IRS COMPLIANCE WITH THE REGULATORY FLEXIBILITY ACT

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

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HEARING ON IRS COMPLIANCE WITH THE REGULATORY FLEXIBILITY ACT

THURSDAY, MAY 1, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
Washington, D.C.

The Committee met, pursuant to call, at 9:36 a.m. in Room 2360, Rayburn House Office Building, Hon. Donald Manzullo [chairman of the Committee] presiding.

Present: Representatives Manzullo, Toomey, Graves, Velazquez, Millender-McDonald, Napolitano, Majette.

Chairman MANZULLO. I will call the Committee to order.

On March 19, 2002, the President stated that, "Every agency is required to analyze the impact of new regulations on small businesses before issuing them. That is an important law. The problem is it is often being ignored. The law is on the books. The regulators do not care that the law is on the books." This sounds like something I would say. "From this day forward, they will care that the law is on the books. We want to enforce the law."

The President was talking about the Regulatory Flexibility Act or the RFA. The statement was categorical and applied to all agencies. There was no exception for the Department of the Treasury or the IRS in his statement.

Rather than viewing the RFA as a hurdle to be jumped or avoided, we believe the Service should view the RFA as a place where to explain in understandable terms the rationale and economic consequences of its regulatory actions. Furthermore, the President's tax relief package is seeking long-term economic growth and must assist the manufacturing sector to achieve that outcome. The IRS can help achieve that objective by embracing the letter and spirit of the RFA to reduce regulatory burdens on the already overburdened small manufacturing sector.

Rather than embrace the changes in SBREFA, the IRS and the Department adopted new interpretations to avoid compliance with the RFA. President Bush stated, "From that day forward the regulators will care." Since then, this Committee has held a number of hearings, and while improvement are being made there are still too many regulators out there that do not care despite the bold statement from President Bush and the superb efforts of Dr. Graham and Tom Sullivan.

If problems persist and the President's call continues to be ignored, this Committee is ready to work with the Committee on the Judiciary to make the necessary changes in the RFA that will close

loopholes and empower the Office of Advocacy to prevent non-compliance with the RFA.

[Mr. Manzullo's statement may be found in the appendix.]

Chairman MANZULLO. I now recognize the Ranking Member of our Committee, the distinguished gentlelady from New York, for her opening statement.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Small businesses in America today face many challenges to success. One of the biggest is understanding and complying with the overwhelming array and number of federal regulations. It is unfortunate that the burden of the federal regulations weigh most heavily on small businesses.

As the engine of the American economy, small businesses are key to our economic recovery. It is now more critical than ever that small businesses spend less time complying with regulations and more time focusing on growing their business.

The federal compliance price tag for small firms is high. It has reached nearly $7,000 per employee per year. That is 56 percent higher than large firms with 500 or more employees. In terms of tax compliance, the difference between costs to large and small firms is even more pronounced. The cost per employee for small businesses topped the cost for large firms by 114 percent.

One of the greatest costs stems from complying with the Internal Revenue Code and its myriad of rules and regulations. The primary reason why small businesses have to use so much of their resources to comply with the Tax Code is due to its sheer complexity. Unlike larger businesses, small businesses are at a real disadvantage. They often do not have the resources to analyze and deal with the intricate issues and requirements.

Rather than try to correct this problem, the IRS has instead passed more rules and regulations. As with many other agencies, the IRS has continuously failed to address the impact the rules and regulations have on small businesses. As a result, small businesses are left to outsource their complex tax work, which is extremely costly.

Today's hearing will address how the IRS has failed to meet its obligations under the one statutory tool designed to protect small businesses from departments and agencies that unfairly burden them, the Regulatory Flexibility Act.

Reg Flex is designed to make sure the IRS and other federal agencies address the needs of small business when they issue rules and regulations. The Reg Flex Act requires federal agencies to assess their proposed and final rules and determine whether they will have a significant economic impact on small businesses and examine less burdensome alternatives if that is indeed the case.

Despite the fact that the IRS is the agency responsible for the highest regulatory costs impacting small businesses, it has been the worst violator of applying Reg Flex analysis. The IRS systematically avoids the statutory requirements of Reg Flex by using interpretive loopholes. In 1996, Congress sought to close some of those loopholes, only to find the IRS created other ways to bypass Reg Flex.

It appears we are going to have to close these loopholes before the IRS finally addresses the needs of small businesses. One way to make sure the IRS complies with Reg Flex is to amend it so that

the IRS is held to the same standards as the EPA and OSHA. In 1996, we required that these two agencies have representatives of small entities who may be affected by the rules make statements through a review kind of process.

By putting the IRS under the same review panel process, it will better ensure that small businesses have a voice in the creation and execution of federal regulations that might harm them. It will force the IRS to account for the huge burden they have placed on small businesses. There is clearly an institutional and maybe cultural problem within the IRS that requires fixing.

Since the IRS has failed to comply with Reg Flex in the past, adding them to the list of agencies that must go through the panel process is one way to make sure that they do so in the future. Only then can we begin to help free small businesses from the burdensome and heavy costs associated with IRS regulations.

Thank you, Mr. Chairman.

[Ms. Velazquez's statement may be found in the appendix.]

Chairman MANZULLO. Thank you. Let me add a footnote to my opening statement.

This Committee has had an extremely close relationship with former Commissioner Rossotti. On three occasions I think he went beyond what Reg Flex did, especially on working with us on the regulations on the Hope Scholarship. Those of you from the IRS may recall the extraordinary efforts of his finessing those regulations over a period of four years until we could work out legislation.

As a result of Mr. Rossotti's direct intervention and concern, a congressionally mandated reporting form, which would have cost the 6,000 colleges, universities, technical training schools and community colleges in excess of $100 million a year, because of his personal intervention that amount of money is saved.

I know that was congressionally mandated. It was the words that came from us. It was given to him, and he and I agreed that if the full effect of those words had been put into effect it would have cost that much more money for reporting, but, because he was very sensitive to the problem, we worked with him to a tremendous conclusion, and also the same with the accrual basis for small business people. There has been no greater advocate than Charles Rossotti to increase dramatically the limits for accrual.

Our purpose here is to continue this very close relationship with the IRS and to work on a formal basis with the RFA and obviously continue our informal basis.

With that segue, I look forward to our first witness, Pamela Olson from the IRS. Mrs. Olson?

STATEMENT OF THE HONORABLE PAMELA F. OLSON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Ms. OLSON. I am actually from the Treasury Department.

Chairman MANZULLO. I am sorry. Forgive me.

Ms. OLSON. Mr. Chairman, Ranking Member Velazquez and Members of the Committee, I am pleased to be here today to discuss the efforts of the IRS to reduce the burdens of tax compliance on small businesses and the Regulatory Flexibility Act.

I did submit formal testimony, which is a little bit longer than the statement that I am going to make. I would ask that that be included in the record. Thank you.

The entire administration, including the IRS and the Department of the Treasury, is committed to working closely with the small business community and its representatives to help small businesses and the self-employed understand their tax obligations and reduce their compliance burdens. We believe our record bears out this commitment.

Nevertheless, there is always room for improvement. We appreciate the efforts of this Committee and the Small Business Administration, particularly the advocate, Tom Sullivan, who is here with us today, to keep the burdens of complying with the laws at the forefront of our consideration as we write the regulations that carry out the laws of Congress.

The newly restructured IRS is built around four organizational units with end-to-end responsibility for serving specific groups of taxpayers. One of these units is the Small Business and Self-Employed Operating Division, which serves the approximately 7,000,000 taxpayers that are small businesses. This division exists because the IRS recognizes that small businesses have unique issues that could be given short shrift unless a specific operating division was devoted to them.

In addition, because the IRS recognizes that these taxpayers may lack the financial resources to understand and address these unique issues, one of the primary focuses of the Small Business Division is to work with small businesses to teach them about their federal tax responsibilities and to develop less burdensome and more practical means of compliance.

The Small Business Division has also assumed an important role in reviewing IRS regulations to ensure that they minimize, consistent with the requirements of the laws enacted by Congress and sound principles of tax administration, the burdens placed on small businesses.

We are extremely pleased that last December the Small Business Administration presented the IRS with its 2002 Agency of the Year award. SBA recognized Small Business' Taxpayer Education and Communication organization for its outstanding progress in creating an effective education and compliance assistance program for small businesses and the self-employed. We are committed to continuing this record of achievement in serving the small business community.

The IRS continues to expand the ways it communicates with small businesses. For example, in 1999 the IRS initiated the Small Business Corner on the IRS Internet site. The goal of this type of convenient, one-stop shopping is to provide virtually all of the products and services that a small business needs to meet its tax compliance responsibilities.

The IRS has also initiated a comprehensive taxpayer burden reduction initiative. The Service wide Taxpayer Burden Reduction Council develops, coordinates and champions cross-functional or Service-wide burden reduction projects. Small business taxpayers participate in the IRS Industry Issue Resolution Program, which includes taxpayer burden reduction as a program criterion.

Recently implemented burden reduction projects benefiting small businesses include exempting 2.6 million small corporations from filing Schedules L, M–1 and M–2, reducing burden by 61,000,000 hours annually. The IRS has also streamlined many of its procedures to make compliance less burdensome for small business taxpayers.

It is the long-term and continuing goal of the IRS and the Treasury to ease the burden of small businesses to the greatest extent practical, consistent with the laws as enacted by Congress. We look forward to working with this Committee as we continue those efforts.

Minimizing taxpayer burdens, whether for small businesses or other taxpayers, is a paramount objective of the regulations and other guidance issued by the IRS. Unfortunately, our tax laws have become devastatingly complex in recent years. That complexity threatens to undermine taxpayer confidence in the system as people come to view the system as one that encourages aggressive tax planning by those with the resources to hire sophisticated planners.

We view a system that puts people to the choice of being a cheat or a chump as inherently unstable. It is essential that we simplify the tax laws wherever and whenever we can. Just as importantly, we must refrain from making the system any more complicated than it already is.

It is important to emphasize that tax regulations and other guidance are themselves means by which taxpayer burdens are reduced. Regulations, rulings and notices serve to make clear how the tax laws enacted by Congress apply in real life situations faced by businesses, including small businesses, as they plan their affairs and file their tax returns.

The business community desires and needs such guidance. Without it, the law would remain unclear, and businesses would be forced to make their best guess with the consequence being an IRS audit and additional taxes if the guess is wrong. With regulations in place, the guesswork and the potential for an audit is significantly reduced. Certainty—knowing how the IRS will interpret and apply a law written by Congress—is the most efficient and effective way to reduce the burden of small businesses complying with the tax law.

In developing tax guidance, Treasury and the IRS actively seek input from interested parties, including small business, and endeavor to offer as many opportunities as possible for interested parties to participate in this process. In almost all situations, the IRS issues proposed rules for public comment. The same is often done for draft revenue procedures.

When public comments raise new issues, we often issue a second notice of proposed rule making. Treasury and IRS carefully consider all comments received from the public, and we revise proposed rules to minimize burdens and simplify compliance whenever possible, consistent with principles of sound policy and tax administration.

In this context, it is important to remember that IRS regulations do not make the laws that apply to small businesses or any other taxpayer. Congress does that by amendments to the Internal Rev-

enue Code. The role of IRS and Treasury is to interpret and apply those laws. In that way, tax regulations differ greatly from regulations issued by other regulatory agencies. We provide taxpayers with the guidance they need to comply with their obligations under the Internal Revenue Code as enacted by Congress.

Providing timely, comprehensive and understandable guidance to taxpayers reduces controversy, eliminates disputes and provides taxpayers with certainty concerning their obligations under the Tax Code. Just as important, clear IRS regulations and guidance minimize the likelihood that there will be contact between IRS and taxpayers. Without this guidance, compliance obligations would be established through burdensome taxpayer audits and costly litigation.

Audits and litigation are an ineffective and inefficient means of interpreting the law. For example, several years ago the IRS was devoting significant audit resources to examining the use of the cash method of accounting. This was an issue on which I last appeared before this Committee as a private sector participant, an officer of the ABA section of taxation to talk about the burden and the Treasury's authority to change those rules by regulation. This is one of the most heavily litigated tax issues.

I am pleased to say that a year ago we issued a final revenue procedure that expressly permits certain businesses with gross receipts of less than $10 million to use the cash method of accounting. We provided tremendous clarity and wiped an issue off the table for the small business community. We expect that the revenue procedure will eliminate most disputes concerning the use of the cash method by small business taxpayers.

This example illustrates what may be a unique feature of tax regulations in that they interpret statutory tax obligations, but do not impose tax obligations. That is, the statutory requirements take effect, taxpayers must comply with them, and the IRS must enforce them.

In the absence of regulations, the IRS must still enforce the law, and it will do so without the benefit of the interpretive guidance that the regulations provide. The result is likely to be increased cost and burden for taxpayers if regulations are not issued or are not issued on a timely basis.

The Department of the Treasury and the IRS fully support the objectives of the Regulatory Flexibility Act. In 1996, when Congress amended the RFA to make it applicable to interpretive regulations, the IRS took those into account to the extent that those regulations impose a collection of information on small entities consistent with the language of the statutory amendment.

This amendment, which Treasury worked with the Congress to develop, recognizes two important elements of tax regulations. The first is that provisions of the Internal Revenue Code as enacted by Congress must be applied equally to all businesses regardless of whether they are a large, multi-national corporation or the small business down the street. The second is that paperwork burdens imposed by regulations that effect small businesses must be carefully considered by the IRS and minimized to the maximum extent the laws written by Congress allow.

The 1996 amendment made the RFA applicable to an interpretive regulation when that regulation is subject to review and approval by OMB under the Paperwork Reduction Act of 1995. That means the IRS must prepare a regulatory flexibility analysis for any rule that imposes a collection of information on small businesses unless the IRS certifies that the collection of information will not have a significant economic impact on a substantial number of small businesses.

Treasury and IRS take their responsibilities under the RFA very seriously. Indeed, every IRS regulation is reviewed by three different offices for compliance with RFA, as well as the other laws in Executive Orders that govern the regulatory process.

Chairman MANZULLO. How are you doing on time?

Ms. OLSON. Not well, so I am going to turn to mobile machinery.

Chairman MANZULLO. I gave you a double dose there because the IRS usually gets a double dose in the press.

Ms. OLSON. And I have used it up anyway.

Chairman MANZULLO. That is correct.

Ms. OLSON. I apologize.

The two regulations which you specifically cited in your letter relate to mobile machinery and interest reporting by banks. The first concerns excise taxes on certain motor vehicles, which was issued in June 2002.

Under current law, various excise taxes are imposed to provide revenues to fund the Highway Trust Fund. Those statutory provisions are broadly written, applying to virtually all vehicles and fuels for those vehicles that are capable of traveling on highways. The IRS defines a highway vehicle as any self-propelled vehicle, trailer or semitrailer designed to perform a function of transporting a load over public highways, whether or not it is also designed to perform other functions.

The regulations, and not the statute, exempt from those taxes vehicles that are in essence mobile machinery mounts. The exception was apparently based on the assumption that vehicles that transport mobile machinery would make minimal use of public highways and, thus, would receive only minimal benefit from highway construction and maintenance.

This broadly written exception, however, was the source of much dispute between taxpayers and the IRS. These factual and definitional disputes are draining on taxpayer and IRS resources. We concluded that the issue was better resolved through specific guidance in order to reduce the number of disputes and provide certainty.

The proposed regulations were developed with that goal in mind. We are aware that the proposed regulations were controversial and have advised that they will not be finalized until the Congress completes its work on the Highway Trust Fund reauthorization. We have been advised that we will be provided guidance through the legislative process.

I think I better conclude with that since I am already a minute over time.

Chairman MANZULLO. Actually, you are six minutes over time, but that is okay.

Ms. OLSON. I am sorry. I thought I had 10 minutes.

Chairman MANZULLO. We try to keep it to five.

Ms. OLSON. I am sorry.

Chairman MANZULLO. That is okay. It was interesting.

[Ms. Olson's statement may be found in the appendix.]

Our next guest is Dr. John Graham with the OMB, the head of OIRA.

Doctor, you may not realize it, but there are numerous travel agencies in this country that owe the ability to get the emergency loans as a result of 9/11 as a result of a hearing that we had here with you and Hector Baretto on increasing the size standards for that.

I want to thank you for personally intervening in that situation on something that had been stuck in the bureaucracy. You and Mr. Baretto I think cleared the whole thing up in about 10 days, so I appreciate that very much.

We look forward to your testimony.

STATEMENT OF JOHN GRAHAM, PH.D., ADMINISTRATOR, OIRA, OFFICE OF MANAGEMENT AND BUDGET, WASHINGTON, DC

Mr. GRAHAM. Thank you, Mr. Chairman and Members of the Committee.

On the travel agent issue, although I would like to take some credit for it, I think we know this Committee had a pretty substantial role in that effort.

I would like to keep my oral remarks very brief. I just want to lay out a few points about OMB's responsibilities in the area of protecting small businesses from unnecessary paperwork burdens and, in particular, explain the role of the Paperwork Reduction Act as it works in sync with the Regulatory Flexibility Act.

The Paperwork Reduction Act defines a key term called a collection of information. People have in their mind when they hear 'collection of information' that that might be a paperwork burden, and that it does cover all reports that people, the public and businesses, have to give to the government, but it is a broader term than that in the Paperwork Reduction Act.

Collection of information also includes record-keeping requirements, even if you do not have to give that information to the government, and third-party reporting requirements when the government says business, for example, must give information to this other person over here; for example, a food label for consumer benefit. All of these are covered in a broad definition of an information collection.

Now, why am I boring you with this notion of an information collection? I have a feeling that there may be some questions and answers on this subject. I want to make sure we all are grounded in what is meant in the Paperwork Reduction Act.

The reason it is important is the Paperwork Reduction Act says the federal government is not allowed to collect information from people, without going through a very specific process that involves agency deliberation and OMB review. The OMB review process requires ultimately an OMB Control Number on every one of these collections. This is an attempt to manage in some sense what we all know is an extremely difficult thing to manage, the total overall

amount of information being collected from the American people and businesses.

The Paperwork Reduction Act requires an initial approval from OMB for every one of these collections, but also requires OMB approval every three years if the agency wants to continue these collections. The test in the Paperwork Reduction Act does not require that we eliminate all paperwork. It requires that we eliminate unnecessary paperwork.

Since a lot of the functions of government, whether it be in the administration of the Food Stamp Program or whether it be in a grant application at a university, requires paperwork, so the effort is to balance the need for the information against the burden that it imposes on the public.

The Paperwork Reduction Act, particularly the 1995 amendments, are very cognizant of the unique burdens on small businesses, and it specifies specifically that, to the extent practicable and appropriate, the burden on small businesses shall be reduced.

O.M.B. recently reported to Congress our fiscal year 2003 annual report on this information collection problem. We analyzed how well the agencies are doing. We devoted a specific chapter to the work of Treasury and particularly IRS, and I urge you to take a peek at that because there actually is a lot of good news happening within Treasury in reducing these unnecessary paperwork burdens.

We have also tried to develop progress in reducing what are called paperwork violations. This is when agencies ignore the process I just described to you, and impose burdens and collect information without OMB approval. We are trying to have a zero tolerance policy on these violations, and a recent GAO testimony before the House Government Reform Committee documented some of the progress we are making there.

I think sooner or later we are going to have a dialogue here on the subject of whether the Regulatory Flexibility Act applies in certain circumstance, and I hope in my oral testimony I have just given you a little background on how the Paperwork Reduction Act works. Then we can combine that with later testimony on the Regulatory Flexibility Act.

Thank you very much.

[Mr. Graham's statement may be found in the appendix.]

Chairman MANZULLO. Thank you, Dr. Graham.

Our next witness is Tom Sullivan, Chief Counsel for Advocacy for the U.S. Small Business Administration.

Mr. Sullivan, I look forward to your testimony.

STATEMENT OF THOMAS SULLIVAN, CHIEF COUNSEL FOR ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Mr. SULLIVAN. Good morning, Mr. Chairman, Congresswoman Velazquez, Members of the Small Business Committee. Thank you for the opportunity to testify this morning.

