment responsibilities. Complexity adds to that burden when these taxpayers must also determine if and how specific Code provisions apply to them. On the other end of the spectrum, significant reductions in burden, as well as increases in compliance may be driven by a simplification change that affects many taxpayers.

By the same token, noncompliance can result from taxpayers' frustrations with the complexity encountered when trying to obey the law. Individual taxpayers cope with complexity as best they can. Some struggle with it by themselves, while others rely on tax preparation software or paid preparers. Approximately 50 percent of all individual taxpayers use paid preparers to complete their tax returns. At least 33 percent use software.

Complexity also creates opportunities for "gray areas" where taxpayers can take aggressive positions that may or may not be legitimate. For example, this could include the use of conflicting definitions for the same terms or concepts, such as the definition of a child. Taxpayers with children may be eligible for a number of different tax benefits. However the definition of a child may vary among these provisions, and as a result, taxpayers may find that they are not able to claim the same child for dependent exemptions, head-of-household, filing status, child tax credits, the Earned Income Tax Credit (EITC), and other child-related benefits. These same considerations make it all the more difficult for the IRS to enforce the Code consistently and fairly.

This complexity also requires providing additional government resources to carry out all of the IRS' programs, from providing taxpayers telephone and walk-in assistance, as well as easy-to-understand forms and publications, to auditing potentially non-compliant returns. For example, for calendar year 1999, the IRS responded to almost two million taxpayer inquiries related to filing season definitions, yet over three million returns were filed with errors involving filing definitions.

Complexity is also introduced through a variety of sources, including the Code, other federal statutes, regulations, forms, publications, and procedures. In addition, changes in individuals' circumstances can introduce complexity. For example, when two people marry, they must decide which filing status to use to minimize their taxes. They are now dealing with tax system complexity. Divorce creates its own set of complexity considerations.

Complexity is rooted even deeper in the national landscape. In a complex economy and social structure, such as those in the United States, many tax goals can be achieved only through tax provisions that reflect the underlying complexity of the financial transaction or goal. Complexity is frequently introduced as policymakers make trade-offs between simple tax designs and the desire to make the tax system fair and equitable in a fashion that supports social and economic as well as tax policy goals.

The Impact of Statutory Change

At one time or another, legislative changes to the Code have had an impact on all taxpayer segments. When tax laws change, individuals often face uncertainty as to how to comply with the changes. In addition, the inability to stay current with tax law changes has been cited by small business owners and individuals as a primary reason for their use of paid preparers.

Many of the taxpayers, tax practitioners, scholars, and other stakeholders with whom the IRS spoke when researching and writing the tax complexity report, emphasized that even the simplest changes to the Code can have complex and serious consequences for taxpayers and the IRS if the change is frequent and/or has a retroactive or short lead time for the effective date.

Mr. Chairman, let me provide some historical context for this discussion. Since 1986, seventy-eight tax laws have been enacted. The EITC has been changed almost yearly for the past decade. One of the 78 new laws, the Tax and Trade Relief Extension Act of 1998, contained 25 sections of tax changes. Of these changes, 11 were effective retroactively and four were effective within 90 days of the end of the calendar year.

The enactment of provisions with retroactive or short effective lead times also increases complexity. Both the IRS and taxpayers are challenged and frustrated by this situation and both must act quickly to accommodate these changes.

The IRS must ensure that its systems, training, and other employee tools are current and reflect the most recent legislation. The IRS must also issue clear guidance and tax forms covering the changes in time for the next filing season. Especially problematic are changes that come late in the calendar year when the forms and publications for the next filing season are ready to go, or have already been sent to the printers.

Beyond the logistical challenges and the additional costs the IRS may incur, short time frames frequently do not allow the IRS to consult with taxpayers and other stakeholders when developing new forms. This can result in the forms being more difficult for taxpayers to understand or complete than they would be under normal circumstances.