I do have a somewhat lengthy written statement, but I would like to summarize it orally.

Chairman MANZULLO. All of the written statements of the witnesses and any Members of Congress will be made part of the total record without objection.

Mr. SULLIVAN. Thank you, Mr. Chairman.

Congress established the Office of Advocacy to represent the views of small entities before federal agencies and Congress. The Office of Advocacy is an independent entity within the SBA, so the views expressed in this statement may not reflect the views of the administration or the SBA. My statement was not circulated within the administration for comment or clearance.

Before I address IRS compliance with the RFA, I want to give credit for the accessibility and responsiveness of the administration officials testifying here this morning. I believe Small Business has a friend in both Dr. Graham and Assistant Secretary Olson. My office works with Dr. Graham and the desk officers in the Office of Information and Regulatory Affairs every day.

Since Assistant Secretary Olson assumed her present role, she has gone out of her way to seek out and listen to the concerns of small business. In addition to her schedule as the President's lead tax adviser, Pam Olson reaches out to small business groups and maintains an open door policy for stakeholder involvement.

Even in the midst of finalizing the President's Jobs and Economic Growth Plan, working to confirm and then acclimate a new Treasury Secretary and working with a new IRS commissioner, Assistant Secretary Pam Olson has been responsive to me and to my office.

The premise of the Regulatory Flexibility Act is that an agency must undertake a transparent and careful analysis of its proposed regulations with specific attention to the small business community to identify their impact on small businesses and develop alternatives to reduce or eliminate the small business burdens without compromising the public policy objectives of the proposal.

In our view, Treasury and IRS have drawn the requirements of the Reg Flex Act too narrowly, thereby limiting meaningful open analysis intended by Congress in the Reg Flex Act and its amendments which are the Small Business Regulatory Enforcement Fairness Act, SBREFA.

The Office of Advocacy believes that the collection of information standard was established to trigger the requirements of the RFA, not to limit the scope of the analysis to be performed.

The Chairman of the Judiciary Committee, when SBREFA was passed, said, "The intent of this phrase, 'collection of information', in the context of the RFA is to include all IRS interpretative rules of general applicability that lead to or result in small entities keeping records, filing reports or otherwise providing information to IRS or third parties.

"One of the primary purposes of the RFA is to reduce the compliance burdens on small entities whenever possible under the statute. To accomplish this purpose, the IRS should take an expansive approach to interpreting the phrase 'collection of information' when considering whether to conduct a regulatory flexibility analysis." End of the quote from Chairman Hyde.

As the Office of Advocacy stated in our annual report to Congress this past January, IRS has often taken the view that unless a form is required, no record keeping requirement is imposed by the rule. We believe that this approach is a root problem in two rule makings last year.

In one of those rulemakings on the excise tax's definition of highway vehicle, which we call the mobile machinery rule, IRS did not analyze the rule making because the proposals "do not impose on small entities a collection of information requirement," according to the published preamble of the proposal.

The Office of Advocacy respectfully disagreed with IRS' original rationale, and ultimately under Assistant Secretary Pam Olson's leadership Treasury rethought how their proposal would impact small business, and we believe this realization would have happened earlier if IRS had more thoroughly and publicly analyzed small business impact.

In those cases where the IRS feels that they are constrained by the law to structure their regulations in a certain way, and it is apparent that the structure will have a significant economic impact on a substantial number of small entities, we still believe that there is value in assessing the impact in an open and transparent process of that structure on small business. We also feel that considering alternatives could help them reach the same public policy goals, but in a manner less burdensome to small businesses.

I will sum up with responding to what the Committee asked in my letter of invitation, and that was to report on Treasury and IRS compliance with Executive Order 13272, specifically the President's requirement that plans on complying with the RFA be submitted to the Office of Advocacy and, after revision, be made publicly available. Treasury/IRS have complied with Executive Order 13272, and their compliance plan is on line. The URL for that plan and the Web site are in my written testimony.

The Office of Advocacy is currently preparing to move into the next phase under Executive Order 13272, which requires the Office of Advocacy to train federal agencies on how to adequately consider small business impact prior to finalizing rules and regulations.

Thank you for allowing me to present these views. I would be happy to answer any questions after the witnesses have presented their statements.

[Mr. Sullivan's statement may be found in the appendix.]

Chairman MANZULLO. Thank you, Mr. Sullivan.

Batting clean-up, in the appropriate place because the first three witnesses were not in a position to analyze the RFA at the time of its enactment, is former Congressman Andy Ireland. Andy was elected to Congress in 1976, a Member of the Committee on Small Business his entire tenure, retiring in 1992 as the Committee's Ranking Minority Member.

He is the 1980 author of the Regulatory Flexibility Act, so he is going to tell us what he meant by it and whether or not it is being complied with. We really look forward to your testimony.

STATEMENT OF ANDY IRELAND, PRINCIPAL, ZELIFF, IRELAND & ASSOCIATES, WASHINGTON, DC

Mr. IRELAND. Thank you, Mr. Chairman. I appreciate the opportunity to be with you and the others this morning.

In my extended testimony that you have said you will put in the record you will find some detail, but I thought in my remarks here that I would address some of the background, as you say, that got us to where we are.

When I arrived at the beginning of my 16 years in the Congress, I, like many others, had the real concern about the federal government's one-size-fits-all regulatory process and began in the spring of 1977 with a little, tiny bill that gradually became the Regulatory Flexibility Act to bring some sense to the one-size-fits-all operation.

A lot of people worked on it to help. Mike McKevitt and John Motley of the NFIB were influential. Ike Skelton, who came with me into the Congress, was very helpful. The late Steve Lynch was a real pioneer on the staff working on it, and a much younger Frank Swain here was deep into it as well.

An unusual thing happened during 1980. They had a Small Business White House Conference, which was kind of a new thing. Because of that and the handiwork of Mr. Swain here, the result was three really important small business pieces of legislation. Not only the Regulatory Flexibility Act was passed, but also the Equal Access to Justice and the Paperwork Reduction Act, all a result of that in 1980.

Of course, that was quite a triumph and new thing for the small business community coast to coast, but the implementation of the Regulatory Flexibility Act was a very difficult hill to climb. It was new. There was a lot of resistance among the departments and regulatory bodies, chiefly agencies saying that they are not covered by this new Act and then the old time handicap of not having judicial review.

One of the most consistent arguments against compliance at that time, however, always seemed to come from the IRS. It was their view that they did not need to comply with the RFA when they were engaged in interpretive rule makings; that since the RFA was for the most part an extension of the Administrative Procedures Act, they were not required to do anything in the way of cost/benefit analysis because they were not making new demands on small businesses, but only formatting legislative edicts that were already contained in the Internal Revenue Code. That was then and is now the foundation of IRS resistance to this.

As I exited, the year or two before I left the Congress there was one or two examples of this. A rule making was proposed by the IRS on the payroll tax reporting. It turned out that the people, when I went down to the IRS for a meeting with the Commissioner's people, they could not understand the ruling, and yet they were expecting the small businessman in America to do it. I fortunately had a good schoolmate in college named Nick Brady, who happened to be Secretary of the Treasury, and he was able to get it straightened out.

The other big hill to climb was the judicial review. Tom Ewing, your colleague from Illinois, was instrumental, along with Kit Bond, in getting that problem straightened out.

Here we are again with the same kind of a problem seven years after SBREFA has been passed and 23 years after the Regulatory Flexibility Act was passed. We are here again with the same kind of resistance problem that just really in this day and age just need not be what we have to devote our time to.

The current issues, many are going to speak directly to them, and I will not elaborate on them. The IRS rule on deposit interest is bad economics. It is bad as a burden to small business. Applica-

tion of a Reg Flex analysis at the beginning of the process would have saved an awful lot of problems for us all.

With that, Mr. Chairman, I will be ready for any questions. Thank you.

[Mr. Ireland's statement may be found in the appendix.]

Chairman MANZULLO. Thank you, Congressman Ireland.

Our next witness is Frank Swain. Frank, we look forward to your testimony.

STATEMENT OF FRANK SWAIN, ESQ., PARTNER, BAKER & DANIELS, WASHINGTON, DC

Mr. SWAIN. Thank you very much, Mr. Chairman. It is a real pleasure to be here and to be on this very distinguished panel.

Secretary Olson's observation about accounting rules reminded me it is difficult and challenging to work with small business. When I was Chief Counsel for Advocacy, I recall a conversation with several small business owners over the accounting issues, which were related to the ones that have been more recently solved. This was 20-some years ago.

I said to the business people, I said well, do you generally use LIFO or FIFO? One guy spoke up and he said well, I use FISH. I was not familiar with that. I said what is FISH? That is first in, still here.

[Laughter.]

Mr. SWAIN. This is a pretty arcane issue, and I come this morning to try to crystallize it with one example.

Essentially the Regulatory Flexibility Act, which Congressman Ireland was really the godfather of, attempts to get agencies to take a second look at regulations if they have a significant economic impact on a substantial number of small businesses.

For reasons that Secretary Olson has described, the IRS rule making procedure is actually different than EPA and OSHA and other regulatory agencies because they issue a lot of rules that they regard as interpretive. I will leave it to other more articulate people as to why that is different or the same, but, at any rate, when IRS issues these interpretive rules, they do not have to for technical legal reasons go through this analysis of whether it is significant or not. As Dr. Graham said, they really go back to an analysis of simply whether new information is collected or not.

One of the questions for you to determine in this whole issue is how that works and whether that is an adequate hook, if you will, to get the IRS to do what I think it ultimately should be doing in more cases than it is.

I absolutely agree with the description by Secretary Olson that this administration has done a lot in a number of ways to make the Service much more responsive to small business and to take a second look and probably a third and a fourth look at several significant regulations. I suspect that reflects a lot of time and effort on the part of her and her colleagues at Treasury and the very senior people at IRS. I am not sure that it is a message that has filtered down far enough in the bureaucracy yet.

The mobile machinery rule is the case in point. It is a rule based on a law that the Congress passed 50 years ago. It has been a rule in place since 1977, and last year the IRS proposed to eliminate a

certain part of that exemption. Now, I will not get into the details about whether that should happen or should not happen. I certainly have my views on that, but the fact is that when IRS proposed the elimination of this exemption they said we do not need to do a regulatory flexibility analysis because we do not collect any additional information by eliminating this exemption, and this is not a major rule.

Left with no analysis, the affected community, which turns out to be heavily small business, can only guess at what the impact is. The impact for businesses that use this kind of machinery is quite significant in additional fuel taxes and additional excise taxes.

As I mention in my written statement, I think it is terrific that the Service has been actually quite open in discussing this. Secretary Olson and her office have been quite open in meeting and discussing it. As she mentioned, the administration has directed the IRS not to make any final rule on this until the Congress has the opportunity to review it, presumably in the context of the transportation legislation now pending.

My point is simply that had IRS done an analysis earlier on, I think we could have had a lot smarter and more efficient discussion of this. The reason I am able to say that even more definitively this morning than I was a week ago is because two days ago in the mail we received a report from the Federal Highway Administration, a copy of which is appended to my testimony.

The Federal Highway Administration, it turns out, had told the IRS in 1999 that elimination of this exemption would have an annual cost of approximately $250 million. The Federal Highway Administration sent me an update of that analysis, and they now estimate that the elimination of the exemption would have an annual cost of $460 million or approximately half a billion dollars.

All I am saying is this is information that somebody someplace down in the bowels of the IRS probably had in a file, but for whatever reason it did not get to or it was not noticed by the people when they were publishing the proposal. This is clearly a rule that whatever the technicalities of the Reg Flex Act will certainly have a significant economic impact on a substantial number of small businesses.

It appears to me that it is also a rule that is a major rule, a significant rule deserving of Dr. Graham's office review, but it did not happen. There needs to be a way to get that to happen, and there needs to be a will on the part of the IRS to take significant actions, which is certainly not every action that they take, but to take the more significant actions and say we are going to take a look at this, we are going to try to do a minimal analysis and at least get the public on the same wavelength as to what we are doing and why we are doing it.

Thank you very much for the opportunity to appear, and I will be happy to answer any questions.

[Mr. Swain's statement may be found in the appendix.]

Chairman MANZULLO. Thank you. Appreciate your testimony.

Our last witness is Dan Mastromarco testifying on behalf of National Small Business United. We look forward to your testimony.

STATEMENT OF DAN MASTROMARCO, ESQ., PRINCIPAL, THE ARGUS GROUP, ARLINGTON, VA

Mr. MASTROMARCO. Thank you. What you will hear in my testimony is a recurring theme Frank Swain mentioned concerning the crossover between rulemaking and policy-making. If the rule that Frank mentioned is one that cost small businesses $500 million, that is a rule that should be done in a legislative process where at least it could be used to pay for something such as repeal of the death tax, in part.

Let me begin, before rushing to disingratiate myself with Treasury officials, to thank you for exploring how well the RFA functions or does not. NSBU is the oldest small business organization in the nation, established before the Reg Flex Act and before President Truman's Administrative Procedure Act.

We know that ensuring sound regulatory due process is a sweeter victory than any individual fight in which small businesses may engage—because the results last much longer. Having said that, let me be blunter than Mr. Sullivan could be and perhaps a tax lawyer should be. The RFA is an invaluable due process tool, but for nearly a quarter century it has been reviled by a culture like a bad strain of SARS, which I will call the severe acute regulatory sophistry, and has found a way to mutate around the changes in SBREFA.

The primary infirmity from which the RFA suffers is not a legal one. Rather, it is an institutional one, but it manifests itself in legal interpretations that are as parsimoniously drawn as lawyerly possible. Responding to President Bush's strong support of the RFA through his Executive Order, the Treasury wrote a policy handbook. That handbook merely adopts the positions of an existing internal 1998 checklist. Both read like survival guides for bureaucrats seeking to avoid the RFA.

Pamela has an excellent opportunity to change all this, and with her experience, background and inclination I would challenge her to do so.

Let me walk through the decisional flowchart for the RFA that is presented on the easel and that looks kind of like an organic chemistry reaction. It is suitable for framing, Mr. Chairman.

Chairman MANZULLO. In reference to your biological terms of SARS, an organic chemistry compound would make sense.

Mr. MASTROMARCO. That is exactly right.

Chairman MANZULLO. It looks more like the directions to Johnny Carson's used car lot, but go ahead please.

Mr. MASTROMARCO. Let me use the non-resident alien reporting rule as an example of just how narrowly the Treasury parses the law.

Coined the U.S. anti-savings directive, this rule would require U.S. payers of interest to residents of France, Germany and other friendly countries to report these payments to the IRS and ultimately foreign governments. Treasury asserts the rule is interpretive and imposes no collection of information requirement.

Assuming a formal rule making threshold question Frank mentioned is whether the Treasury properly calls the rule merely interpretive. If interpretive, it is exempted from the RFA as long as

there is no collection of information requirement and also from the possible impact analysis since it stems from the underlying statute.

Treasury frequently uses this interpretative rubber stamp, but what standard they apply is difficult to know because their Pavlovian reflex to consider virtually all rules as interpretive is untenable. Seventeen years ago, former Commissioner Egger testified that the difference is primarily the degree of discretion in applying the rules. How much discretion was used here?

Turning to this rule making, the Treasury not only used discretion, but crossed the line into law making by fiat and to such a degree that if the policy were properly considered by the Congress the policy assumption that it was Treasury's role to help foreign nations' tax investments in the United States would have been rejected.

Witnesses at the administrative hearing raised nothing but policy concerns. They questioned why the rule would overturn U.S. economic policy, why it was needed when bank deposit interest is not taxable to foreigners, why it was more like foreign policy than tax policy, and bad foreign policy at that, why asset mobility, like the freedom to immigrate, does not create a welcome check on governments against excessive taxation.

As narrow as Treasury's interpretation of legislative rules is, it is the Rio Grande when compared to the interpretation of the collection of information requirement. Here, in this rule, the Treasury said 2,000 persons were subjected to it. It may have wrongfully estimated the burden as 15 minutes per respondent, and I submit it would take that long just to speed read the rule. That still hurdled the 10 person threshold of the RFA.

If the Service argues, as they seemingly are today, Mr. Chairman, that there is no collection of information if there is an OMB control number or an existing form, imagine a hypothetical form or not—we will call it the 1099 Miscellaneous—that integrates all future record keeping the Service thinks it needs. It may be 560 page long, but it will serve the purpose of avoiding the Regulatory Flexibility Act.

If the Service is able to claim this non-resident alien rule is interpretive even as the entire hearing was based on policy and if the Service was able to argue that it did not impose a collection of information requirement when the essence of the rule was reporting, then, Mr. Chairman, the Service has defined the Reg Flex Act out of existence, and we are in 1995.

Mr. Chairman, I have several recommendations that are made in my testimony. Doubtless, your very able counsel, Barry Pineles, will have his. I raise only one here. If the IRS should be singled out in the future as it was in SBREFA, it should be singled out for more stringent standards since it is the only agency which rules affect all 23,000,000 small firms.

Congress must not only close the loopholes, but it must continue to exercise vigilant oversight like today. If you are successful, you will accelerate the adoption of true guidance and ensure that pure policy choices, as this rule I mentioned, are properly left to Congress. To the Service's surprise, greater compliance, less controversy and higher enforcement will result.

[Mr. Mastromarco's statement may be found in the appendix.]

Chairman MANZULLO. Thank you very much. I appreciate everybody's testimony.

Ms. Olson, in answering the questions if there is somebody from your staff that you feel would have more information than you do to testify, you can bring that person up next to you and just introduce them for the record.

Ms. OLSON. Thank you, Mr. Chairman. I promise to do my best to field questions myself.

Chairman MANZULLO. Okay. The same with you, Dr. Graham. We always have that invitation out there. I would rather have that happen than the whispering that might incur trying to get the information.

I need to reconcile a couple things. On Mr. Sullivan's statement, page 8, it says, "As we stated in our report to Congress in January, the IRS has often taken the view that unless a form is required no record keeping requirement is imposed by the rule."

Then Mrs. Olson says on page 5 at the bottom, the last paragraph, "We have heard some speculation that the IRS considers the 1996 amendment to apply only when a regulation results in small business taxpayers having to complete a new form. This is categorically not correct."

Someone help us out. Let us have a dialogue here between Mr. Sullivan and Mrs. Olson. Are we speaking about the same thing? What is going on here?

Ms. OLSON. The IRS and Treasury do interpret the Paperwork Reduction Act and the RFA to apply not just to information that is put on forms and furnished to the IRS, but also to the record keeping that underlies complying with the tax laws, so we do take a broader interpretation.

Chairman MANZULLO. Mr. Sullivan?

Mr. SULLIVAN. I would be happy to clarify my written statement on page 8.

What we have put in our testimony is not a written policy by the Department of Treasury, and so in that sense Pam Olson is absolutely correct. What we do view it as is a rationale, and that is when we look at the two examples that really were mentioned I think best by the other members of the panel, mobile machinery and non-resident reporting on interest. What we see is the lower tiered folks who looked at the burden and approached the rationale of information collection requests, Paperwork Reduction Act and the Reg Flex Act, by focusing on whether or not additional forms would be used, and we believe that point is where the lack of analysis and flushing out of burden existed.

I also need to clarify that there is a distinction in the view of the Office of Advocacy between the analysis done under the Paperwork Reduction Act and the analysis done under the Regulatory Flexibility Act. I think that distinction really is what is driving at the differences of opinion.

The distinction that is under the Regulatory Flexibility Act you are required to look at the segments of the small business community who would be affected. Additionally, you are required to analyze the less burdensome alternatives that arise in your consideration of a rule making. Those two requirements do not exist under the Paperwork Reduction Act or the process under which informa-

tion collection requests are made, and it is that distinction, the more thorough analysis specific to the small business community, where information comes up and should be made publicly available so that there is less of a disagreement of whether or not the analysis has been done.

Chairman MANZULLO. Let me throw this out. On the interest, on reporting requirement of payments of interest, Section 6049 of the Code where it says Interest Is Defined, A General Rule. It says, "The term interest means...", and then it just talks about interest on any obligation, blah, blah, blah, all the way down to (G) where it says, "To the extent provided in regulations prescribed by the Secretary, any other interest which is not described in paragraph 2."

My question is Congress gave to Treasury the ability to define other areas of interest, and my question is, is that legislative, or is that interpretive? The IRS has ruled it is interpretive.

Ms. OLSON. Yes. It is the Treasury Department's view that it is an interpretive rule.

Chairman MANZULLO. Good. When I see something that interprets something, somebody speaks in Polish, and then an interpreter says exactly what that person says. In other words, interpretation has an equal mark. Something has been stated, and an interpretation is a restatement from the Greek or the Hebrew in the Bible to the vernacular, to the English so we can understand it. It is a statement of existing facts that are already there, and it is simply a matter of interpreting or saying the same thing in another manner.

I cannot understand when the Treasury is tasked with the responsibility for coming up with additional definitions of that which interest is and obviously a tremendous impact on the small business factor how the word interpretation could come in as opposed to reading an extension of the legislative power we gave to the Treasury in order to further define interest.

Does that make sense, or do you still say it is interpretive?

Ms. OLSON. I would still say it is interpretive. Although many times I have thought that parts of the Code are written in Greek, they are in fact written in English, and what we were interpreting was the meaning of the term interest.

I had the misfortune perhaps in my younger days of having been a drafting attorney in the Legislation and Regulations Division and spent about six months of my life trying to help people understand what interest meant and what dividends meant in the context of rules that were enacted in 1982.

I can tell you from that experience that there are always questions about the meanings of even simple words written in English and that the IRS undertakes as much as possible to provide as much clarity as possible to people on complying with the law.

Chairman MANZULLO. I guess the reason I bring this up is, you know, why not err on the side of safety? You know, why not err on the side of small businesses?

Mr. Mastromarco mentioned that the studies had already been done by the Federal Highway Administration, a half billion dollar impact on moving this massive equipment onto roads. I mean, the IRS is 106,000 employees. I mean, why not just as a matter of

course say, you know, whatever we do here, whether it is interpretation or legislative, regardless of what we do it has a significant impact on the community of taxpayers.

Let us just as a matter of course follow the RFA. Would that be too oppressive? Too onerous?

Ms. OLSON. Again, the Reg Flex Act applies to the paperwork and the record keeping and so forth that goes along with the statutory provisions, but it does not apply to the substance of the statutory provisions or what the statutory provisions mean.

In the context of the mobile machinery exception, the IRS had been taking the position in audits and in litigation for an extended period of time that those vehicles were in fact subject to the excise tax and so by ceasing the audits and litigation and instead issuing a notice of proposed rule making, we open the opportunity for a discussion about what those——.

Chairman MANZULLO. But then you walk into the trap—I think it was Congressman LaFalce's language—in Section 385, Treatment of Certain Interest in Corporations, Stock or Indebtedness, down to (C), Effect of Classification by Issuer, Section 2.

This section appears all over the Code. It says, "Except as provided in regulations, paragraph 1 shall not apply to any holder of an interest if such holder on his return discloses..." Wait. Is this what I wanted, Barry? Am I reading the wrong one here? Section 2? I am sorry.

Section 3 on Regulations. "The Secretary is authorized to require such information as the Secretary determines to be necessary to carry out the provisions." This is a mandate that whenever you do something at the IRS, as with any other profession, that there has to be a collection process.

I guess what I am asking you in my final question, because I am over my time, is I read the statute to require we want more from the IRS. What language would you suggest that would be clear to the IRS as to what Congress is expecting of you than what language you presently have now?

Ms. OLSON. I think to the extent we have a difference of opinion as to the interpretation of the Reg Flex Act the question comes down to whether it goes into the substance of the application of the rules that Congress has enacted or whether it only covers the paperwork portion of it.

The Service and Treasury have consistently interpreted it as stopping at the level of the paperwork, and I think what you are talking about is the substance.

Chairman MANZULLO. I just find that a reach. I mean, the purpose of the RFA, which Andy Ireland drafted in 1980—I mean, small businesses are getting crushed. You know, my brother has a small Italian restaurant. He does not have regulatory counsel. He cannot follow all the rules out there. Every time that there is an IRS interpretation of whatever it is, he is the one that is getting nailed.

This is what we want, and I am going to do whatever is possible to get this through, whether I have to sit down with the new Commissioner and say this is what we want or have one of our hearings here where we lock the door, bring everybody together and say this is going to be the result of it.

As far as I am concerned, IRS is simply somebody calls a switch and says well, this is interpretive. We do not have to do any more work on it. That hurts small business. As in the rest of the testimony, you could have all the Web sites you want. You could have all the outreach as to the IRS. They just want to know when you are going to pass a regulation how it is going to impact them. They are not given that. They do not have it.

Mrs. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Ms. Olson, the non-resident alien deposit interest rule discussed by the panel is of interest to me. We have heard testimony that your proposal will have a dramatic impact on many small and large financial institutions.

Mr. Mastromarco testified that this change was a legislative rule. Why did the IRS not classify this as a legislative regulation instead of an interpretive regulation? If this major regulation is not legislative then what is? Would you not agree that this rule would have a significant impact on small businesses and should be reviewed under the Reg Flex?

Ms. OLSON. Ms. Velazquez, no, we do not believe that it is a legislative regulation. We believe that we are merely interpreting the word interest, and that is why we treat it as an interpretive regulation.

We also do not believe that it has a significant impact on small entities.

Ms. VELAZQUEZ. How do you know that? How do you——.

Ms. OLSON. The reason we know that is through the work that we did under the Patriot Act relating to the collection of information relating to terrorism.

During the course of that work, what the Treasury learned was that the accounts maintained by non-resident aliens typically come in through correspondent banks, and the correspondent banks are the U.S. branches of large international banks, so the entities that we expect to be affected by these regulations are large financial institutions and not small banks.

Ms. VELAZQUEZ. Thank you, Ms. Olson.

Mr. Sullivan, based on Ms. Olson's testimony, the IRS is not going to make any changes unless we draft legislative reforms requiring them to change the way that they must analyze the rules and regulations.

In your testimony you stated that the IRS has drawn the requirements of the Reg Flex analysis far too narrowly. What changes can be made by us as lawmakers to increase the transparency of lawmaking and require the IRS to address the impact that their rules have on small businesses when it is clear they will not?

Mr. SULLIVAN. Congresswoman, I believe still that IRS may go beyond what it currently does as far as analyzing a proposal's impact on small business. I think that there has been a lot of discussion about the difference between legislative and interpretative rules.

Ms. VELAZQUEZ. What if they do not?

Mr. SULLIVAN. I think that the analysis should go beyond the Paperwork Reduction Act analysis and the information collection re-

quests regardless of whether or not it is interpretative or legislative.

If the IRS does not take that enlightened view from small business, then legislative fixes I think would be before this Committee. Past proposals have mentioned whether or not the SBREFA panels that currently encompass OSHA and EPA should be extended to IRS.

In my position as the Chief Counsel for Advocacy, I can only take a position where small business owners have told me to, and in this specific legislative arena extending the SBREFA panels to IRS, a number of small business groups—NSBU, Small Business Legislative Council, NFIB—have all been strongly supportive of extending the panel process to IRS, so in my current position I would have to support that legislative approach.

Ms. VELAZQUEZ. Thank you.

Ms. Olson, going back to the non-resident alien reporting rule, at a time when the economy is trying to regain its footing it would be disastrous if a significant flight of assets left the U.S. economy due to this rule change.

Indeed, I understand that there have been various studies conducted by the private sector groups that suggest that the withdrawal of assets will be significant and the adverse impact to our economy even more significant.

Has Treasury conducted any detailed analysis about this potential flight of capital? If so, what did it conclude?

Ms. OLSON. We have looked at that question, and what we have concluded is that based on back in 1996 we put a similar rule in place with respect to Canadian residents with accounts here in the U.S., and there was no flight of capital in that case so we do not expect a flight of capital to occur in this case either.

Moreover, the amount of dollars and assets that would be covered by this rule is much smaller than the studies have indicated, and many of the assets are held not by individuals, but by entities, so it would be an even smaller effect so we do not anticipate a flight of capital as a consequence.

Ms. VELAZQUEZ. Thank you, Ms. Olson.

Do any of the other members have comments regarding any studies that have been done on this topic?

Mr. MASTROMARCO. If I can, let me just back up for one second if you will permit me——

Ms. VELAZQUEZ. Sure.

Mr. MASTROMARCO [continuing]. And say that I think that one of the most important things that you are gathering from Assistant Secretary Olson's testimony is not really a question of arguing whether the rule is interpretive or whether there is a collection of information. It is more a question of finding out how they define that and, if need be, change the law.

The real point is, for example, in their policy booklet they did not define what standards they imposed for interpretive rules. The Courts do. Has wide applicability, force of law, exercise of discretion, all of which were triggered here, but they need to put that down, I believe.

Second, as to your specific point of how much would it cost the economy, well, the study that at least I have seen has been former

Deputy Assistant Secretary Stephen Entin, now with Institute for Research on the Economics of Taxation, which says that the outflow of dollars from this country would be significant and in fact would be so much that it would probably exceed the benefit of the President's stimulus package as projected by the administration.

The question here is this. If we are going to be providing—the United States has in 871(i) of the Internal Revenue Code specifically reached a decision not to tax bank deposit interest paid to foreigners. That is because we wanted to attract that currency to the United States, and we have done so. How much have we done so? Maybe a trillion dollars in this economy as a result of that.

If we provide that information to foreign governments who, by the way, in many ways are not so willing to help us with similar things such as the FISK provisions and other benefits that they apply, then we will drive that money out of this country.

Ms. VELAZQUEZ. So what will you tell us lawmakers? How can we fix this conflict that exists between interpretation?

Mr. MASTROMARCO. Well, there are two things, and there are probably more, but I happen to believe, and I know there is some disagreement with this, that the law needs to at least set the standards for what is considered an interpretative rule making because the decision, the trigger point of interpretative rule making, was the primary point.

Remember, collection of information requirements was just the fail safe. At one point Senator Pryor in the taxpayer bill of rights was going to subject all rules and regulations of the IRS to the Reg Flex Act. The only thing that Congress did was they said okay, we will have a truce. Collection of information.

They defined their way out of that too, so I would make collection of information independent of OMB review of forms so that it is its own special standard. When a collection of information exists, the RFA is triggered.

Chairman MANZULLO. Congresswoman Majette?

Wait a second. Mr. Sullivan, you had a response?

Mr. SULLIVAN. Actually, Congresswoman Velazquez, I do have a response, and actually it gets at your question on whether or not IRS will not do further analysis.

I would posit to the Committee that if you took Secretary Olson's response to your question about flight of capital and you were to detail that out in IRS' proposed rule with the work that they have already done, you would have in fact met the further analytical requirements in a transparent way to put small business and large businesses on notice about what they were intending to do with that rule making.

Chairman MANZULLO. Ms. Majette?

Ms. MAJETTE. Good morning, Mr. Chairman, and thank you.

Good morning, ladies and gentlemen. My question is addressed to Ms. Olson. I know that one of the biggest ways that your agency avoids performing the Reg Flex analysis is by making a determination that the rule does not have a significant impact on small businesses.

Sitting here just listening to all the comments and discussion, I am wondering from your perspective what is it that this Committee

can do or what is it that Congress can do to make it easier for your agency to be in compliance?

Ms. OLSON. Rewrite the tax laws so they are much simpler than they are. That would be the best thing you could do.

Ms. MAJETTE. Well, assuming we cannot do that this week or this session, although I would love to, and I think that was probably the only thing that every single Member of Congress was able to agree on a few weeks ago when we voted on a resolution with respect to that.

Having said that, perhaps we cannot do that this week. What would you do?

Ms. OLSON. It is very difficult within the confines of the statutory provisions that have been written for us to simplify the laws and to simplify compliance with the laws and to ease the small business burden.

We have as a paramount objective and have had it at the top of our list since I joined the Treasury Department two years ago to look for every opportunity to simplify the tax laws, particularly for small business. We do not undertake a project without considering specifically its impact on small business, if there are ways for us to carve small business out of it.

I will give you one example. You know, we have recently undertaken a lot of activity to try to stomp out tax shelters, and in the rules that we have written we have designed them around small business so that small businesses are not captured by the rules because they only apply to very large transactions, so we are always looking for ways to simplify things for small business.

One of the budget proposals that the President put forward is a pension plan simplification, a 401(k) simplification, again aimed at small businesses because we know that small businesses do not have the resources, do not have the assets, to be able to afford the same number of lawyers, accountants, actuaries, et cetera, that are necessary in order to adopt pension plans and stay in compliance with pension plans, so we are always looking at.

We welcome as many comments from you from your constituents as you might have about ways in which we have put burdens on small businesses that are not necessary or that might be minimized. We are always looking for ways to do that.

Ms. MAJETTE. Thank you. I see I still have a little bit more time, so I will shift gears for a moment.

One of the things that we are going to continue to deal with this year is the issue of the possible repeal of the dividend tax, and so my question is what benefit do you see that small businesses would reap from the repeal of the dividend tax inasmuch as that is estimated to cost nearly $400 billion?

Ms. OLSON. Well, there are indeed a number of small businesses that are organized as C corporations, which are the kind of businesses that do end up paying a double level of tax, so the benefit that they would get is an elimination of the double level of tax.

To the extent that they have paid income tax at the corporate level, they will not pay it again when they make distributions to their shareholders, so that would be a significant benefit.

We have also——.

Ms. VELAZQUEZ. Would the gentlelady yield?

Ms. OLSON. We have also proposed a simplification in the S corporation area, which would allow more companies, small businesses, to move into S corporation status, which is a full elimination of the corporate tax.

Ms. MAJETTE. Thank you. I yield to the Ranking Member.

Ms. VELAZQUEZ. Would you tell us what is the percentage of small businesses that will benefit from the dividend tax cut?

Ms. OLSON. I am sorry. I do not remember the exact number. I could probably get it if you want to do a question for the record.

Ms. VELAZQUEZ. Is it less than three percent?

Ms. OLSON. There are many more companies on the small business side that are operating in C status than the large, so it is a very large number of companies. I think it is somewhere close to 1,000,000 companies that are small businesses that operate in C corporation and are subject to the double level of tax.

Ms. VELAZQUEZ. What percent would represent 1,000,000 out of 25,000,000?

Ms. OLSON. One million out of 25,000,000? I am not sure what you are referring to.

Ms. VELAZQUEZ. You just said that 1,000,000 businesses out of 25,000,000 small businesses in America.

Ms. OLSON. That are organized as C corporations and bear an extra level of tax. Yes. The rest of them have all sensibly structured themselves as either S corporations or as partnerships or LLCs and so they avoid that double level of tax.

Ms. VELAZQUEZ. It is quite small.

Chairman MANZULLO. Congresswoman Millender-McDonald?

Ms. MILLENDER-MCDONALD. Thank you, Mr. Chairman, and good morning to all of you. Quite a distinguished panel, I might add.

When you speak about small businesses in terms of how many will benefit from dividend taxes, we really do not have a definitive on what small businesses are we talking about. It could be one who is under 100, one who is under 50, one who is under 500.

You know, again we are trying to bounce around what is a small business in terms of definition, and it seems as if as I came here this morning semantics is a problem with especially the Department of Treasury and the Small Business Administration because your interpretations tend to vary differently, and I suppose with that it appears to me like semantics. We are having problems with semantics and definitions of different terms—interest, analysis of data and those types of things. It appears to me that we are having those problems.

Given that, Ms. Olson, you said that you are always looking at ways by which to simplify the burdens on small businesses. Have you done a collection of information with reference to those burdensome concepts that are really affecting small businesses?

In other words, I heard Mastromarco say that there is not a collection of information, and if that is indeed true then what information, or are you collecting any information, that will gleam the burdensome task that small businesses have with RFA?

Ms. OLSON. Well, the IRS is always analyzing the forms and the burden associated with the forms. In fact, the IRS has recently undertaken a significant study of the burden that is imposed on taxpayers in complying with the laws.

They completed a study just on the burden imposed on individual taxpayers, not counting any business taxpayers, but just individual taxpayers and complying with the laws, and concluded that the cost of complying with the laws was nearly $70 billion.

They have done things with respect to the forms over the course of the last couple of years that have significantly reduced the burden hours associated with completing the forms, some of them specifically targeted at small businesses, by removing, for example, the requirement that small businesses complete certain schedules that get attached to the tax returns that are very complicated.

We can do small things. We can say things like, you know, increase the threshold for filing special schedules like, for example, they increased the threshold from $400 to $1,500 for filing a Schedule B if you have dividend or interest income. That wipes out the requirement for a whole lot of people to have to deal with another schedule. It is an effort that goes on every year with respect to the IRS forms.

Ms. MILLENDER-MCDONALD. And yet in spite of this we are still seeing this burdensome task on small businesses with reference to this RFA Act. What can be done about this?

Dr. Graham, you are the monitor, I suppose, of the rule making and other provisions that are imposed upon small businesses. What are we going to do about this particular issue facing small businesses?

Mr. GRAHAM. Well, I think there is some very good work going on at Treasury on an expanded model of how to protect and estimate different kinds of burdens, particularly information collection burdens, on different segments of individual and corporate taxpayers.

I would encourage you to look into the progress they are making and whether they will have the capability to isolate small business defined in various ways and show how changes in tax policy and regulations will affect the information collection burdens of small businesses.

There is progress in that direction, but I think it is an area that is worth learning more about and understanding what more can be done.

Ms. MILLENDER-MCDONALD. And though there is progress that is being made, would you then agree that legislation needs to be done to really fix this problem?

Mr. GRAHAM. I think we would need to look at the specifics.

Mr. SWAIN. Congresswoman, could I make a suggestion?

Ms. MILLENDER-MCDONALD. Yes.

Mr. SWAIN. As you stated, one of the debates this morning has largely been about semantics, and I think it is very——

Ms. MILLENDER-MCDONALD. Yes.

Mr. SWAIN. [continuing]. Challenging to figure out what is interpretive and legislative. This is actually an idea that I just thought of as we were listening to the discussion, so it may not be very good, but why not take an entirely different approach?

Why not say that any IRS regulation, no matter how they characterize it, if it has an impact of over $100 million annually has to have a full-blown Regulatory Flexibility Act analysis; not just

the paperwork collection analysis, but the full analysis of impact and alternatives.

That way we get out from saddling IRS with the burden of doing an analysis on every little thing that comes along, and we also get away from this morass of figuring out and arguing about whether something ought to be interpretive or something ought to be legislative.

That also installs Dr. Graham's office in a little firmer position of responsibility because he has to evaluate whether that threshold decision about the economic impact is an appropriate decision. It is just a different way of looking at it. It may not be ultimately adequate after some further thought.

Could I mention one other thing briefly?

Ms. MILLENDER-MCDONALD. I could not agree with you more on that because a threshold has to be established and analyses be driven by the threshold that you have just outlined. I could not agree with you more on that.

Mr. SWAIN. If I could mention just one other thing on the dividend tax issue?

As a private attorney, if somebody comes to me and they say I want to start a business, usually what I say to them is the last thing you want to be is a C corporation. That is why, Congresswoman Velazquez, there are so few C corporations, percentagewise, because you do not want to be a C corporation so that you are paying dividends to your investors and you are taxed twice.

I think the big advantage of the proposal to eliminate taxation on dividends is that a business owner will be able to either form a corporation or not form a corporation, either borrow money or receive equity money from investors, based on business reasons of what is best for the business and not based on reasons of what is best for the tax return.

Ms. VELAZQUEZ. If the gentlelady would yield?

Ms. MILLENDER-MCDONALD. Wait, wait, wait. Ms. Ranking Member, let me just conclude here.

Mr. Chairman, this is why, given just what the gentleman has said—Mr. Ireland is it? I cannot see you. Mr. Swain?

Chairman MANZULLO. This is Swain over here.

Ms. MILLENDER-MCDONALD. Wait a minute. The one who just spoke. Swain. Right.

I think there needs to be a set of standards set that will be established to guide this issue because otherwise misinterpretations are going to be made, and we are going to continue to be mired in this type of issue, so to me, as I close and turn it over to you or the Ranking Member, I think we need to have some standards set, and for that I do have a——.