Taxpayers also face the uncertainty that late changes introduce around their current and future tax obligations. With short lead times, both the IRS and taxpayers have little time or opportunity to become knowledgeable about the changes to the Code. This creates additional opportunities for error as well as heightened frustration and conflict.

In addition, because the time between when a tax return is filed and when it could be audited could be from one to two years, taxpayers and IRS employees must also accommodate circumstances where the Tax Code has changed in the intervening time period.

Obviously, time limitations affect our ability to make the systems changes necessary to support the statutory changes I have described. The Taxpayer Relief Act of 1997 and RRA 98 are good examples of statutes with many challenging tax-related changes and short effective date lead times. The following table provides in greater details the extensive changes and effective dates set by recent statutes.

Bill Title and Public Law Number	Date Passed	Number of Sections	Retro-active Over 1 Year	Total Number of Sections that are Retroactive	Effective Date Between Oct. 1 and Dec. 31
Small Business Job Protection Act of 1996 P. L. 104–188	8/20/96	111	12	28	44
Taxpayer Bill of Rights 2 P. L. 104–168	7/30/96	47	0	3	2
Balanced Budget Act of 1997 P. L. 105–33	8/5/97	218	10	24	77
Taxpayer Relief Act of 1997 P. L. 105–34					
Tax Provisions of the Transportation Equity Act for the 21st Century P. L. 105–178	6/9/98	13	1	2	0
IRS Reform and Restructuring Act of 1998 P. L. 105–206	7/22/98	113	2	12	2
Tax and Trade Relief Extension Act of 1998 P. L. 105–277	10/21/98	25	2	11	4

Source: IRS Legislative Affairs

Mr. Chairman, as I mentioned at the beginning of my testimony, I also want to commend the House Ways and Means and Senate Finance Committees for their enormous help, understanding and cooperation on effective dates related to the IRS' Century Date Change project. I seriously doubt that we would have had such a successful Y2K conversion without this excellent working relationship.

Report's Objectives and Scope

For this report, the IRS limited its analysis to provisions of the Code that impact individual taxpayers—both Wage and Investment, and Small Business/Self-Employed taxpayers. The three specific provisions in the Code that we selected for our in-depth review were filing definitions, individual Alternative Minimum Tax (AMT), and estimated taxes.

Filing Definitions

The IRS focused its analysis on inconsistencies in filing definitions because they clearly illustrate how complexity is introduced into the Federal tax return preparation and filing processes.

Numerous definitions are used to determine a taxpayer's filing status and eligibility to claim the dependency exemptions and credits for qualifying individuals. The complexity associated with filing status definitions is reflected in the high volume of contacts IRS receives from taxpayers through customer service calls, TeleTax, and the Internet. Frontline IRS employees also identified definitions for eligibility of credits as a major contributor to taxpayer complexity. Of special interest to the IRS was how relationship tests and income tests, which are used to determine eligibility for credits, can have an impact on complexity.

Based on our analysis, we developed the following options for Congress to consider that would reduce complexity associated with inconsistent filing definitions:

- Adopt one definition of relationship for dependents and qualifying individuals for tax credits including the EITC;
- Use Adjusted Gross Income rather than the modified Adjusted Gross Income for determining eligibility under the Child Tax Credit and Education credits;
- Use one set of income thresholds for the Child Tax Credit and Education credits; and
- Adopt one age criterion for defining a qualifying child.

It is important to note that we have not analyzed the budgetary effects of these options or the others presented in the complexity report or their effects on other policy goals, such as fairness and promoting economic growth. Accordingly, the options should not be considered as policy recommendations. However, we hope that they will at least other ways to simplify the tax system.

Individual Alternative Minimum Tax

The AMT was created by the Revenue Act of 1978 and was intended to ensure that no taxpayer with substantial economic income avoids a tax liability through the use of exclusions, deductions, and credits. The AMT is a complex provision that is not indexed for inflation. As such, the number of taxpayers experiencing the complexity of computing Alternative Minimum Tax Income (AMTI) and paying AMT is projected to increase substantially in the years to come.