Chairman MANZULLO. I agree with you. We are going to come up with legislation.

I am going to go back to the Ranking Member for one last question because I know that Ms. Olson——.

Ms. VELAZQUEZ. Thank you.

Ms. MILLENDER-MCDONALD. I just want to put my statement in the record.

Chairman MANZULLO. Right. That will be in the record.

Before I do that, let me just state that since 1996 there have been 330 proposed rules by the IRS. There have been 13 preliminary RFAs and only nine final RFAs. I just think that is not acceptable. I mean, everything is interpretive. It just means that is a way for the IRS to do less work.

If you really want to help out, Ms. Olson, if you really want to help out small businesses, you know, you do not need the programs. You do not need the Web sites. Do the RFA because when you find out the impact on small businesses after you have done the RFA chances are you will pull back. That is the best thing you can do for the small businesses is to comply with the RFA.

Now, a point in fact where somebody did not comply with the RFA and got in big trouble is HUD on that proposed RSPA. With a $9 billion impact, they came up with a miserable report of $140 million per page where HUD told us and this Committee that they had the right to determine which entities were impacted.

The quality of the RFA will determine the viability of the proposed regulation.

One last question from Mrs. Velazquez, and then we will end up here.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Swain, you know, you just were talking about the dividend tax cut, so a small percentage of small businesses will benefit out of that, but we are here discussing how can we protect and enhance small businesses.

In light of the proposed stimulus package, I would like to know what is your opinion in light of the fiscal constraints that we are facing here in Washington regarding the dividend tax cut or the increased expensing proposal aimed at small businesses? What will you choose between those two? As you know, we will not be able to pass both.

Mr. SWAIN. I think the challenge to Congress is choosing among a number of worthy things, and complete elimination of the dividend taxes is extraordinarily expensive and very difficult.

I am simply pointing out, because you had asked the question earlier, why so few small businesses are corporations. It is because of the way the tax system is structured. Whether you can afford to change it as it ought to be changed this year or not, I cannot judge that. Certainly expensing is a very valuable option, but dividend taxation is something that ought to be changed if not now, then eventually.

Chairman MANZULLO. Okay. Mr. Ireland?

Mr. IRELAND. One last comment for you and the Ranking Member.

Both of you seemed, in my interpretation, predisposed to do something about this, and I would congratulate you. This is 23 years we have been hearing this same thing. You have articulated it better than I have heard it before, but the time has come for the IRS and some of these other agencies—they are not alone—to respond to the Congress and Congress representing the small business.

You know, maybe some of the things like a commission or something like that might be something of last resort, but after all this

period of time and a clear indication of what is needed, the time has come to do something.

Chairman MANZULLO. I think we have, as a result of this hearing, come up with some language that would be very specific and directed.

If there is any commission, Andy, you will be a commission of one that has been around trying to interpret the rules.

Ms. Velazquez?

Ms. VELAZQUEZ. Yes. Mr. Ireland, would you not agree with me that a solution could be to bring the IRS under the SBREFA panel review process?

Mr. IRELAND. Absolutely. I mean, in each one of these there have been all these threats along the way, but they always get nibbled. There is always this track around it.

If they really wanted to save the country money and energy and real dollars, wherever it bubbles up at the bowels of the Internal Revenue they have said look, the deal is over. We are going to stop fighting.

Devote that energy to really doing something. That is what these initiatives that you are referring to are pointed toward.

Chairman MANZULLO. Again, thank you all for coming here. This has been extremely helpful. We have gotten some great ideas on drafting very specific legislation. Obviously we are going to bounce it off everybody here.

Again, thank you for your time, and thank you for your patience. This hearing is adjourned.

[Whereupon, at 11:09 a.m. the Subcommittee was adjourned.]

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States

House of Representatives

108th Congress

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515–6315

Statement of Donald A. Manzullo
Chairman
Committee on Small Business
United States House of Representatives
Washington, DC
May 1, 2003

On March 19, 2002, the President stated that "every agency is required to analyze the impact of new regulations on small businesses before issuing them. That is an important law. The problem is it is often being ignored. The law is on the books; the regulators do not care that the law is on the books. From this day forward they will care that the law is on the books. We want to enforce the law."

The President was talking about the Regulatory Flexibility Act or RFA. The statement was categorical and applied to all agencies. There was no exception for the Department of Treasury or the IRS in his statement. Let me repeat what the President said: "From this day forward they will care that the law is on the books." I fully concur with that statement and remind the agencies that their Constitutional responsibility is to "take Care that the Laws be faithfully executed."

Compliance with the RFA is not just another procedural hoop that agencies must jump through. Instead it provides the focal point around which rational rulemaking should be conducted

This is especially true of the IRS – an agency whose rules touch every single one of America's 25 million small businesses and countless thousands of small not-for-profit organizations. Rather than viewing the RFA as hurdle to be jumped or avoided, the Service should view the RFA as the place where to explain, in understandable terms, the rationale and economic consequences of its regulatory actions which are a significant compliance burden to small businesses as noted in a 2001 study sponsored by the Office of Advocacy. Furthermore, the President's tax relief package is seeking long-term economic growth and must assist the manufacturing sector to achieve that outcome. The IRS can help achieve that objective by embracing the letter and spirit of the RFA to reduce regulatory burdens on the already overburdened small manufacturing sector.

But alas neither the Department nor the IRS has ever evidenced any interest in complying with the letter and spirit of the RFA. Prior to changes made in 1996, the Office of Advocacy has no record of the IRS ever performing an initial or final regulatory flexibility analysis because the agency claimed that all of its rules were interpretative.

Congress countered that loophole with the passage of the Small Business Regulatory Enforcement Fairness Act or SBREFA. That Act amended the RFA by requiring the Department and the IRS to comply with the RFA whenever it published a proposed interpretative rule that "impose on small entities a collection of information requirement."

Rather than embrace the changes, the IRS and the Department adopted new interpretations to avoid compliance with the RFA For example, the Department and the

Service claim that only new forms trigger the application of the RFA and then only to the extent that of the cost of filling out the new form.

The statistics on compliance with the RFA since the changes in SBREFA took effect are not good. Since July 1, 1996, the Service has issued about 340 notices of proposed rulemaking, conducted 13 initial regulatory flexibility analyses, and certified 120 proposed rules leaving almost two-thirds of the proposed rules not covered by the RFA at all. These statistics fully support the claim that President Bush made on March 19, 2002 that the "regulators do not care that the law is on the books."

President Bush stated from that day forward the regulators will care. Since then, this Committee has held a number of hearings and while improvement are being made, there are still too many regulators out there that do not care despite the bold statement from President Bush and the superb efforts of Dr. Graham and Tom Sullivan. If problems persist and the President's call continues to be ignored, the Committee is ready to work with the Committee on the Judiciary to make the necessary changes in the RFA that will close loopholes and empower the Office of Advocacy to prevent non-compliance with the RFA.

Now I will recognize the ranking member of the full committee, the distinguished Gentlelady from New York, for her opening statement.

House Committee on Small Business

"IRS Compliance with the Regulatory Flexibility Act"

May 1, 2003

Opening Statement of Committee Ranking Member Nydia Velazquez

Thank you, Mr. Chairman.

Small businesses in America today face many challenges to success. One of the biggest is understanding and complying with the overwhelming array and number of federal regulations.

It is unfortunate that the burden of federal regulations weighs most heavily on small businesses. As the engine of the American economy, small businesses are key to our economic recovery. It is now more critical than ever that small businesses spend less time complying with regulations and more time focusing on growing their business.

The federal compliance price tag for small firms is high. It has reached nearly $7,000 per employee per year. That is 56 percent higher than large firms with 500 or more employees.

In terms of tax compliance, the difference between costs to large and small firms is even more pronounced. The costs per employee for small businesses topped the costs for large firms by 114 percent.

One of the greatest costs stems from complying with the Internal Revenue Code and its myriad of rules and regulations. The primary reason why small businesses have to use so much of their resources to comply with the tax code is due to its sheer complexity. And unlike larger businesses, small businesses are at a real disadvantage – they often don't have the resources to analyze and deal with these intricate issues and requirements.

Rather than try to correct this problem, the IRS has instead passed more rules and regulations. As with many other agencies, the IRS has continually failed to address the impact their rules and regulations have on small businesses. As a result, small businesses are left to outsource their complex tax work, which is extremely costly.

Today's hearing will address how the IRS has failed to meet its obligations under the one statutory tool designed to protect small businesses from departments and agencies that unfairly burden them – the Regulatory Flexibility Act.

RegFlex is designed to make sure the IRS and other federal agencies address the needs of small business when they issue rules and

regulations. The RegFlex Act requires federal agencies to assess their proposed and final rules and determine whether they will have a significant economic impact on small businesses and examine less burdensome alternatives – if that is indeed the case.

Despite the fact that the IRS is the agency responsible for the highest regulatory costs impacting small businesses, it has been the worst violator of applying RegFlex analysis. The IRS systematically avoids the statutory requirements of RegFlex by using interpretative loopholes. In 1996, Congress sought to close some of these loopholes only to find the IRS created other ways to bypass RegFlex.

It appears we are going to have to close these loopholes before the IRS finally addresses the needs of small businesses. One way to make sure the IRS complies with RegFlex is to amend it so that the IRS is held to the same standards as the EPA and OSHA. In 1996, we required that these two agencies have representatives of small entities who may be affected by their rules make statements through a review panel process.

By putting the IRS under the same review panel process, it will better ensure that small businesses have a voice in the creation and execution of federal regulations that might harm them. It will force the IRS to account for the huge burden that they place on small businesses.

There is clearly an institutional problem within the IRS that requires fixing. Since the IRS has failed to comply with RegFlex in the past, adding them to the list of agencies that must go through the panel process is one way to make sure they do so in the future. Only then can we begin to help free small businesses from the burdensome and heavy costs associated with IRS regulations.

Thank you, Mr. Chairman.

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Opening Statement of Congresswoman Juanita Millender-McDonald

Small Business Committee Hearing

"Internal Revenue Service Compliance With the Regulatory Flexibility Act"

2360 Rayburn House Office Building
May 1, 2003 – 9:30 a.m.

Mr. Chairman and Ranking Member, I am pleased to have an opportunity to hear from this distinguished panel on the Internal Revenue Service's compliance with the Regulatory Flexibility Act.

I would like to thank all of the witnesses for being here today, including the Honorable Pamela Olson, the Assistant Secretary for Tax Policy in the Department of the Treasury.

In 1980, Congress passed the Regulatory Flexibility Act. The law requires agencies to analyze the impact on small entities when there is likely to be a significant economic impact on a substantial number of small entities subject to the rule, and to consider regulatory alternatives that will achieve the agency's goal while minimizing the burden on small entities. All Federal agencies are subject to the provisions of the RFA.

When a Federal agency proposes a rule, they are required by law to complete an economic analysis on the entities subject to the regulation.

When an agency finds that small businesses could be subject to adverse economic impacts, they are required to do an initial regulatory flexibility analysis (IRFA), which outlines costs and regulatory alternatives to mitigate these costs for small firms.

Unfortunately, many agencies, including the IRS, were finding "loopholes" in the RFA to avoid initiating initial regulatory flexibility analyses on proposed rules. In response, Congress passed the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA).

This law amended the RFA and provided additional tools to aid small businesses in the fight for regulatory fairness. One of the most significant

provisions of SBREFA include expanding the coverage of the RFA to include IRS interpretive rules that provide for a `collection of information' from small entities.

Many IRS rulemakings involve `interpretative rules' that IRS contends need not be promulgated pursuant to section 553 of the Administrative Procedures Act. However, these interpretative rules may have significant economic effects on small entities and should be covered by the RFA.

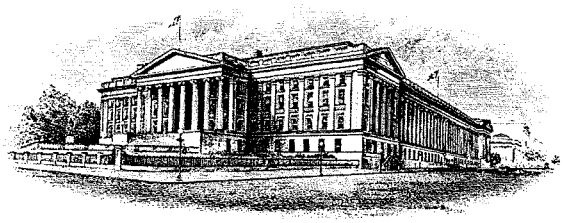
According to the legislative history of the SBREFA amendments, the intent of this phrase `collection of information' in the context of the RFA is to include all IRS interpretive rules of general applicability that lead to or result in

small entities making calculations, keeping records, filing reports or otherwise providing information to IRS or third parties. The IRS has generally avoided the requirements of SBREFA, even though the law was, in part, specifically written to address IRS compliance with the RFA.

Mr. Chairman, our nation's small businesses are already face challenges with rising health care costs, limited access to capital and disproportional paperwork and regulatory burdens. Regulatory agencies should be helping small businesses, not coming up with creative loopholes to avoid compliance with the law.

I look forward to working with the Chairman and Ranking Member to

ensure that small businesses can work with the IRS to come to reasonable solutions as the agency promulgates rules.



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

Embargoed Until Delivery
May 1, 2003

Contact: Tara Bradshaw
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STATEMENT OF PAMELA F. OLSON
ASSISTANT SECRETARY FOR TAX POLICY
DEPARTMENT OF THE TREASURY

BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

Mr. Chairman, Ranking Member Velazquez, and Members of the Committee:

I am pleased to be here today to discuss the efforts of the IRS to reduce the burdens of tax compliance on small businesses and the Regulatory Flexibility Act (RFA).

ADMINISTRATION PRIORTY ON REDUCING SMALL BUSINESS BURDENS

The entire Administration, including the IRS and the Department of the Treasury, is committed to working closely with the small business community and its representatives to help small businesses and the self-employed understand their tax obligations and reduce their compliance burdens. We believe our record bears out this commitment.

The newly restructured IRS is built around four organizational units with end-to-end responsibility for serving specific groups of taxpayers. One of these units is the Small Business and Self-Employed (SB/SE) Operating Division, which serves the approximately 7 million taxpayers that are small businesses. SB/SE exists because the IRS recognizes that small businesses have unique issues that could be given short shrift unless a specific operating unit was devoted to them. In addition, because the IRS recognizes that these taxpayers may lack the financial resources to understand and address these unique issues, one of the primary focuses of the SB/SE Division is to work with small businesses to teach them about their federal tax responsibilities and to develop less burdensome and more practical means of compliance. The SB/SE Division has also assumed an important role in reviewing IRS regulations to ensure that they minimize burdens placed on small businesses consistent with the requirements of the tax law and principles of sound tax administration.

We are extremely pleased that last December the Small Business Administration presented the IRS with its 2002 Agency of the Year Award. SBA recognized SB/SE's Taxpayer Education and Communication organization for its outstanding progress in creating an effective education and compliance assistance program for small businesses and the self-employed. We are committed to continuing this record of achievement in serving the small business community.

The IRS continues to expand the ways it communicates with small businesses. For example, in 1999 the IRS initiated "The Small Business Corner" on the IRS Internet site. It provides small business taxpayers with easy-to-access and easy-to-understand information necessary to comply with their federal tax responsibilities. The goal of this type of convenient "one-stop shopping" is to provide virtually all of the products and services that a small business needs to meet its tax compliance responsibilities.

The IRS has also initiated a comprehensive taxpayer burden reduction initiative. The Service-wide Taxpayer Burden Reduction Council develops, coordinates, and champions cross-functional or service-wide burden reduction projects. Small business taxpayers participate in the IRS Industry Issue Resolution Program, which includes taxpayer burden reduction as a program criterion. Recently implemented burden reduction projects benefiting small businesses include:

- Exempting 2.6 million small corporations from filing Schedules L, M-1 & M-2, reducing burden by 61 million hours annually. (April 2002)

- Reducing the number of lines on Schedules D, Forms 1040 and 1041, resulting in estimated burden reduction of 9.5 million hours for 22.4 million taxpayers. (January 2002)

- Eliminating the requirement for filing Part III of Schedule D (capital gains), Form 1120S for 221,000 S-Corporation taxpayers, reducing burden by almost 600,000 hours. (November 2002)

The IRS has also streamlined many of its procedures to make compliance less burdensome for small business taxpayers. A few examples include:

- The establishment of a permanent special group to work with payroll services to resolve problems before notices are issued and penalties are assessed against the individual small businesses serviced by these bulk and batch filers. (October 2002)

- Business filers can now e-file employment tax and fiduciary tax returns, and at the same time, pay the balance due electronically by authorizing an electronic funds withdrawal.

- Business preparers can now e-file their clients' employment tax returns.

- The IRS has continued to improve its Web site to offer its customers the ability to both order, and in many cases, utilize its Small Business Products online.

The IRS Website now includes the Electronic Marketing Card, which introduces small businesses and the self-employed to the SB/SE Division, and its mission, services, products, and contacts. Small business taxpayers can also automatically download tax events from the 2003 Small Business Tax Calendar into their Outlook calendars.

In addition, the Small Business Resource Guide, and the Virtual Small Business Workshop, are all now available to view online. The Virtual Small Business Workshop is powered by video streaming technology and is available through the Online Classroom. IRS customers can visit the Online Classroom when it is convenient for them. If a small business owner or self-employed individual needs to speak with someone from the IRS directly, he or she is just a click away from the "New Toll-Free Numbers to Reach the IRS" located on the Small Business Community homepage.

It is the long-term and continuing goal of the IRS and the Treasury to ease the burden of small businesses to the greatest extent practical, consistent with the law as enacted by Congress. We look forward to working with this committee as we continue those efforts.

THE BENEFITS OF TIMELY IRS GUIDANCE TO SMALL BUSINESS

Minimizing taxpayer burdens, whether for small businesses or other taxpayers, is a paramount objective of the regulations and other guidance issued by the IRS. Unfortunately, our tax laws have become devastatingly complex in recent years. That complexity threatens to undermine taxpayer confidence in the system, as people come to view the system as one that encourages aggressive tax planning by those with the resources to hire sophisticated planners. We view a system that puts people to the choice of being a cheat or a chump as inherently unstable. It is essential that we simplify the tax laws wherever and whenever we can. Just as importantly, we must refrain from making the system any worse than it already is.

It is important to emphasize that tax regulations and other guidance are, themselves, means by which taxpayer burdens are reduced. Regulations, rulings, and notices serve to make clear how the tax laws enacted by Congress will apply in the real life situations faced by businesses, including small businesses as they plan their affairs and file their tax returns. The business community desires and needs such guidance. Without it, the law would remain unclear and businesses would be forced to take their best guess, with the consequence being an IRS audit if the guess is wrong. With regulations in place, the guesswork (and the potential for an audit) is significantly reduced. Certainty – knowing how the IRS will interpret and apply a law written by Congress – is the most efficient and effective way to reduce the burden of small businesses complying with the tax law.

In developing tax guidance, Treasury and the IRS actively seek input from interested parties, including small business, and endeavor to offer as many opportunities as possible for interested parties to participate in the process. In almost all situations, the IRS issues proposed rules and in some cases advance notices of proposed rulemaking for public comment. The same is often done for draft revenue procedures. When public comments raise new issues, we often issue a second notice of proposed rulemaking. Treasury and IRS carefully consider all

comments received from the public and we revise proposed rules to minimize burdens and simplify compliance whenever possible, consistent with principles of sound policy and tax administration.

In this context, it is important to remember that IRS regulations do not make the laws that apply to small businesses or any other taxpayer. Congress does that by amendments to the Internal Revenue Code. The role of IRS and Treasury is to interpret and apply those laws. In that way, tax regulations differ greatly from regulations issued by other regulatory agencies. We provide taxpayers with the guidance they need to comply with their obligations under the Internal Revenue Code as enacted by the Congress.

Providing timely, comprehensive, and understandable guidance to taxpayers reduces controversy, eliminates disputes, and provides taxpayers with certainty concerning their obligations under the tax code. Just as important, clear IRS regulations and guidance minimize the likelihood that there will be contact between IRS and taxpayers. Without this guidance, compliance obligations would have to be established through burdensome taxpayer audits and costly litigation. Audits and litigation are a costly and inefficient means of interpreting the law.

For example, several years ago the IRS was devoting significant audit resources to examining the use of the cash method of accounting. This was one of the most heavily litigated tax issues. In order to reduce administrative and compliance burdens on small business taxpayers and to minimize controversy between the IRS and these taxpayers, we issued in December 2001 a proposed revenue procedure on the use of the cash method of accounting by small businesses and requested comments from the public on the proposed guidance. After considering the issues raised in the comments, we made changes and clarifications to the guidance and issued a final revenue procedure in April 2002. The final revenue procedure expressly permits certain businesses with gross receipts of less than $10 million to use the cash method of accounting. We expect that the revenue procedure will eliminate most disputes concerning the use of the cash method by small business taxpayers.

This example illustrates what may be a unique feature of tax regulations in that they interpret statutory tax obligations, but do not impose tax obligations. That is, the statutory requirements take effect, taxpayers must comply with them, and the IRS must enforce them. In the absence of regulations, the IRS must still enforce the law, and it will do so without the benefit of the interpretative guidance that the regulations provide. The result is likely to be increased cost and burden for taxpayers if regulations are not issued or are not issued on a timely basis.

The IRS and Treasury are committed to easing the burden on small business wherever possible, consistent with the laws enacted by Congress and sound tax administration. Reducing taxpayer burden frees up IRS resources for more important tasks, including aggressive pursuit of tax evasion.

IRS GUIDANCE AND THE REGULATORY FLEXIBILITY ACT

The Department of the Treasury and the IRS fully support the objectives of the Regulatory Flexibility Act.

In 1996, Congress amended the RFA to make it applicable to interpretative tax regulations to the extent that those regulations impose a collection of information on small entities. This amendment, which Treasury worked with the Congress to develop, recognizes two important elements of tax regulations. The first is that provisions of the Internal Revenue Code, as enacted by Congress, must be applied equally to all businesses regardless of whether they are large multinational corporations or small businesses down the street. The second is that paperwork burdens imposed by regulations that affect small businesses must be carefully considered by the IRS and minimized when possible.

The 1996 amendment made the RFA applicable to an interpretative tax regulation when that regulation is subject to review and approval by OMB under the Paperwork Reduction Act of 1995. That means that the IRS must prepare a regulatory flexibility analysis for any rule that imposes a collection of information on small businesses unless the IRS certifies that the collection of information will not have a significant economic impact on a substantial number of small businesses.

Treasury and the IRS take their responsibilities under the RFA very seriously. Indeed, every IRS regulation is reviewed by three different offices for compliance with the RFA, as well as the other laws and Executive orders that govern the regulatory process. The first review occurs in the Office of the IRS Chief Counsel, the second by tax counsel at the Department, and the third in the office of Treasury's General Counsel.

In addition, every single IRS rule is required by section 7805 of the Internal Revenue Code to be sent to the Chief Counsel for Advocacy for comment on its impact on small businesses. If the Chief Counsel submits comments, the IRS is required by law to respond to those comments in the final rule. The law imposes no such requirement on any other agency.

With one very limited exception for regulations involving information collections conducted in connection with civil or criminal enforcement actions, the 1996 amendment applies to any interpretative tax regulation that requires small business taxpayers to (1) report information to the IRS, (2) disclose information to any other person, or (3) maintain specified records. Whenever a regulation involves one of these requirements, the IRS is required to prepare a regulatory flexibility analysis or certify that the regulation will not have a significant economic impact on a substantial number of small entities and explain the basis for its certification. The IRS complies with these requirements for every interpretative regulation it issues.

We have heard some speculation that the IRS considers the 1996 amendment to apply only when a regulation results in small business taxpayers having to complete a new form. This is categorically not correct. This misconception is understandable because most people associate IRS paperwork burdens with the preparation and filing of tax returns or information returns.

Even when an interpretative tax regulation is not subject to the RFA because it does not impose a requirement for collection of information, it is the policy of the Department of the Treasury to minimize, consistent with statutory requirements and sound regulatory policy, the compliance and paperwork burdens that their regulations impose on small businesses. This policy, as well as the Treasury Department's overall policy and procedures for complying with the RFA, are reflected in the formal guidance developed by the Department and recently posted on our Website pursuant to Executive Order 13272.

Since the 1996 amendments to the RFA, we have identified 24 proposed or final rules for which the IRS has prepared an initial or final regulatory flexibility analysis. For many of these, the IRS prepared the analysis not because it believed that the paperwork components in the regulations imposed a significant economic impact on a substantial number of small businesses, but rather because to do so comported with the spirit of the RFA. For the balance of the regulations issued during that period, the IRS certified that the information collections contained in the regulations would not have a significant economic impact on a substantial number of small entities.

IRS GUIDANCE RELATING TO MOBILE MACHINERY AND INTEREST REPORTING BY BANKS

Finally, the letter inviting us to testify today raised concerns over IRS compliance with the RFA in connection with two specific regulations.

The first is a proposed rule that concerns excise taxes on certain motor vehicles issued in June, 2002. Under current law, various excise taxes are imposed to provide revenues to fund the Highway Trust Fund. Those statutory provisions are broadly written, applying to virtually all vehicles (and fuels for those vehicles) that are capable of traveling on highways.

IRS defines a highway vehicle as any self-propelled vehicle, trailer, or semitrailer designed to perform a function of transporting a load over public highways, whether or not it is also designed to perform other functions. The regulations (and not the statute itself) broadly exempt from those excise taxes vehicles that were, in essence, mobile machinery mounts. This exemption was consistent with the notion that, because the taxes were enacted to support the construction and maintenance of public highways, the applicable statutory provisions should only be applied with respect to vehicles generally capable of traveling on highways. The exception was apparently based on the assumption that vehicles that transport mobile machinery would make minimal use of public highways and thus would receive only minimal benefit from highway construction and maintenance.

This broadly-written exception, however, was the source of much dispute between taxpayers and the IRS. Much of the disputes centered on what was and what was not mobile machinery, and reflected increasing technological advances that permitted heavier equipment to be mounted on vehicles perfectly capable of significant use of our highways. Many of those disputes involved very large rather than small businesses.

These factual and definitional disputes were and remain a continuous drain on taxpayer and IRS resources. We concluded that taxpayers needed more specific guidance in order to reduce the number of disputes and to provide certainty to taxpayers. The proposed regulations were developed with that goal in mind. We are aware that the proposed regulations were controversial, and have advised that they will not be finalized until the Congress completes its work on the Highway Trust Fund reauthorization.

An initial regulatory flexibility analysis was not prepared for this proposed rule because it does not meet any of the requirements for such an analysis under the 1996 amendment. The regulation does not contain any requirement that any taxpayer report information to the IRS, report information to another person, or maintain specified records. While it is true that some small business taxpayers may become subject to these excise taxes if this rule is finalized, this is a function of the Internal Revenue Code and not the result of a collection of information contained in the regulation. Thus, the proposed regulation complied fully with the requirements of the 1996 amendment.

The second is a proposed regulation regarding reporting by banks in the United States on interest paid to certain nonresident alien depositors. This information reporting is intended to improve compliance with U.S. tax obligations, and will not unduly burden U.S. banks. Tax evasion through the use of offshore accounts is a significant and growing problem in the United States. Enhancing appropriate information exchange pursuant to our bilateral tax treaties in appropriate circumstances, subject to the strict protections of the confidentiality of taxpayer information, is an important means of reducing the opportunities for tax avoidance in the offshore sector. We must address the potential for tax evasion through use of offshore accounts or entities in order to maintain confidence of all Americans in the fairness of our tax system. This proposed regulation is just one element of our multi-faceted effort to protect the interests of honest taxpayers who are prepared to pay their fair share of U.S. taxes and who should not have to bear a greater burden because of the few who are less than honest. In today's world, it is more important than ever that no safe haven exist anywhere in the world for the funds associated with illicit activities.

The currently-pending regulation is the second proposed regulation on this matter. The original proposed regulation, which was issued in January of 2001, was withdrawn and re-proposed in July of 2002 following thorough consideration by the Treasury Department and the IRS of all the comments received on the January 2001 proposed regulation. The regulation as re-proposed was narrowed significantly in scope – requiring information reporting with respect to interest paid only to residents of sixteen countries that are major trading partners of the United States – in order to address the banking industry's concerns about the January 2001 regulation, which would have required information reporting with respect to interest paid to all foreign depositors wherever they reside. Moreover, the regulation was again issued in proposed form in order to provide another opportunity for those potentially affected to comment on its impact.

Treasury and the IRS have carefully considered the requirements of the RFA with respect to this proposed regulation. We do not believe that the information reporting that would be required under this regulation would have a significant economic impact on a substantial number of small entities. The depository accounts, the interest on which would be subject to reporting

under the regulation, tend to be with larger financial institutions operating in the United States because such institutions tend to maintain correspondent account relationships with financial institutions in the countries specified in the regulations. Thus, the number of small entities that would be required to undertake this reporting is expected to be small. To the extent small financial institutions have accounts for which reporting would be required under this regulation, the number of such accounts is expected to be very limited. Moreover, the amount of time required to complete the forms and statements that would be required is not substantial. The information reporting that would be required is consistent with the reporting that U.S. banks do currently for interest paid to U.S. persons and to Canadian residents and would build on systems already in place.

That concludes my prepared statement. I would be pleased to answer any questions the Committee may have.

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

BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES
May 1, 2003

Good morning, Mr. Chairman, and Members of this Committee. I am John D. Graham, Ph.D., Administrator, Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget. I appreciate this opportunity to discuss OIRA's responsibilities under the Paperwork Reduction Act (PRA) and our efforts to alleviate the paperwork burdens that Federal agencies impose on small businesses.

In your letter of invitation, you specifically requested that my testimony address OIRA's interpretation of the term "collection of information" and describe the actions OIRA can take to enforce agency compliance with the PRA and the Regulatory Flexibility Act (RFA). Before discussing these issues, I would like to reiterate for the Committee OMB's deep commitment to reducing the regulatory and paperwork burdens that America's small businesses deal with every day. Both the PRA and RFA are vitally important to efforts by OMB, the Small Business Administration (SBA), and agencies such as the Department of the Treasury to eliminate unnecessary compliance burdens for small business.

The PRA Definition of Collection of Information

The PRA defines collection of information quite broadly. There are three specific types of information that are covered by the PRA: information that the public transmits to Federal agencies, recordkeeping requirements, and third party reporting requirements.

The first type of information collection is perhaps the first one that comes to mind for most individuals and businesses. This type involves requests for information from the public for transmission to the Federal government. These collections include tax returns, grant application forms, written report forms, telephone surveys, and electronic data collections. The second category of information—recordkeeping requirements—involve compilation and maintenance of specified records, either alone or in conjunction with the reporting of information to an agency or a third party. The final type of information collection involves what are referred to as "third-party" disclosure requirements, in which the Federal Government requires an entity or individual to disclose information to another entity or individual (an example is a Federal requirement for the disclosure of information on labels, such as the nutritional labels that are found on food packages).[1]

[1] 44 U.S.C. 3502(3).

Information collections, recordkeeping requirements, and third-party disclosure requirements can be contained in or authorized by regulations as monitoring or enforcement tools. They can also appear in forms and their accompanying instructions. Subject to certain exemptions, all agency collections of information are subject to OMB review and approval, regardless of the format a collection may take (e.g., paper, telephone, in-person, automation, electronic).[2]

In 1996, in the Small Business Regulatory Enforcement Fairness Act, Congress amended the Regulatory Flexibility Act in several ways. One of these amendments included, within the coverage of the RFA, those "interpretative rules" that involve "the internal revenue laws of the United States" and are "published in the Federal Register for codification in the Code of Federal Regulations, but only to the extent that such interpretative rules impose on small entities a collection of information requirement." The 1996 amendments to the RFA incorporated into the RFA, verbatim, the PRA's definition of what is a "collection of information." In other words, the term "collection of information" has the same meaning in both the PRA and the FRA.

OIRA and the Paperwork Reduction Act

The Paperwork Reduction Act directs OMB to work with Chief Information Officers—the officials designated by the PRA as responsible for the management of information resources within their agencies—to reduce information collection burdens on the public that "represent[s] the maximum practicable opportunity in each agency" and improve "agency management of the process for review of collections of information." OIRA exercises its PRA oversight authority in a number of ways, the two most important of which are our day-to-day reviews of agency information collection requests and the annual development of the Information Collection Budget (ICB).

For all collections of information subject to the PRA, agencies must obtain OMB approval before implementing them. After the initial approval, agencies must receive extensions of OMB approval at least once every three years. OIRA's reviews of agency requests involve an assessment of the "practical utility" of the information to agency and associated burden that collecting this information imposes on the public.

OIRA is particularly sensitive to collections targeted at small businesses, and continually seeks to ensure that the paperwork burdens imposed are justified by the usefulness and timeliness of the information to the government. The Paperwork Reduction Act itself directs agencies to reduce the burdens that collections of information impose on small businesses. The PRA's statement of "purposes" expressly mentions the minimization of "paperwork burden" on "small businesses" as one of the Act's goals. Moreover, the 1995 amendments to the PRA require agencies to certify, when the agency submits a proposed collection to OMB for review, that the collection "reduces to the extent practicable and appropriate the burden" on small businesses and other small entities. As the PRA indicates, agencies should reduce the paperwork burden on small

[2] 44 U.S.C. 3502(3); 5 CFR 1320.3(c)(1); 60 Fed. Reg. 44978-79 (August 29, 1995).

businesses through "such techniques as – (i) establishing differing compliance or reporting requirements or timetables that take into account the resources available to those who are to respond; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements; or (iii) an exemption from coverage of the collection of information, or any part thereof."[3] OMB incorporated this certification requirement into OMB's PRA regulations [at 5 C.F.R. 13209.9(c)] as well as in the form that agencies must submit to OMB requesting OMB approval of a proposed collection (the Form 83-I). In addition, this PRA submission form requires agencies to tell OMB whether or not "this information collection [will] have a significant economic impact on a substantial number of small entities."

Finally, I should also note that Congress in last year's Small Business Paperwork Relief Act reinforced the PRA's focus on minimizing the paperwork burden that the Federal government imposes on small businesses. In addition to establishing a multi-agency task force on this issue, to which I will turn shortly, Congress amended the PRA to require agencies to "make efforts to further reduce the information collection burden for small business concerns with fewer than 25 employees."[4]

OMB recently submitted to Congress its FY 2003 Information Collection Budget, the annual development of which is a key component of OMB's oversight of agencies. Each year, through our efforts to prepare the ICB, we ask agencies to review their information collections, keeping in mind the PRA's burden reduction goals and OMB's commitment to burden reduction. Agency CIOs send their agencies' annual submission to OMB, identifying the "maximum practicable" paperwork burden reduction they can achieve, consistent with the agency's statutory and programmatic responsibilities. Based on this information, OMB is able to manage overall burden and seek information on priority burden reduction initiatives.

During my tenure as OIRA Administrator, OMB has also adopted a "zero-tolerance policy" for violations of the PRA, which involve the use by agencies of information collections without the required OMB approval. Accordingly, we have been working diligently with agency staff and policy officials throughout the last 18 months to eliminate all existing violations and put procedures into place to avoid any future violations. The success that OMB and the agencies have had in significantly reducing the number of agency violations of the PRA is recounted in the FY 2003 Information Collection Budget and was also discussed by the General Accounting Office in its recent testimony before the House Government Reform Committee, Subcommittee of Energy Policy, Natural Resources and Regulatory Affairs.[5]

[3] 44 U.S.C. 3506(c)(3)(C)
[4] Section 2(c) of the Small Business Paperwork Relief Act, adding 44 U.S.C. 3506(c)(4).
[5] GAO-03-691T, April 11, 2003

OIRA and the Regulatory Flexibility Act

Mr. Chairman, your letter of invitation asked about actions that OIRA has taken to enforce the Regulatory Flexibility Act. The Reg Flex Act does not give OMB an enforcement role. Nonetheless, many of OIRA's activities provide an opportunity to encourage agency compliance with the spirit of the RFA. For example, OMB is currently in the process of implementing the Small Business Paperwork Relief Act of 2002. This Act established a multi-agency task force on information collection and dissemination chaired by OMB. Mitch Daniels, the Director of OMB, appointed Mark Forman, OMB's Associate Director for Information Technology and E-Government, and me, to co-chair the task force. The task force includes representatives from the following agencies:

- Department of Labor (including the Bureau of Labor Statistics and the Occupational Safety and Health Administration)
- Environmental Protection Agency
- Department of Transportation
- Small Business Administration's Office of Advocacy
- Small Business Administration
- Department of Commerce
- Internal Revenue Service
- Department of Health and Human Services
- Department of Agriculture
- Department of Interior
- General Services Administration

The group's efforts will support the goal of the Government-to-Business, E-Government Portfolio: reducing the burden on businesses by adopting processes that enable collecting data once for multiple uses. In fact, as the managing partner for the Business Compliance One Stop (one of the cross-agency E-gov initiatives), SBA has already demonstrated in its prototype savings of one hour per user in reporting burden. Given IRS estimates that 2.4 million businesses annually apply for an EIN, this application could save $96 million per year from streamlining, harmonizing, and automating these processes. The initiative will use three strategies to accomplish this, including reducing the information required from businesses through analyzing if information is needed; assessing whether definitions in different forms and forms in different agencies can be harmonized to reduce overlap; and increasing the effectiveness of data collections processes by collecting once and sharing data among programs and agencies. This initiative also represents the first Web service that fulfills both a state and a federal regulatory requirement at the same time. In addition, the BCOS team has developed a proof of concept for harmonizing coal miner reporting, where information is collected once and used several times, which is estimated to cut the reporting burden by 50 percent, from 50,000 hours annually to 25,000 hours.

Another related E-government project that reduces burden on businesses is the Expanding Electronic Tax Products for Businesses (EETPB) initiative. The objective of the EETPB is to reduce the tax-reporting burden on businesses while improving the

efficiency and effectiveness of government operations. The initiative is comprised of seven projects that will deliver benefits by reducing the number of tax-related forms that businesses must file, providing timely and accurate tax information to businesses, increasing the availability of electronic tax filing, and modeling simplified Federal and state tax employment laws. These projects include Form 94x Series, Form 1120/1120S, Form 8850, Internet Employer Identification Number (EIN), and the Standardized EIN.

Further, the task force seeks to propose recommendations that will reduce the paperwork burden on small businesses and make it easier to find, understand and comply with government collections of information. Specifically, SBPRA charges the task force with examining five ideas:

1. Examine the feasibility and desirability of consolidating information collection requirements within and across Federal agencies and programs, and identify ways of doing so.

2. Examine the feasibility and benefits to small businesses of having OMB publish a list of information collections organized in a manner by which they can more easily identify requirements with which they are expected to comply.

3. Examine the savings and develop recommendations for implementing electronic submissions of information to the Federal government with immediate feedback to the submitter.

4. Make recommendations to improve the electronic dissemination of information collected under Federal requirements.

5. Recommend a plan to develop an interactive Government-wide Internet program to identify applicable collections and facilitate compliance.

The task force began its work with a meeting of the full membership to develop a common understanding of the law, project goals, scope, roles and responsibilities, resource requirements, strategy, timeline, and deliverables. A professionally facilitated brainstorming session followed, during which members began looking at the first three tasks for the 2003 report. After the initial meeting, the task force divided into three subcommittees to examine the three tasks in greater detail. The task force met again on April 4, 2003 to discuss the subcommittee findings and recommendations.

A report of findings and recommendations will be published for the first three ideas by June 2003, and the remaining two ideas by June 2004. The draft for this year's report is now under development in preparation for a public comment period during May 2003. SBA's Office of Advocacy already held a public meeting on March 4, 2003 to solicit views of interested persons regarding the SBPRA.

In addition to these activities, we have taken steps to ensure that small business concerns are addressed in OIRA's regular review of draft agency regulations. For

example, on March 19, 2002, OIRA and SBA's Office of Advocacy entered into a memorandum of understanding (MOU) to formalize OIRA's long-standing practice of involving the Office of Advocacy in our review of agency regulations under Executive Order 12866. The MOU provides for consultations between OIRA and Advocacy on agency compliance with the RFA, and it authorizes OIRA to return rules to agencies for non-compliance with the RFA. We expect that the MOU will enhance our ability to ensure that agencies are meeting their RFA responsibilities.