Our analysis of AMT included a review of many elements that contribute to the provision's complexity, including the various thresholds and phase-outs that must be considered, the complex mathematical calculations that must be performed, and the linkages that must be made between forms and schedules.

Based on our analysis of the complexity within AMT and a review of proposals made by stakeholders, both inside and outside of government, the IRS developed the following options for enacting or amending legislation that would alleviate AMT complexity. Once again, these options should not be considered as policy recommendations:

- Calculate AMTI using information already on the tax return;
- Repeal the excess AMTI provisions for married filing separately taxpayers;
- Repeal the requirement for recalculation of depreciation; and
- Index exemption amounts and phase-out thresholds for inflation.

Estimated Taxes

Taxpayers face several areas of complexity in meeting their estimated tax obligations. These include complexity in the Code and regulations regarding inconsistent time periods for calculating and remitting the tax and the safe-harbor provisions for high-income taxpayers. These are the areas we focused on in our analysis for this report.

Some of the options that Congress may wish to consider for alleviating the complexity associated with preparing and filing estimated tax returns are:

- Standardize the installment payment schedule with payments due 15 days after the end of the quarter;
- Standardize the payment periods under the annualized method; and
- Keep the high-income safe harbor percentage constant.

Conclusion

Mr. Chairman, in conclusion, I believe that this first report represents an important initial step in identifying, analyzing and explaining some of the most fundamental problems related to tax law complexity and providing options for reducing undue and unnecessary complexity. Although these options should not be considered policy recommendations, we look forward to working with the Administration and Congress to help reduce taxpayer burden related to tax law complexity.

Chairman HOUGHTON. Thank you very much, Mr. Commissioner. Mr. Coyne?

Mr. COYNE. Thank you, Mr. Chairman.

Commissioner Rossotti, in your testimony—as you alluded to—the chart that shows that since 1995 there have been 527 tax law changes and you are required to implement those changes as quickly and as fairly as possible.

What are the most complex of those 527 changes, from your estimation?

Commissioner ROSSOTTI. I don't know that I could answer that off the top of my head, Mr. Coyne. I would have to go back and analyze those changes and get back to you on that.

I think one point to be made is the sheer numbers. It is not just one change, but the sheer combination of them that really causes probably the most difficulty. But if you would like, I can get back to you with an answer.

Mr. COYNE. Just maybe the top three or four most complex.

Commissioner ROSSOTTI. Sure.

[The information follows:]

Because the tax code does not affect all taxpayers in the same way, it is difficult to quantity exactly which of the 527 tax law changes since 1995 qualifies as the "most complex." Generally speaking, for individuals the most complex tax provision is the 1997 capital gains tax reduction which requires taxpayers to apply up to four separate rates to the different components of the taxpayer's net long-term capital gain to calculate their capital gain tax. Part IV of the 1999 Schedule D, which is used for this computation, contains 35 lines entries. Compare this to the pre-1987 capital gains tax which simply excluded a percentage of the taxpayer's long-term capital gain (60% in 1986) and applied the regular tax rates tot he remainder. (Between 1987 and 1996, the tax on long-term capital gains was limited to 28%.)

Another notable area of complexity is the multiple benefits provided for education. These benefits include education IRAs, two different credits for college expenses, exemption from tax for qualified stat tuition programs, and the deduction for interest on education loans. While none of these provisions in and of itself is that complicated, the total of these benefits and the rules for coordination between benefits can be overwhelming. Pub. 970, Tax Benefits for Higher Education, which attempts to provide an oversimplified explanation of these benefits, contains more than 15 pages of text.

Mr. COYNE. How does your report recommend, for instance, that the capital gains be simplified? Do you have any recommendation?

Commissioner ROSSOTTI. In this particular report, we did not address the capital gains provisions—not that that isn't one that could be subject to analysis—and I would hope that in future years we could perhaps include capital gains as one of the provisions. Because of the limitations of time and the enormity of the tax code, we thought it would be more effective to pick certain areas this year and try to provide some analysis for those. We are not claiming those are the only complex areas.