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

SBA Office of Advocacy

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IRS Compliance with the Regulatory Flexibility Act

United States House of Representatives, Committee on Small Business
Thursday, May 1, 2003

Thomas M. Sullivan, Chief Counsel for Advocacy, U.S. Small Business Administration

TESTIMONY SUMMARY

As stated in the FY 2002 Annual Report of the Chief Counsel for Advocacy on Implementation of the RFA, Advocacy believes the Treasury Department's Internal Revenue Service (IRS) can improve its rulemaking process.

Advocacy believes Congress established the "collection of information" requirement to trigger IRS compliance with the RFA on certain rules, not to limit the scope of the analysis to only the small business impacts resulting from the collection of information. Advocacy believes Congress passed the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) to require the IRS to perform an RFA analysis of entire rules and their impacts. Advocacy recommends that IRS certify a rule under Section 605(b) of the RFA only if the rule in its entirety will not have a significant economic impact on a substantial number of small entities.

The IRS generally bases its RFA analyses for rules on its burden analysis under the Paperwork Reduction Act, but Advocacy believes the RFA requires the IRS to look at alternatives and the impact of the tax the regulation imposes in certain cases. Advocacy believes the IRS should seek to identify costs and hardships imposed by the regulatory approaches under consideration and look for alternatives to achieve the objective with fewer burdens, prior to publishing a rule for comment.

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is a voice for small business within the federal government. Advocacy is an independent office, so the views in the testimony do not necessarily reflect the views of the SBA or the Administration.

Appointed by the President and confirmed by the U.S. Senate, the Chief Counsel for Advocacy directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Economic research, policy analyses, and small business outreach help identify issues of concern. Regional Advocates and an office in Washington, DC, support the Chief Counsel's efforts.

For more information on the Office of Advocacy, visit www.sba.gov/advo, or call (202) 205-6533.

STATEMENT OF
HON. ANDY IRELAND
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
MAY 1, 2003

Mr. Chairman and Members of the Committees, my name is Andy Ireland and I thank you for inviting me to testify before you today on a subject that is near and dear to my heart--the Regulatory Flexibility Act.

As many of you know, I was a long-standing Member of this Committee when I served in the House from 1977-1993. During my last term, I was honored to serve as the Committee's Ranking Republican Member. During my entire Congressional career I was most proud of some of the accomplishments I was able to take part in on behalf of this nation's small businesses. During my sixteen years service on this Committee (eight as a Democrat and eight as a Republican) some of my most difficult challenges involved trying to get regulatory agencies to better understand that "one-size fits all" regulations did not work for most of this nation's small businesses--in fact, for many, this kind of regulatory activity was a death sentence.

During my first term I was pleased to sponsor legislation called the Regulatory Flexibility Act. We had several hearings, heard much testimony, but we were unable to move our legislation. The next Congress we worked a little harder, listened to more testimony, made some adjustments, worked with the Senate, experienced some very good luck, and finally got our legislation through. I had a lot of help back then--most of it

from some of this Committee's finest Members, like Ike Skelton; and finest staff, like the late Steve Lynch.

Our good luck charm turned out to be the 1980 White House Conference on Small Business. There was a growing chorus of complaints from the small business community back then. Small Business lobbyists like Mike McKevitt, John Motley and a much younger Frank Swain were at the forefront of pushing for meaningful regulatory reform. The White House Conference on Small Business helped serve as a catalyst for our efforts and we were able to realize not one, not two, but three meaningful legislative victories for small business in 1980. During the fall of 1980, President Carter signed into law the Regulatory Flexibility Act, the Equal Access to Justice Act and the Paperwork Reduction Act.

Unfortunately, the implementation of the Regulatory Flexibility Act has been anything but smooth. Despite solid efforts by Frank Swain and other Chief Counsels for Advocacy over the years, the letter and spirit of the Regulatory Flexibility Act has fallen mostly on deaf ears throughout many of the executive departments and regulatory agencies. We are here today to discuss one of these culprits--the Internal Revenue Service.

It was clear to me by the mid-1980's that there were a number of agencies that were of the opinion that the RFA did not apply to them. It was also clear that there were a number of agencies that would creatively use some of the shortcomings of the original RFA to circumvent their need for compliance. The lack of judicial review of agency compliance with the RFA was a monumental problem--however, that was something that

we had to bargain away back in 1980 with the House and Senate Judiciary Committees in order to get our legislation on the President's desk.

The most consistent argument against compliance, however, always seemed to come from the IRS. It was their view that they did not need to comply with the RFA when they were engaged in interpretative rulemakings--that since the RFA was, for the most part, an extension of the Administrative Procedure Act, they were not required to do anything in the way of a cost/benefit analysis because they were not making new demands on small businesses but only formatting legislative edicts that were already contained in the Internal Revenue Code.

I and other members of this Committee fought with Treasury and the IRS on this issue year in and year out from the mid-1980's until I retired from Congress. In fact, one of my last oversight battles was fought over changes that the IRS sought to make to the payroll tax deposit system--of course, without doing a regulatory flexibility analysis. What they put out as a proposed rule can best be described as gibberish. I couldn't understand it. Every tax lawyer I spoke with couldn't understand it. And, when I went to testify at a hearing before the staff of the IRS Commissioner none of his people seemed to understand it. Yet these same people were confident that the average small business person would have no problem complying with this new proposed regimen for payroll tax deposits. As in the past, the IRS argued that this rulemaking was an interpretative rule. (Historically, they have argued that all of the rulemakings involved interpretative rules.) Well I wasn't prepared to settle for that so I went to see Nick Brady, the Secretary of Treasury. I complained. I went to see him a second time and I complained some more. Finally, we got a meeting with some of the senior people at Treasury and we made some

serious inroads into improving the rule. There was still no regulatory flexibility analysis—but I was able to use my position to make some significant improvements to the rule.

As I was leaving Congress towards the end of 1992 I was approached by a new Member, Tom Ewing of Illinois, who quite graciously thanked me for all that I had done on Reg Flex and asked if I would support his efforts to seek needed amendments to the RFA--primarily judicial review for non-compliance with the RFA. Tom introduced legislation that year, but unfortunately only the Judiciary Committee had jurisdiction over the Regulatory Flexibility Act. He couldn't even get a hearing before a Judiciary Committee subcommittee. The next Congress, Tom introduced his RFA improvement legislation again--this issue, judicial review for Reg Flex compliance, had become a labor of love for Tom Ewing much like the original Reg Flex Act had been for me. Tom finally got a hearing before a Judiciary Committee subcommittee during the 103rd Congress, thanks to the efforts of another Member of this Committee at the time, Jim Ramstad, who also served on Judiciary back then. The hearing came and went but Tom couldn't get his legislation through.

Finally, in the next Congress, the 104th, Tom's dogged persistence finally paid off and his legislation was included in a package of legislation that was advanced by the new leadership of the House. It still took almost two years to get it passed into law, and much of the credit for that accomplishment should go to Sen. Kit Bond, who took much of Tom Ewing's reg flex improvement legislation and folded it into the Small Business Regulatory Enforcement Fairness Act or SBREFA.

Well, the improvements to Reg Flex that were contained in SBREFA are 7 years old this month, and the original Reg Flex Act will be 23 years old this coming September. Unfortunately, we still have to have hearings like this one today because the IRS continues to resist doing what it should do to comply with a law that was signed by President Jimmy Carter. As Yogi Berra might say, for me today's hearing is like déjà vu all over again.

But now, a word about the current issue of the proposed IRS regulation concerning the reporting of interest paid on deposits of non resident aliens by U.S. Financial institutions.

Prior to my service in Congress, I had a career in the banking. I served as a senior executive and director of one of Florida's largest banks, and was a principle owner and CEO of a group of banks serving a predominantly small business market. I served as Treasurer of the Florida Bankers Association and on the board of directors of the Jacksonville Branch of the Federal Reserve Board of Atlanta. I currently serve as a director and chairman of the Investment Committee of a prominent community bank in central Florida.

It was, therefore, a source of some concern when I found that in the closing days of the Clinton administration, the Treasury Department was proposing regulations to U.S. financial institutions to report automatically to the federal government interest paid to non-resident aliens. Congress made a decision some years ago not to tax interest paid to non-resident aliens as part of an effort to attract foreign investment in the U.S. So it does not seem to make sense for the Internal Revenue Service to be requiring the collection of information about interest payments that are not subject to tax. The job of the IRS is to

collect taxes due the federal government – not impose additional burdens on business unnecessarily.

Another problem with these proposed regulations is that they may succeed in driving large amounts of foreign investment out of the U.S. It has been estimated that there is a trillion dollars in foreign owned U.S. issued financial assets. A significant portion of that could be driven out of this country if automatic interest reporting is required by the IRS.

When the interest reporting regulations were first proposed, the Florida Bankers Association, to its great credit, took the lead in fighting against this new burden. One of the problems that affected Florida banks most directly was the concern that in some countries financial privacy is not effectively guarded. If the information which US financial institutions were forced to collect was shared with the government in a nation that did not guard that information carefully, the information could find its way into the wrong hands. In some nations there is a problem with kidnapping of people who are believed to have money, followed by a demand for ransom. Congressman Dave Weldon of Florida played a leading role in expressing opposition to this first version of the proposed regulations.

In response to strong opposition from Congress and others, the IRS withdrew the first version of the proposed regulations in the summer of 2002, and issued a second version of the proposed regs, which was exactly the same as the first version except that it was limited to non resident aliens in approximately fifteen countries, mostly in Europe.

Except for limiting the number of countries to which the proposed regs are applicable, all the problems that were in the first version of the proposed regs still remain in the second version. The IRS will still be requiring US financial institutions to report payments that are not subject to U.S. tax. The effect of the regs will still be to drive large amounts of foreign investment away from the U.S. adversely effecting the economy.

The FBA among others have expressed their dissatisfaction with this new IRS proposal. I have spoken out personally and on behalf of others who will be adversely effected by the burden of reporting under this proposal and the adverse economic impact to small business across America.

Mr. Chairman, others testifying before you today will speak in detail to the adverse economic effects of this ill conceived IRS rule. The need to avoid these effects and the reporting burden they cause would be clear if the IRS would comply with the intent of Congress and produce a Regulatory Flexibility Analysis.

Statement of Frank S. Swain

Committee on Small Business

US House of Representatives

Regarding Internal Revenue Service Compliance with the Regulatory Flexibility Act

May 1, 2003

Mr. Chairman, Representative Velazquez and Members of the Committee:

Thank you very much for the opportunity to participate in this hearing. I am a partner in the law firm of Baker & Daniels and served as SBA Chief Counsel for Advocacy from 1981 through 1989. Having represented small businesses from a trade association, within the government and as a practicing attorney, I can reiterate that no agency of the Federal government has a more significant economic impact on small businesses than the Internal Revenue Service.

This hearing is focused on whether the Service complies with the requirements of the Regulatory Flexibility Act. My response is based on my experience as SBA Chief Counsel, and on a recent and ongoing representation of a coalition of small businesses on a tax issue. During my tenure as SBA Chief Counsel, the IRS did not have an admirable record of making or at least sharing with the public small business impact analyses. Unfortunately, the IRS attention to this requirement does not seem to have greatly improved, despite Congress' attempt in 1996 to tighten the legal standards. In fact, the most recent semi annual regulatory agenda published by the Internal Revenue Service in the December 9, 2002 Federal Register lists 286 regulatory projects in various phases of completion, but indicates that only two of these projects have any small business impact (with the question of Regulatory Flexibility Act "undetermined" in 37 actions). Whatever the IRS reading of the law is, in the real world it strains credibility that only two of 286 current IRS regulatory matters have a significant impact on small business.

This is unfortunate, and more importantly, unnecessary. The small business community does not, of course, want to pay any more tax than necessary, but it is not opposed to a tax system or to the IRS. The purpose of the Regulatory Flexibility Act is to require an analysis which might shed some light as to whether the equivalent regulatory or tax policy goal could be accomplished with lesser burden, or more flexibility for small businesses. The Regulatory Flexibility procedures are effectively a subset of best practices in rulemaking, that should yield more effective and more finely tuned rules, which accomplish the governmental objective with the least possible burden. That is a goal which every Congress and every Administration has endorsed in one way or another since 1980, the year of enactment of the Regulatory Flexibility Act. Better rules will lead to better compliance, for the IRS and for any other agency. Poor rules and poor explanations for rules, after nearly 25 years of Federal government focus on rulemaking improvements, can no longer be acceptable.

My experience in dealing with the Service when I was in the government was that the IRS offered two reasons not to make the Regulatory Flexibility analyses:

- that analyses were not actually required by law;
- that efficient administration of the tax system meant that rules had to be made rapidly and could not be held up for necessary analyses.

Legal Coverage of IRS Actions

While the IRS has in recent years taken several welcome steps to generally focus more on tax issues specific to smaller firms, the record does not suggest it regards small business regulatory analysis as a priority. I will leave to others a more detailed discussion as to why the IRS position, as a matter of law, does not appear to be consistent with the Small Business Regulatory Enforcement Fairness Act (SBREFA). I simply conclude that a legal analysis that results in small business analysis by IRS of only two of 286 rulemakings appears to be quite narrow.

IRS Need to Stay Efficient and Flexible

Collecting the taxes is an essential and daunting task. The Service is chronically short of necessary resources. It is perhaps understandable to hear some question the priority of doing an economic analysis, when there are hundreds of competing regulatory and enforcement priorities. But the Regulatory Flexibility Act is not itself inflexible. It allows introduction of information at an initial phase and at a final phase. The SBA Office of Advocacy has for many years on an informal basis, and recently more formally, offered guidance, information and advice on how analyses can be effectively accomplished.

The perfect should not be the enemy of the good – some minimal analysis of businesses impacted and burdens created by tax regulations is very useful to the public and attainable. For more than 20 years the IRS and every agency have had to make related estimates for Paperwork Reduction Act purposes. The most basic small business question that any agency, especially the IRS, should be able to answer is how many small businesses will an action affect. Because of its function as the tax collector, the IRS in particular has information at hand on these issues. Its data should regularly and publicly inform the rulemaking process, with no loss of regulatory efficiency. Performing at least a minimal small business analysis does not require a delay, especially for an agency as rich in data as IRS.

Much more so than when the Congress passed the Regulatory Flexibility Act in 1980, we are awash in data about business, including small business. We are also much smarter and more efficient about calculating costs. The Federal government itself is the major source of data about business, and as every witness at this hearing knows, the data can be sliced and diced in countless ways. The Service, in particular, has the ability to tap many other government agencies for information relevant to assessing the impact of tax rules on various segments of business. Whether IRS chooses to use that resource, or shares their considerable information with the taxpaying public, is the key question. An analysis does not have to mean a delay.

Mobile Machinery Rulemaking Proposal – the Lost Analysis

Nearly a year ago the IRS announced in the Federal Register a new regulatory proposal which is a case study of how the rulemaking process would be improved were Regulatory Flexibility analyses performed, and furthermore how the IRS could have accomplished such analyses with no delay based on information it already had in its files. I should initially state that the overall procedural approach of the Department of Treasury and IRS to this rule, since it became aware of certain small business concerns, has been admirable in many ways. Responding to Congressional and SBA Advocacy requests, IRS extended the comment period and held a public hearing. IRS and Treasury have, within appropriate limitations, been available for discussions regarding the tax issue involved. Most recently, Secretary Olson in response to numerous Congressional expressions of concern, including a letter from the Chairman and several Members of this Committee, announced that final action on the rule would be suspended until Congress had the opportunity to review the matter.

All that is good. But public discussion of this proposal could be much more efficient focused if the IRS had only done the analyses, based on information which they already had in their files.

In June 2002 the IRS published a proposal to eliminate an existing regulatory exemption from certain fuel and other excise taxes – the mobile machinery exemption. This regulation had been effective since 1977, and the principle dated back earlier and was reflected in various IRS rulings. There is a long line of private letter rulings and judicial decisions interpreting this rule. The IRS publication noted that the proposal would not have a significant economic impact on small business, and also that it was not a major rule subject to OIRA review.

Although it is now clear IRS had been thinking about this issue for several years, for reasons IRS has never quite explained, IRS proposed not modifying but eliminating this exemption. It turns out that many industries regularly utilize equipment which has been categorized by IRS as fitting this exemption for special mobile machinery. It also turns out that many of these industries,

including construction, well digging services, mobile cranes, and other services often related to the national "infrastructure" have a significant small business population.

A coalition rapidly formed, representing trade and business associations concerned about the elimination of this rule. The Mobile Machinery Coalition includes many industry specific small business associations, including concrete pumpers, crane operators and water well services, as well as the National Federation of Independent Business and the National Association of Manufacturers. It is fair to state that these larger organizations are active with the coalition not only because they have members who will be adversely affected by the proposal, but also because there was an strong concern about the IRS moving on such a major change in tax law through a regulatory process, with no analysis or publicity as to its impact.

Based on the Coalition survey of its own firms and associations, comments were filed estimating the impact of the proposal to be as much as $ 250 million annually in increased taxes. But the IRS attitude to date can be fairly summarized as minimizing the effect of the proposal. The IRS position has been that this is at most an incremental change. Without an IRS Regulatory Flexibility or major rule analysis, we are all left guessing.

As it turns out, this IRS proposal to eliminate the mobile machinery exemption is a very major proposal, with a huge impact on affected taxpayers, and clearly a significant economic impact on a substantial number of small firms. We now know this because the Federal Highway Administration, in response to a Freedom of Information Act request, delivered to us this week a copy of an analysis of the economic impact of elimination of the mobile machinery exemption, an analysis which it had furnished to IRS in **December 1999**.

That Federal Highway Administration (FHWA) 1999 analysis for IRS estimated that the annual revenue impact of that change was **$ 256,632,910**. FHWA has updated this analysis to a current estimate of a **$ 462 million** annual impact. The FHWA documents (attached to this statement) further state that their estimate may be low, as it is based on 1997 data, and that the FHWA estimate "is about half of the potential loss estimated by IRS."

Conclusion

The mobile machinery rulemaking suggests that IRS could easily and simply produce basic impact analyses of many of their proposals. Its cursory statements avoiding analysis requirements are not supported by studies in their own files. Whatever the legalities of whether the analyses must be done, in fact they can be done, probably with minimal delay. It is not proper to state that a proposal which will have nearly a half billion dollar annual impact on taxpayers who own mobile machinery is not significant or major. There may arguably be tax policy reasons to review excise tax rules, or other parts of the Code. But until IRS shares its reasoning and its knowledge of impact with its customers -- small businesses and other taxpayers, no one knows. In the absence of such information, stating why the change is sought and the impact it will have, the IRS does not have an adequate public policy or legal basis for taking action.

Federal Highway Administration

Estimating HTF Losses From the Mobile Machinery Exemption

The attached table shows the estimated Highway Trust Fund (HTF) losses as a result of the mobile machinery exemption. These estimates are based on vehicle population and weight distribution information from the Truck Inventory and Use Survey (TIUS) conducted by the Census Bureau and information from the Highway Revenue Forecasting Model (HRFM) of the Federal Highway Administration (FHWA).

The fuel consumption figures shown are based on TIUS data for certain vehicle types and their reported annual mileage, fuel economy, fuel type and off-road usage. The appropriate tax rate was applied to the highway fuel usage to compute the estimated fuel tax loss. This estimate is less than the estimate prepared by IRS both because the volume of fuel is less and the tax rate per gallon is less than shown in the IRS estimate. Only about 60% of the vehicles use diesel fuel which is taxed at 24.3¢ per gallon. The remaining fuel is taxed at lower rates.

The TIUS data was used to identify the number of vehicles of certain body types by weight. The sales tax (§4051 of the Internal Revenue Code of 1986) is 12% of the retail price of trucks over 33,000 gross vehicle weight. Less than ¼ of the vehicles have gross weights over 33,000 pounds and are subject to the sales tax. The retail price is estimated as $70,000 from the HRFM. It is estimated that 10% of the fleet is replaced annually.

The Heavy Vehicle Use Tax (HVUT) is computed based on the vehicle populations for the appropriate vehicle types that are over 55,000 pounds with application of an exclusion to that population for those vehicle used on the highway less than 5,000 miles per year. Most vehicles identified as the type that would be included in the mobile machinery exemption are below the HVUT threshold. For those vehicles less than 75,000 pounds, the HVUT less than the maximum was used, as appropriate. This estimate is lower than the IRS estimate both because the number of vehicles subject to the tax is reduced compared with the IRS estimate and the maximum rate is not applied to all the vehicles.