We did not analyze capital gains, although certainly that is a complex area.

Mr. COYNE. Do you hold out hope that there might be some salvation for being able to simplify capital gains filing?

Commissioner ROSSOTTI. I really don't know, Mr. Coyne. I think what we can do, as we go on each year, is add additional analyses for different provisions. I certainly have heard from many people that capital gains is one that we ought to analyze. So we can certainly put that high on our priority list for next year.

Mr. COYNE. Has the statutory requirement for tax complexity analysis, as required by the Reform Act of 2 years ago—has that been effective?

Commissioner ROSSOTTI. Of course, there haven't been too many major tax changes since that was put in, so I think we will have to wait and see. I know we have worked with the Joint Committee on every significant tax provision and have provided information through the Joint Committee to the taxwriting Committees on the impact of proposed changes. I hope that those have been helpful to the members as they have considered these provisions.

We have conformed to the requirements of the law and have provided that analysis in working closely with the Joint Committee. But of course, there hasn't been too much in the way of tax legislation yet, so we will have to wait and see how effective that is.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Ms. Dunn?

Ms. DUNN. Good morning, Mr. Rossotti. It is nice to see you again.

I have been trying to simplify the Tax Code for you by eliminating a whole class of taxes, the estate tax. We succeeded in passing that in the House of Representatives, which is now before the Senate.

Some of the alternatives are based on an effort to increase the exemption for family held businesses and farms and estates. I don't mean to shanghai you on this—and maybe it is something you would like to answer in writing—but I have great concerns about that way to approach the relief of the death tax because it seems to me that the work that we did in 1997 to define a family held estate created such a narrow spectrum of possibilities that only between about 3 and 5 percent of family held businesses were even able to take advantage of it.

So I believe it is deceptive for some to say now we are going to increase the exemption based on that same description.

I was wondering if you had any thoughts on this, if you know about that.

Commissioner ROSSOTTI. I would have to say I would have to get back to you. Not because it isn't complex, but only because we had limited resources, we did not cover any estate tax provisions in this report. So I don't have any data right now to really answer your question. But I would be happy to get back and try to get with your staff.

Ms. DUNN. Perhaps I can put it in writing.

Commissioner ROSSOTTI. Sure. We will attempt to do that.

Chairman HOUGHTON. I have a couple of questions here. The first is pretty broad, and that is really the working relationship between the IRS and Congress. Where do you see Congress really helping—within the next year—us make a dent in this complexity issue? Where do you see us working with you on this?

Commissioner ROSSOTTI. In my statement, I made a couple of points. On any provisions that the Congress chooses to change—hopefully in the direction of simplification, but for perhaps other reasons as well—I think the kind of relationship we had as we were going through the Y2K change, where we really had good conversation as these provisions were being considered is important.

There are two points, really. One is as required by the law, and through the Joint Committee we do provide an analysis of the complexity and the impact on tax forms and things like that. That would be our opportunity to provide that input to the Congress. Then the other extremely important one is just the timing of these things, which I mentioned in my statement.

Those are two very practical things. I think we have a channel to work with and if we can maintain that and improve it, I think it would be extremely good for everyone.

Of course, the other one is that we do have this report and we have laid out some possibilities there. We will again have a report next year in the early part of the year that will build on this. Based on the comments we get in this hearing and from other stakeholders, we will expand into other areas of the Code—as you suggest in your opening statement—to analyze additional areas of complexity. We hope that those would be helpful to the taxwriting Committees in considering ways that the Committee could reduce complexity in the Code.

Those would be my two major suggestions.

Chairman HOUGHTON. Moving more toward the administrative rather than the legislative route, and picking up on something Mrs. Dunn was talking about, small businesses.

I understand that there are upward of 200 requirements, forms, and reports for small businesses. It seems like an awful lot. I can't put a figure on it, but it is just sort of a gut feeling that it is wrong. I wonder whether there are things you can do administratively, rather than having to go through the legislative process, to help with that.

Commissioner ROSSOTTI. I think there is. This is one of our real priorities. As you know, part of our whole modernization plan is to set up a whole division that will be dedicated to small businesses and self-employed individuals. A major part of their mission is just going to be focusing on working with small business taxpayers, identify what we need to do to make life simpler for them, and to also educate them because there is a minimum that has to be done to comply with the Code.

Some of the things we have done already—and there is more we can do—we took about 2 million taxpayers out of the need to provide what are called tax deposits. These are usually monthly forms that you fill out with employment taxes. It used to be that if you had more than $500 per quarter—which is a very small number in today's economy—you had to file these. We were able to administratively, with the help of Treasury, to increase that to $1,000 a quarter. That doesn't sound like much, but it took 2 million businesses out of that whole thing entirely.

So we are looking at those kinds of options. That is already done and there are other possibilities like that.

Another approach that we are trying to take is to package things. As you mentioned, the 200 plus—and if you take a big book like this and hand it to somebody it is hard to figure out what applies to you and what doesn't. A lot of things don't really apply, but you don't know which ones apply. So we are trying to package them to make them easier.

One of the things we have done, working with the Small Business Administration, is to come up with a CD-Rom that has been quite positively received. It has all the information on it looked at from a small business point of view. First of all, it is all there in one place and you can search it and it points you down to what is really applicable to you.

Your question is very, very much on target and is really a whole strategy that we have. There is no one solution that I am aware of that magically solves it. But I believe if we keep working on it and working with the small business community and the self-employed individuals we can definitely reduce that burden.

One of the areas that we covered in our report has to do with estimated taxes. One of the reasons we picked that one out is because that one does affect self-employed individuals and small business owners in particular. It is important for people to pay taxes as you go, but we think that is an area that potentially could be simplified in terms of how it is implemented to make it easier for people. That is one of the most common places that self-employed individuals go wrong and get into penalty situations.

I am just summarizing some of the areas, but I certainly agree with your point and I think it is something, if we keep working on it, we can over time make a dramatic difference in the ease with which small businesses and self-employed people can comply with the Code.

Chairman HOUGHTON. Thank you very much.

Mr. Coyne?

Mr. COYNE. Thank you, Mr. Chairman.

Commissioner, I commend you in taking on the problem of the complexity of the earned income tax credit through standardizing criteria for a qualifying child and adopting one definition of relationship for dependents and qualifying individuals.

Can you tell us to what extent this could serve to reduce errors in the EITC Program?

Commissioner ROSSOTTI. I don't have any way to quantify it precisely, but I can tell you that the whole area of people putting down an individual as a qualifying child and having it be incorrect is the most common error that occurs. As you can tell from the complexity of the definitions and the fact that those definitions are different from what you need to qualify for an exemption, there is certainly an understandable reason why there would be errors in that.

And by the way, people also make errors without the EIC in terms of their dependents. It seems to the average person that these are all the same thing. But according to the Tax Code, they are not the same thing.

It is a complex area to figure out how to solve, but I would certainly say if you had to pick out one area that affects the largest number of taxpayers, these things that are on this chart—to the extent they could be simplified, it would make a big difference.

To give you an example, here is a booklet that we put out that is pretty popular, a common thing that people use, similar to what is in their tax forms. The first part explains how to fill out your 1040 return. If you look at this, there are about 13 pages here just in the beginning that cover just the first two rows on there, which is the filing status and the dependent exemption.

There is a flow chart. This is to determine if you can take someone who lives in your house—your son or your daughter or anyone who lives in your house—as a dependent. This is pretty complicated for the average person to do, and it is the average person that is doing this.

This is why we highlight this area in our analysis. Certainly from the point of view of our employees, from the point of view of our hot line, and from the point of view of the phone service, this is the area we get the most questions on, and that we get the most errors on. It is perfectly understandable if you just leaf through the first 13 pages here to tell someone what seems like a simple question.