The tire tax is based on computing a tire consumption rate and thus a corresponding tax per mile for the different weight vehicles. This tire consumption rate is based on HRFM data and the tire tax rates. These rate were applied to the vehicle miles of travel for the relevant vehicle types as determined by TIUS.

The total estimated HTF loss from the mobile machinery exemption would be about $257 million per year if all vehicles eligible for the mobile machinery exemption claimed it. This estimate is largely based on data from 1992. There may have been some growth in the size of the fleet and the corresponding potential HTF loss since that time.

This estimate is about half of the potential loss estimated by IRS. While both the FHWA and IRS estimates are based on the same overall fleet size, FHWA assumes that a much smaller number of vehicles would be subject to the HVUT and as noted above has significantly lower estimates of fuel tax losses based on lower fuel consumption and fuel type data from the TIUS.

§4041 & §4081

Fuel Type	Fuel (Gallons)	Highway Fuel (Gallons)	**Fuel Tax $**
Leaded Gas	48,002,850	40,935,767	
Unleaded	245,640,062	224,409,444	
Diesel	464,556,422	428,734,439	
LPG/LNG	21,533,022	21,194,591	
Other	936,418	857,481	
	780,668,774	716,131,722	**$155,342,116**

§4051

Wt.	Vehs.	Estimated Vehicle Price	**Sales Tax**
32,999 or less	381,773	$70,000	0
>32,999	104,934	$70,000	**$88,144,560**

Tax is 12% of retail price

§4481

Wt.	Vehs.	Heavy Vehicle Use Tax $/veh	**HVUT**
54,999 or less	458,020	0	
55,000-75,000	15,062	Varies	
>75,000	13,625	550	

Tax is $100 at 55,000 lbs gvw and $22 per thousand lbs over 55,000 with a maximum tax of $550/year/vehicle.

Vehicles used less than 5,000 highway miles/year are exempt

$7,219,459

§4071 **Tire Tax**

Tire Weight	Tax Rate
40 lbs or less	No tax
40-70 lbs	¢/lb over 40 lbs
70-90 lbs	¢/lb over 70 lbs
over 90 lbs	$10.50 plus 50¢/lb over 90 lbs

$5,926,775

Total **$256,632,910**

April 8, 2003

Estimating HTF Losses From the Mobile Machinery Exemption

The attached table shows the estimated Highway Trust Fund (HTF) losses as a result of the mobile machinery exemption. These estimates are based on vehicle population and weight distribution information from the Vehicle Inventory and Use Survey (VIUS) conducted by the Census Bureau and information from the Highway Revenue Forecasting Model (HRFM) of the Federal Highway Administration (FHWA).

The vehicles included from the VIUS database are those with body types that are easily identified as likely to fit under the mobile machinery definition. These body types include platforms with added devices, public utility trucks, and concrete mixers. Garbage trucks, which may or may not include compacting equipment are not included nor is any estimate of vehicles that have power take-offs or similar equipment attempted.

The fuel consumption figures shown are based on VIUS data for certain vehicle types and their reported annual mileage, fuel economy, fuel type and off-road usage. The appropriate tax rate was applied to the highway fuel usage to compute the estimated fuel tax loss. Only about 60% of the vehicles use diesel fuel, which is taxed at 24.34 per gallon. The remaining fuel is taxed at lower rates.

The VIUS data was used to identify the number of vehicles of certain body types by weight. The sales tax (∋4051 of the Internal Revenue Code of 1986) is 12% of the retail price of trucks over 33,000 gross vehicle weight. Less than 40% of the vehicles have gross weights over 33,000 pounds and are subject to the sales tax. The retail price is estimated as $70,000 from the HRFM. It is estimated that 10% of the fleet is replaced annually.

The Heavy Vehicle Use Tax (HVUT) is computed based on the vehicle populations for the appropriate vehicle types that are over 55,000 pounds with application of an exclusion to that population for those vehicle used on the highway less than 5,000 miles per year. Most vehicles identified as the type that would be included in the mobile machinery exemption are below the HVUT threshold. For those vehicles less than 75,000 pounds, the HVUT less than the maximum was used, as appropriate.

The tire tax is based on computing a tire consumption rate and thus a corresponding tax per mile for the different weight vehicles. This tire consumption rate is based on HRFM data and the tire tax rates. These rates were applied to the vehicle miles of travel for the relevant vehicle types as determined by VIUS.

The total estimated HTF loss from the mobile machinery exemption would be about $462 million per year if all vehicles eligible for the mobile machinery exemption claimed it. This estimate is largely based on data from 1997. There may have been some growth in the size of the fleet and the corresponding potential HTF loss since that time.

08-Apr-03

§4041 & §4081

Fuel Type	Fuel (Gallons)	Highway Fuel (Gallons)	**Fuel Tax $**
Leaded Gas	21,990,759	20,426,111	
Unleaded	217,017,026	197,799,259	
Diesel	915,489,745	858,301,371	
LPG/LNG	11,416,904	10,883,250	
Other	3,818,395	3,610,595	
	1,169,732,829	1,091,020,586	**$250,000,000**

§4051

Wt.	Vehs.	Estimated Vehicle Price	**Sales Tax**
32,999 or less	359,357	$70,000	0
>32,999	197,502	$70,000	**$166,000,000**

Tax is 12% of retail price

§4481

Wt.	Vehs.	Heavy Vehicle Use Tax $/veh	**HVUT**
54,999 or less	456,798	0	
55,000-75,000	74,592	Varies	
>75,000	25,469	550	

Tax is $100 at 55,000 lbs gvw and $22 per thousand lbs over 55,000 with a maximum tax of $550/year/vehicle.
Vehicles used less than 5,000 highway miles/year are exempt

$34,000,000

§4071 **Tire Tax**

Tire Weight	Tax Rate
40 lbs or less	No tax
40-70 lbs	15¢/lb over 40 lbs
70-90 lbs	$4.50 plus 30¢/lb over 70 lbs
over 90 lbs	$10.50 plus 50¢/lb over 90 lbs

$12,000,000

Total **$462,000,000**

TESTIMONY OF
DAN R. MASTROMARCO
ON BEHALF OF THE
NATIONAL SMALL BUSINESS UNITED
BEFORE THE COMMITTEEE ON SMALL BUSINESS
U.S. HOUSE OF REPRENTATIVES
(MAY 1, 2003)

Chairman Manzullo and Members of the Committee:

On behalf of National Small Business United – the nation's oldest small business organization -- I commend you for holding this hearing on how the letter and the spirit of the Regulatory Flexibility Act and the Small Business Regulatory Enforcement Fairness Act might be better fulfilled by Treasury, especially the Internal Revenue Service.

Over more than 15 years, in both the private and public sectors, I have engaged in many small business regulatory debates. I have also advised emerging democracies and their trade associations on the need for regulatory due process. If I were to abstract from these experiences one overarching lesson it would be this: on the short list of things critical to a democracy is adherence to regulatory due processes. The basic elements of healthy due process include notice, opportunity for comment, and a required rationalization of decisions. Part of this due process – ushered through the Congress by then Chairman Andy Ireland – is the requirement agencies examine the impact of their rules on small entities which bear disproportionate costs of rules. The ranks of Washington tax lobbyists would diminish if agencies were required in an orderly manner to measure the effects of their rules on small firms, and consider how to implement them with least imposition of costs.

Allow me three key observations on the RFA:

- First, the RFA can be an irreplaceably valuable tool that will not only result in better, less costly IRS rules, but faster guidance, guidance with which businesses will more readily comply and less controversial guidance.
- Second, the RFA has not functioned well in application to the IRS; primarily because the agency culture still has not embraced it nearly a quarter century after enactment.
- Last, this extant culture of resistance will only be changed if Congression gets serious in closing loopholes and exercises vigilant oversight, such as that conducted today.

I am sure today's hearing generated lively discussion between OMB and the IRS about compliance with the Regulatory Flexibility Act (RFA, used hereafter to encompass SBREFA).

The primary infirmity from which RFA suffers is a not a legal one -- it is institutional. As this Committee recognizes, the safeguards of the RFA, as those of the Administrative Procedure Act (APA) were never meant to slow vital guidance, but rather to standardize due process tools that will assist in the development of better rules from the inside out. However, the Service sees it differently. While it is the stated "policy of the Department of Treasury to ... minimize the compliance and paperwork burdens of all their regulations on small entities," it is an unstated policy of the Chief Counsel to interpret the RFA in as parsimonious a manner as possible. The IRS has consistently resisted – not embraced – the procedural strictures of the RFA. Its regulatory culture views the law as a procedural quagmire to be avoided. And by failing to exercise keen oversight, the tax-writing committees have coddled this view.

If avoidance of the RFA has been the Service's implicit goal, they have been unquestionably successful; but for those who care about the efficacy of the RFA, the overall record has been 'dismal.' The Service's failure to debug rules has not only inflicted injury on the small business community, but resulted in false regulatory starts, considerable delay, and ultimately Congressional involvement in the rulemaking process – including regulatory moratoriums.

To fully appreciate the problem, this Committee would benefit from a brief legal diagnosis of the infirmities of the RFA. I will walk you through a flow chart (attached as an appendix) that attempts to decipher what Treasury means by "compliance" and illuminate the decisional points where remedial legislation may be required. The Committee would also benefit from bringing this abstract legal discussion to life through an example of how Treasury misinterprets the RFA in a proposed rulemaking – here the Non-resident Alien (NRA) Reporting requirements. Last, I recommend what might be the focus of the Committee's efforts to truly make the RFA functional.

I.The Decisional Flowchart

As the Committee knows, the Bush Administration strongly signaled support of the RFA through President Bush's Executive Order (EO) 13272 (Proper Consideration of Small Entities in Agency Rulemaking (August 13, 2002)). That EO directed federal agencies, including the Service, to write procedures and policies to "promote compliance with the RFA ... [and] ... ensure that the potential impacts of ... draft rules on [small entities] are properly considered ..." including the "thorough [] review [of] draft rules to ... take appropriate account of the potential impact on [small entities]."

The Treasury responded to this EO by drafting its "Policy and Procedures to Ensure Consideration of Potential Impacts of Regulations on small Business and Entities." In that document, they ostensibly adopted the spirit of the RFA, stating "not withstanding that the RFA may not apply ... it is the policy ... to minimize ... compliance and paperwork burdens ...." But evidence of how little additional thought was given the RFA, can be seen by comparing the EO response to the 1998 IRS Chief Counsel's RFA memorandum and checklist, entitled "Background and Procedures to be Followed in Ensuring Compliance with the RFA" (N(30)(15)531-1).

Both the RFA checklist and Treasury's EO response read like a legal survival guide for bureaucrats seeking to avoid the RFA. In them, rulemakers can learn how they can cross the "t's" and dot the "i's" while 'tipping their hat' to the requisite legal processes of the RFA. The guide is evidence that the Treasury Department has learned to mutate around the new strictures of SBREFA. Like good lawyers, the Treasury officials who wrote the guide wanted to optimize their client's options.

A. To Rule or Not a Rule?

The decisional junctures as shown on the attached flowchart double as escape hatches through which the RFA can be avoided. The first decisional juncture is, quite simply, what to call a rule. More specifically, the Service may promulgate what is essentially a substantive rulemaking under the label of a Revenue Procedure, Revenue Ruling, Technical Advice Memoranda, General Counsel Memoranda, even an IR News Release. By calling guidance other than a Notice of Proposed Rulemaking (NPRM), the Service assumes that the notice and comment provisions of the APA do not apply; and consequently, the RFA does not apply. An added benefit is that the Service may overrule these lesser pronouncements by a pronouncement of equal of higher rank, which avoids the need for notice and comment to change policy. By issuing a rule as other than a NPRM, a whole panoply of expensive and time-consuming procedural protections can be avoided in favor of executive fiat.

Of course, the label the Service chooses is -- in the eyes of the law -- a distinction without a difference. Numerous cases hold that notice and comment is required for rules of general applicability. Indeed, in one case, even a circular and policy letter issued by the Bureau of Apprenticeship and Training at the Department of Labor were considered substantive rulemakings subject to the APA notice and comment requirements (*Associated Builders and Contractors, Inc. v. Reich*, 922 F.Supp 676 (D.Ct. D.C. 1996).

The Office of Advocacy has been troubled with rules wrongly labeled as lesser pronouncements, and this committee should share their concern. Most recently, Rev. Proc. 2002-28, while favorably extending cash accounting eligibility to small firms, was objected to by Advocacy on the grounds that the use of a Revenue Procedure did not provided the correct procedural framework. There are many other examples the Office of Advocacy has opposed, and doubtless more to come.

B. One Person's Interpretation is Another's Discretion.

Assuming the Treasury Department properly issues its pronouncement as a proposed rulemaking, they can attempt to escape the strictures of the APA by calling the rule "interpretative" rather than "legislative". Although many have hoped the ubiquitous "interpretative" rubber stamp was wearing thin, over the past 23 years, the Service has labeled well over 90 percent of its rules as "interpretative." They generally have no difficulty doing so, at least until they are in court urging deference to their interpretation under a Chevron analysis while arguing the rule has the "force of law" (*Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.* (467 U.S. 837 (1984); *United States v. Mead Corp.*, 121 S. Ct. 2164 (2001)).

Calling the rule "interpretative" is perhaps the most egregious initial breach of the RFA because the APA is the fundamental legislation upon which the Federal rulemaking is based (*See*, S. Rep. No. 878, 96th Cong. 1st Sess.). .By side-stepping the APA, the Service is able to argue that it is neither subject to the same judicial review provisions of the APA, nor to the requirements of the RFA so long as there is no "collection of information" requirement. Moreover, according to the Chief Counsel's policy manual, when a rule is interpretative, "any possible impact is inherently part of the revenue impact of the underlying statutes, and thus is not considered in measuring any economic impact attributable to the regulations." In fact, by asserting a rule is "interpretative," the Service is by necessity arguing the corollary that notice and comment would not be needed. Indeed, the rule could apply retroactively, at least legally.

In 5 U.S.C. 553(b), the APA provides that:

[A] [g]eneral notice of propose rulemaking shall be published in the Federal Register,. ... Except when notice or hearing is required by statute, this subsection does not apply ... to interpretative rules [or] general statements of policy (emphasis added). ... After notice required by this section, the agency shall give interested persons an opportunity to participate in the rulemaking .... The required publication or service ... shall be made not less than 30 days before its effective date, except ... interpretative rules and statements of policy (emphasis added).

Whether the Service applies the correct standard for determining the interpretative or legislative nature of a rule is difficult to answer, since the standards they employ are not publicized. Judging by the number of rules considered interpretative, the Service may maintain the position that if a regulation is not expressly mandated by the Congress in the underlying statute, with verbiage such as "the Secretary shall promulgate regulations implementing this section," the rule is *ipso facto* "interpretative."

If that is their position, the Pavlovian reflex to call rules "interpretative" is untenable. Courts routinely find substantive rulemakings to result from agency pronouncements where the Congress has not mandated the regulation. In *Columbia Broadcasting Systems, Inc. v. United States,* 316 U.S. 407 (1942), for instance, the Supreme Court held that a regulation of the Federal Communications Commission constituted an order subject to judicial review. The Court emphasized, "[t]he particular label placed upon it by the Commission is not necessarily conclusive, for it is the substance of what the Commission has purported to do and has done which is decisive." Some courts have found that the exception for interpretative rules does not extend to rules that are intended to have the force of law. In *Pharmaceutical Manufacturers Association v. Frinch*, 307 F.Supp 858 (D.Del. 1970), the District Court of Delaware found:

The Commissioner has characterized the regulations as "procedural and interpretative" and thus contends that they fall within the exception to the notice and comment requirement. But the label placed on the rules does not determine whether the notice and comment provisions are applicable. ... Attempting to provide a facile semantic distinction between an "interpretative and procedural" rule on the one hand and a "substantive" rule on the other does little to clarify whether the regulations here involved are subject to the notice and comment provisions .... Rather that determination must be made in the light of the basic purpose of those statutory requirements..

The court went on to find that the regulations were "pervasive in scope and [had] an immediate and substantial impact on the PMA Members", and were therefore, substantive rules. Similarly in *Mr. Diablo Hospital District v. Bowen*, 860 F.2d 951 (9th Cir. 1988), the 9th Circuit found that "when an administrative policy acts as a substantive rule and alters an existing regulatory scheme, the policy must be adopted according to the procedures set forth in the APA." And as tax lawyers recognize, the Service is given wide discretion by the Congress to implement rules, itself a permanent delegation of authority.

It is equally troublesome that the Service appears to be as out of step with its own very narrow standard as represented to the Congress, as with judicial standards. For example, IRS Commissioner Roscoe Egger's testimony before this Committee stated that the difference between rules is primarily "the degree of discretion that we have in applying the rules." (Hearings Before the Subcommittee on Special Small Business Problems of the House Committee on Small Business, 99th Cong., 2d Sess. (1986).

C. Collection of Information

The next step along the decisional path is to determine if there is a "collection of information". After SBREFA, simply claiming a rule is "interpretative" does not exempt the Service from the RFA. If there are recordkeeping requirements imposed, the Service can avoid the RFA only by asserting that the rulemaking technically "do[es] not impose a collection of information on small entities" (5 U.S.C. 603), or by certifying that the rule does not impose a significant burden on a substantial number of small entities.

The Service apparently cannot disagree that the threshold definition of a collection instrument is low. Title 5 U.S.C. §601(7) unambiguously defines a 'collection of information' as "the ... causing to be obtained ... of facts ... for an agency, regardless of form or format, calling for ...identical reporting or recording requirements imposed on, 10 or more persons." However, the Service has seemingly grafted onto the statute a new requirement. They apparently consider a collection of information to exist only when there is no existing Office of Management and Budget control number for the Form in which the collection of information will be incorporated. The Service implicitly argues this position because the threshold standard in the RFA is borrowed from the Paperwork Reduction Act

(44 USC 3502(3)) standard. Quite simply, the Service may be maintaining that if a current form already exists the RFA is not triggered.

Such a construction was hardly the intention of the Congress and is not supported by the legislative language. In interpreting this provision, the Honorable Henry J. Hyde, the House sponsor, embellished the Congressional Record of April 19, 1996. According to Congressman Hyde:

Many IRS rulemaking involve "interpretative rules" that the IRS contends need not be promulgated pursuant to 553 of the [APA]. However, these interpretative rules may have significant economic effects ... and should be covered by the RFA ....The requirement that IRS interpretative rules comply with the RFA is further limited to those involving a "collection of information." The ...phrase "collection of information" in the context of the RFA [includes] all IRS interpretative rules of general applicability that lead to or result in small entities keeping records, filing reports or otherwise providing information to IRS or third parties. ... [M]ost IRS interpretative rules involve[ing] some aspect of defining or establishing requirements for compliance with the CFR ... [are] covered by the RFA. ... [T]o reduce compliance burdens ... wherever possible ... the IRS should take an expansive approach in interpreting the phrase "collection of information" when considering whether to conduct [a RFA].[1]

Moreover, such a standard makes little sense. The IRS has promulgated nearly a thousand forms, any one of which is a candidate to encompass new enforcement requirements. Imagine a Form 1099 MISC or a 1040 MISC that can integrate all future recordkeeping the Service believes it needs.

The Service reads the statute too narrowly in other respects, a well. According to the Service, once the RFA applies because of the "collection instrument" trigger, it applies only to the additional burden the collection requirement imposes. Second, if the new collection requirement does not itself impose a significant burden on a substantial number of small entities (even though the rest of the rule does), the Service can certify the rule and avoid an RFA. Congress never intended the Service to be able to "certify" a rule does not have a significant impact on a substantial number of small entities merely because the collection burden does not. A certification would be valid only if the rule in its entirety did not impose a substantial burden on a significant number of entities. Congress likely intended that the existence of a recordkeeping burden would transform an "interpretative" rule into a legislative rule, requiring all burdens imposed by the rule to be evaluated.