Can I take my niece that lives with me as a dependent? That sounds like a simple question, but you have to wade through quite a bit of information to try to find the answer to that question.

I think that if we could find a way over time to combine these things and simplify them to make a standard definition, it would without question reduce the burden on individual taxpayers and reduce the number of errors that we have to work with taxpayers on.

Mr. COYNE. You have a report that is due relative to the earned income tax credit. I think you told us at one time that it might be due out by the end of the year.

Commissioner ROSSOTTI. Yes. I hope that will be the case. We are working on that now.

Mr. COYNE. You are still hoping that it could come out before the end of this year?

Commissioner ROSSOTTI. Yes.

Chairman HOUGHTON. Ms. Dunn?

Ms. DUNN. No questions, Mr. Chairman.

Chairman HOUGHTON. Mr. McDermott?

Mr. MCDERMOTT. I have no questions, Mr. Chairman.

Chairman HOUGHTON. Commissioner, you may or may not know this, but I introduced a bill in Congress that seeks to reduce the burden on taxpayers, the same recurring theme. As your report did, my bill focused on tax provisions affecting individuals and small businesses. The bill addresses ways to simplify AMT, estimated taxes, and things like that. It also proposed replacing the current capital gains tax regime of the 50 percent, exclusion from income, raising the gross receipts exemption, broaden the exemption so that more small businesses could avoid the burdensome uniform capitalization, and reducing recordkeeping requirements.

I wonder if your agency had any response to that. Did they develop any other options?

Commissioner ROSSOTTI. We have not specifically analyzed both provisions, Mr. Chairman. I think that certainly we could look at them, as with the legislation we are required to do, and provide tax estimates of what it would do to reduce complexity.

As I mentioned in answer to Mr. Coyne's question, capital gains, in particular, is one area that we know has complexity. I think it would be high on our agenda for next year to analyze. We just didn't get to it for this particular year.

Some of the things, such as reducing recordkeeping requirements and getting rid of records—those kinds of things are practical issues that would probably be very helpful.

I will mention one thing. On July 17th, next month, as a follow-up to this and in preparation for next year, we are actually sponsoring with OMB a Tax Complexity Forum in Washington. We have asked a lot of stakeholders who represent small businesses and practitioners to come in and, having looked at our reports the first time, give us additional input as to what we could do next year.

At that meeting on the 17th—and we would be glad to provide you more information about it—it would be an opportunity to get some input on a variety of additional proposals and ideas that haven't yet been considered in our report.

Chairman HOUGHTON. I have another question for you. We have talked about this before, but I am still fascinated with the whole concept of training.

There are so many changes in the tax laws and regulations. How do you keep abreast of this in training your people?

Commissioner ROSSOTTI. As I mentioned in my statement, this is probably our number one issue. It is interesting. It isn't even the complexity of the Code that is the hardest problem, it is the change in the Code. Many of our practitioner friends and colleagues tell us this over and over again, that even when there are simple changes—people do adjust to the Tax Code over time because they take last year's return. I figured it out last year and my situation doesn't change that much from year to year. They kind of get used to it.

When you interject significant changes—or sometimes even insignificant changes—the education process, both for our own employees and for taxpayers, is a major challenge. Then, of course, you have all the computer software and computer things like that that have to be done.

So the rate of change is without a doubt one of the greatest challenges in tax administration. We have a whole process in our organization, because we know that there will be changes. But the faster they come and the shorter the lead time, the more difficult it is.

Chairman HOUGHTON. Well, that's not a bad record for a hearing, is it?

Commissioner, just one final point. You obviously have nothing to do with the writing of the Tax Code, but obviously the IRS can play a very important role in alleviating some of the Tax Code complexities. We look forward to working with you.

Commissioner ROSSOTTI. Thank you.

Chairman HOUGHTON. We thank you very much for being with us here.

[Whereupon, at 10:37 a.m., the hearing was adjourned.]

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