The Service's narrow interpretation of the collection of information requirement is especially troublesome when one considers the legislative history. Singled out among all federal agencies for such treatment, the requirement that the Service conduct an RFA on interpretative rules was really meant to close the overworked "interpretative" loophole. Moreover, it represented a truce of sorts between Congress and the Service. During debates over the iterations of the first Taxpayer Bill of Rights (TBR), many in Congress through the solution was to subject the Service to the RFA for all rules its promulgates, regardless of their nature. In fact, the Manager of the bill, Senator Pryor, supported this position, and inserted language to that effect in the first TBR. In this, Senator Pryor was supported by the delegates to the 1985 the White House Conference on Small Business.

After strong lobbying, the Service was able to fend off the dracaconian measure, and Senator Pryor's provision was dropped in favor of 7805(f), which had little purpose but to advise the Office of Advocacy when the agency sought to skirt the RFA. However, the issue survived because the problem was left unresolved. In 1996, the Service again found itself in the crosshairs of the Small Business Committees. In the legislative debate that led to SBREFA, the Service argued assiduously that it should not be thrown into the briar patch of the normal RFA procedures applicable to other agencies, embracing the very requirement it now seeks to narrowly construe. The new phraseology

that *"the regulations do not impose a collection of information on small entities"* and hence "the RFA does not apply" was the way the Service inoculated itself against Congressional intent to close the "interpretative" loophole.

II. Specific Example: the Proposed Nonresident Alien Reporting Requirements

Now let U.S. take a specific rule that has caused much needless consternation from many quarters for many reasons. On January 17, 2001, immediately prior to the change in U.S. administrations, the Service promulgated a proposed rule entitled "Guidance on Reporting of Deposit Interest Paid to Non-Resident Aliens." This "guidance" would require payors of interest to all U.S. non-resident aliens (hereinafter NRAs) to file Form 1042-S for the first time. Form 1042-S, *inter alia*, requires the reporting of the payee's name and address, tax numbers and the amount paid. A later iteration of the rule slightly narrowed the January 17th proposal by mandates reporting to residents of Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden and the United Kingdom. The Service intends to collect this information in a central repository, so that it can be made available to the enumerated foreign nations. If the payor has not filed valid Forms W-8 or W-9, the interest payment is subject to backup withholding.

Coined the "US Anti-Savings Directive" by opponents, the rule was criticized by the SBA and NSBU because the Service excused itself from the RFA and other procedural safeguards.

Understanding the significance of the procedural breaches should begin with the Service's implicit assertion that that rule was "interpretative" in nature and therefore not subject to the APA or the RFA. In the preamble, the Service determined the rulemaking was not a "significant regulatory action", requires no regulatory assessment, no cost benefit analyses and for good measure, was so trivial it was merely "interpretative." Apparently, Service proposed the new requirements as a regulation in order to *pro forma* satisfy Internal Revenue Code section 6049's requirement that a new reporting requirement be issued in regulatory form.

Should the rule be considered "interpretative" only, it is difficult to imagine how any rule could be legislative. The truth is that this rule would change policy, and quite significantly. In fact the rule changes policy to such a degree that, if properly considered by the Congress, the policy assumption that it is Treasury's role to help tax collectors of foreign nations tax investments made in the U.S. would be rejected.

To find our how much discretion was exercised, one need only to look at the comments on the administrative record, none of which were remotely favorable to the rule, and all of which related to policy. Every witness at the administration hearing raised policy questions. They questioned why the rule would seemingly overturn express U.S Congressional policy to attract foreign deposits by not taxing the interest. They asserted that collecting information concerning such deposit interest and passing it on to other countries so they can tax the income would almost certainly have the same effect as imposing tax on the interest. They questioned whether the rule would provoke the exodus of billions of dollars of foreign capital on deposit in the United States. They questioned whether reduction in federal tax collections due to the reduced national income might well exceed the additional taxes collected by means of the proposed regulations from U.S. tax evaders attempting to utilize foreign accounts. They questioned why the U.S. should not be cajoled into repealing what is an economically rational means of attracting foreign capital in some altruistic attempt to help EU-member states counteract their own harmful tax policies which impose high marginal tax rates on mobile sources of income. They asked the Service to explain how this rulemaking is needed to improve compliance with or enforce U.S. tax law when the interest that is the subject of the reporting

is not taxable. They questioned why excluding virtually the entire Southern Hemisphere from the rule, would best fulfill their mission of "improving compliance with U.S. tax laws."

Moreover, they questioned why the rule appears to be more foreign policy, than tax policy. Because bank deposit interest is not taxed in the U.S. (IRC section 871(i)(2)(A)), they questioned how gratuitous information sharing benefits U.S. tax collectors, as opposed to French, German or other foreign tax collectors. Now, it is true that small firms are used to being tax collectors and paying agents, but not for other nations.

They questioned whether it was bad foreign policy. European nations are not reluctant to use legal devices such as refundable, border-adjustable value added taxes or tax sparing to gain competitive advantage, nor do they hesitate to attack similar U.S. efforts of a much smaller scale. They asked why the Administration would advocate for a proposal which it claims is necessary to enforce U.S. tax law, when the new rule would fail to provide the U.S. government salient information on U.S. taxpayers. They questioned why asset mobility, like freedom to emigrate, does not create a natural check on governments against excessive taxation.

Finally, they questioned why Treasury appeared to be applying inconsistent policy. There is very little doubt that the rulemaking was in response to European pressures to adopt an American equivalent of the EU Savings Directive, -- a multilateral information exchange and anti-tax competition agreement, since the "Savings Directive" and the OECD's "Harmful Tax Competition Initiative" are contingent on U.S support. The OECD Harmful Tax Competition Initiative emerged from European concerns that low-tax countries – such as the U.S. -- would attract "too much" capital from high-tax countries unless collective information exchange was implemented. But the OECD Harmful Tax Competition and the EU Savings Directive were opposed by the Administration. They rightfully questioned why the primary difference between the unquestionably pure policy choices of the OECD and EU initiatives on the one hand, and this rulemaking on the other, is that the former have been passionately rejected by Administration policymakers. And they asked Treasury to explain why, if the OECD harmful tax competition initiatives was a bad ideas, this rulemaking is not an equally bad idea.

If this rule was really interpretative, it means no notice, no hearing, and no comment would ever have been required; however, the IRC does require notice and comment for form changes.

When considering whether the rule is "interpretative," reflect again upon former IRS Commissioner Roscoe Egger own words to Congress on the difference between the nature of rules, "the degree of discretion that the Service has in applying rules." Did the Service have no discretion but to issue this rulemaking? The rule was clearly issued with discretion, has substantial impact and wide applicability, is intended to alter an existing statutory scheme, and is meant to have the force of law.

Quite apart from the "interpretative" claim, Treasury's assertion that does not impose a collection requirement is equally suspect. Assuming *arguendo* that the Service were to properly label the rule "interpretative," how could the Service could claim there is no collection of information when the sole purpose of the rulemaking is the transmittal of information to the Service and to foreign governments on interest paid to non-resident-aliens? The Service itself states, "[t]he collection of information is mandatory. The likely respondents are businesses and other for-profit institutions." The Service specifically requests comment on "how the quality ... of the information to be collected may be enhanced; [h]ow the burden of complying with the proposed collection of information may be minimized, ... estimates of ... start-up costs and costs of operation, maintenance, and purchase of service to provide information." The collection of information requirements in these proposed regulations are specifically found in Secs. 1.6049-4(b)(5)(i) and 1.6049-6(e)(4) (i) and (ii).

Moreover, the Service agrees that the collection requirements would be imposed on more than ten persons. In the Paperwork Reduction Act section of the proposal, the Service estimates the number of respondents at 2,000. The Service is clearly wrong in downplaying not only the number of effected entities, but the costs and burden hours imposed. The Service posits that the total nationwide annual reporting burden is merely 500 hours, meaning the average estimated annual burden per respondent (of which there are an estimated 2,000) would be 15 minutes. 500 hours is an absurdly low estimate for reporting on thousands of accounts amounting to approximately one trillion dollars. With all due respect, it would take that long just to speed read the proposed rule.

What is ironic is that by ignoring the procedural mandate conduct an IRFA analyses, the Service bypasses the means by which it can obtain a more realistic view of costs. The Service not only underestimates the number of respondents and the reporting time burden, but ignores other factors, such as the time involved in securing legal and accounting advice, establishing or modifying information technology systems to comply with the rule, extracting the relevant information, and printing and mailing the forms to the customer. And quite apart from out-of-pocket costs, are estimated revenue losses from the flight of capital.

The Service may argue that the collection instrument is not "new" in that the Form 1042 already exists. The Service may also argue that the collection of information imposed does not lead to the assessment of U.S. taxes. However, as discussed, the spirit of the RFA was to capture collection instruments that impose new "burdens" through regulatory extension, not just collection instruments that bear a new form number. Further, if the collection of information burden is not required to enforce U.S. taxes against U.S. taxpayers, the rationale for the rule is dubious at best.

If the Service is able to claim that this rule is "interpretative," even as the entire regulatory hearing was based policy; and if the Service is able to argue that this rule does not impose a collection requirement, when the very essence of the rule subjects banks to reporting, then the Service has effectively exempted itself from the legal process protections installed to protect small firms.

III. Recommendations

If the Service is to be accorded special treatment under the RFA, this treatment should be to hold it to a higher standard, as its rulemakings uniquely apply to all 23 million small firms. Allow me to recommend several ways in which the Congress can do so.

- First, the Committee should understand that many rules that do not impose a collection requirement still have a profound effect on small entities and should be subjected to the RFA. The Committee should see the collection instrument requirement as a safety net, merely to ensure compliance when all else fails. On the other hand, almost all rules that impose a collection of information requirement do have the requisite effects.

- In its legislation, the Committee should try to address all ways in which the spirit of the RFA is undermined. For instance, when a collection instrument is imposed, the Committee should ensure the entire rule, not just the collection instrument requirement, undergo an IRFA.

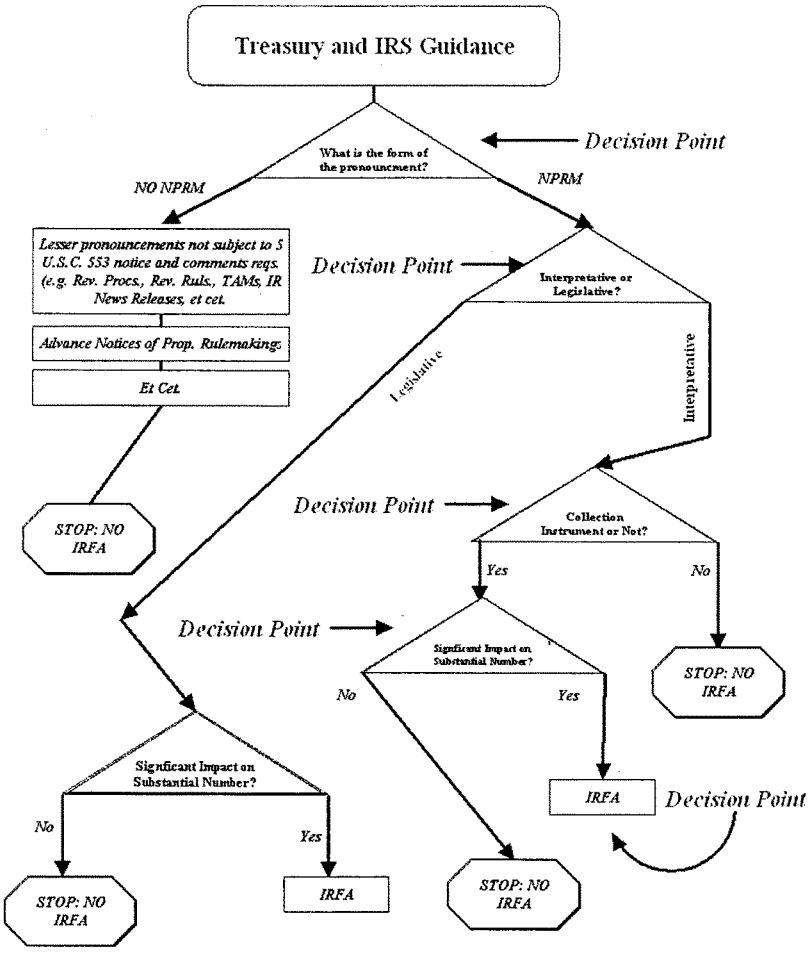
- The Committee should pass legislation that requires the IRS to determine if a collection instrument is present, irrespective of whether a Form exists into which the collection of information can be integrated.

- The Committee should ask the Service to redevelop its Policy Manual to define the factors that influence the choices over an "interpretative" or "legislative" rules, as well as the choice of the form of pronouncement as a formal rulemaking or something less.

- The Committee should consider binding the Service to its assertion that a rule is "interpretative," and thereby denying Chevron deference in cases of legislative ambiguity.

Conclusion

Acceptance of the RFA would actually accelerate the adoption of rules and enhance compliance. Moreover, it would ensure that billions of dollars in wasted resources by the inefficient engineering of rules are saved. It will mean greater compliance, greater respect; and higher enforcement, not to mention more jobs that produce something of value. And it would means less Congressional involvement to rectify regulatory blunders. In short, if I were asked whether I thought the process works with the Service, my answer would be an emphatic "no"; but if you ask me whether it can; my answer would be an enthusiastic "yes."


Treasury and IRS Guidance
What is the form of the pronouncement?
Decision Point
NO NPRM
NPRM
Lesser pronouncements not subject to 5 U.S.C. 553 notice and comments reqs. (e.g. Rev. Procs., Rev. Ruls., TAMs, IR News Releases, et cet.
Advance Notices of Prop. Rulemakings
Et Cet.
Decision Point
Interpretative or Legislative?
Legislative
Interpretative
STOP: NO IRFA
Decision Point
Collection Instrument or Not?
Yes
No
Decision Point
Significant Impact on Substantial Number?
No
Yes
STOP: NO IRFA
Significant Impact on Substantial Number?
No
Yes
IRFA
Decision Point
STOP: NO IRFA
IRFA
STOP: NO IRFA

May 1, 2003

The Honorable Donald Manzullo
Chairman
Committee on Small Business
United States House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

SUBJECT: IRS Compliance with the Regulatory Flexibility Act

Dear Mr. Chairman:

The Conference of State Bank Supervisors (CSBS) respectfully submits the following statement in connection with today's hearing concerning IRS compliance with the Regulatory Flexibility Act. CSBS is the national association of state officials responsible for chartering, regulating and supervising the nation's nearly 7,000 state-chartered commercial and savings banks and more than 500 state-licensed foreign banking organizations.

We submit this statement because of our opposition to the Internal Revenue Service's (IRS) modified proposed regulations governing the reporting requirements for interest on deposits maintained at the U.S. offices of financial institutions and paid to nonresident alien individuals. Attached please find the CSBS comment letter on the proposed regulations submitted to the IRS on November 14, 2002, which details the reasons for our opposition.

While our concern is not with IRS compliance with the Regulatory Flexibility Act *per se*, our opposition to the proposed regulations is consistent with the purpose of the Act and Congress' concern for the likely negative effect on small businesses. First, we have consistently urged that a rigorous analysis of the advantages and disadvantages of the proposed regulations be conducted, particularly in light of the fact that the interest paid is not subject to U.S. income tax, indicating that any advantage would at best be indirect. Second, we are concerned that the regulations would have a negative effect on the liquidity of the U.S. banking system, which likely would reduce commercial lending, including lending to small businesses.

Thank you for your consideration of our views. If you have any questions or we can be of assistance, please do not hesitate to contact me at 202-728-5725 or tbergan@csbs.org.

Sincerely,

TNBergan

Timothy N. Bergan
Senior Vice President, International

CONFERENCE OF STATE BANK SUPERVISORS
1155 Connecticut Ave., N.W. - Fifth Floor • Washington, D.C. 20036-4306 • (202) 296-2840 • FAX (202) 296-1928

November 14, 2002

Internal Revenue Service
CC:DOM:ITA:RU (REG-133254-02)
Room 5226
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Reporting of Deposit Interest Paid to Nonresident Aliens (67 FR 50386)

Dear Sir or Madam:

The Conference of State Bank Supervisors (CSBS) is pleased to have the opportunity to comment on the Internal Revenue Service's (IRS) modified proposed regulations governing the reporting requirements for interest on deposits maintained at the U.S. offices of financial institutions and paid to nonresident alien individuals.[1] CSBS is the national organization of state officials responsible for chartering, regulating and supervising the nation's nearly 7,000 state-chartered commercial and savings banks and more than 500 state-licensed foreign banking organizations. In preparing our comments, we consulted with the CSBS International Bankers Advisory Board, a group of international bank regulators and international bankers similar to the groups utilized by the Federal Reserve Board and the Federal Deposit Insurance Corporation.

In our letter dated February 27, 2001 (copy attached) we submitted comments on the original proposed regulations published on January 17, 2001 (66 FR 3925). We applaud the modification of the original proposed regulations as an effort to improve the proposed regulations. However, the underlying concerns expressed in our original letter continue to exist.

As an initial matter, we note that deposit interest paid to nonresident aliens is not taxable under U.S. tax law. Accordingly, reporting this deposit interest is not necessary to collect taxes on it or otherwise prevent tax evasion or avoidance. Consequently, we believe the threshold for imposing a reporting requirement should be quite high and the justification for doing so exacting.

As our original comment letter indicated, we believe that a rigorous analysis of the advantages and disadvantages of the proposed regulations should be conducted. The modified proposed regulations appear to address this important concern in a somewhat summary fashion, stating that the IRS and Treasury believe that the proposed regulations "will facilitate the goals of improving compliance with U.S. tax laws and permitting appropriate information exchange without imposing an undue administrative burden on U.S. banks." [2] However, the proposed regulations do not describe how they will improve compliance with the U.S. tax laws or what constitutes appropriate information exchange. Similarly, the proposed regulations do not address

[1] 67 Fed. Reg. 50386, (Aug. 2, 2002).

[2] 67 Fed. Reg. at 50387.

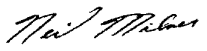
why there is not an undue administrative burden on U.S. banks, or whether the additional costs imposed on the banking industry exceed the benefits to the IRS.

Nonetheless, the administrative burden on U.S. banks is not the only foreseeable disadvantage of the proposed regulations. Another, perhaps more important, consequence is the likely flow of deposits out of the U.S. banking system. The amount of nonresident alien deposits in the U.S. banking system has been estimated to range from hundreds of billions of dollars to about $1 trillion. Even at the low end of the range, the magnitude is substantial, both in terms of the U.S. banking system and the economy as a whole. As a stable source of funds, banks use these deposits to support their commercial lending activities. A significant shift of these deposits to other countries, whether for tax or tax privacy reasons, could thus affect banks' commercial lending, particularly when economic growth once again increases demand for commercial loans. Moreover, such a shift could have a negative impact on the liquidity of the U.S. banking system, and thus its safety and soundness.

Consequently, we remain concerned that the proposed regulations will likely have negative consequences for the U.S. banking system in general, and the state banking system specifically. Legitimate deposits of nonresident alien individuals generally represent a stable source of funds for state-chartered banks and state-licensed foreign banking organizations because of the favorable economic and political environment in the United States. Imposing a reporting requirement on income that currently is not taxable could erode this favorable environment. Thus, to the extent the proposed regulations deprive these institutions of a stable source of funds, the regulations likely will impose direct costs on state-licensed banks and the banking system in the United States. Accordingly, absent a rigorous analysis demonstrating clearly that the benefits of the proposed regulations outweigh the costs, in particular the effect on the liquidity of the U.S. banking system, we respectfully suggest that the proposed regulations be withdrawn in their entirety.

Thank you for this opportunity to comment. If you have any questions please contact me or Tim Bergan, Senior Vice President, International at 202-296-2840 or tbergan@csbs.org.

Sincerely,



Neil Milner, CAE
President & CEO
Conference of State Bank Supervisors
1155 Connecticut Avenue, N.W.
Fifth Floor
Washington, D.C. 20036-4306

cc: Honorable Paul H. O'Neill