CLOSING THE TAX GAP AND THE IMPACT ON SMALL BUSINESS

HEARING

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HOUSE OF REPRESENTATIVES

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CONTENTS

WITNESSES

APPENDIX

CLOSING THE TAX GAP AND THE IMPACT ON SMALL BUSINESS

WEDNESDAY, APRIL 27, 2005

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Committee met, pursuant to call, at 2:15 p.m. in Room 311, Cannon House Office Building, Hon. Donald Manzullo [Chairman of the Committee] presiding.

Present: Representatives Manzullo, Kelly, Sodrel, Fitzpatrick.

Chairman MANZULLO. Good afternoon and welcome to this hearing on a very important topic for small businesses around the country, closing the tax gap.

There would be no tax gap without the Income Tax Code. Interestingly, almost 92 years ago to the day and in this very hearing room, then Ways and Means Chairman Oscar Underwood, with the assistance of Representative Cordell Hull, reported the first income tax out of Committee shortly after the ratification of the 16th Amendment.

This income tax consisted of only eight pages in an 814-page tariff bill. Today the Internal Revenue Code spans more than 60,000 pages.

I guess maybe we can go back 92 years and back to eight pages again. That might work.

As we sit here today, President Bush is delivering a speech during the Small Business Administration 2005 Small Business Expo. His speech will likely not include anything about the topic of the hearing today.

The tax gap is something not many want to talk about, but is nonetheless real. There is a difference between what is owed by many taxpayers and what is actually paid to the Treasury.

The National Research Project was an effort to study the tax gap. Using data from 2001, the study validated that there was a big tax gap in the magnitude of $300 billion. A large portion of this gap has been attributed to small businesses and the self-employed.

The purpose of the hearing is to review with the Commissioner and other witnesses where to go with this data. Before we begin that process, it is important to point out that the preliminary data is woefully incomplete, because it provides no estimate of the tax gap for C corporations or flow-through entities, such as partnerships.

The data for these entities is still from the 1980's, a time that is far removed from the aggressive tax strategies that many blue chip accounting and law firms developed during the late 1990's.

While the data has some deficiencies, no one can argue that there is not a big problem. The question becomes, "What is the appropriate response?"

How do we make small business taxpayers more compliant, while at the same time minimizing the burden? Increasing enforcement means nothing if those being policed don't understand the laws or the nature of the violation.

While I understand the push to lower the budget deficit and the readily available statistics that support increased enforcement, imposing increased burdens on small businesses through more audits cannot be the only answer.

Many times small business owners are attempting, to the best of their ability, to comply with the complex Tax Code. It is not that they don't want to comply. Rather, the system and paperwork are so complex that it is difficult to comply.

No matter how many additional auditors and collection agencies are added to the IRS, there will still be a more pressing need to educate taxpayers about their obligations.

The IRS will never have enough resources to police everyone and thereby enforce compliance. Small business people are not tax experts and they face real difficulties with complying with the tax system.

The method used by the IRS to interact with these individuals can be the difference between success and failure. It is much easier for a small business owner to learn how to comply with the tax laws through taxpayer education and outreach than the adversarial audit and collection processes.

Congress certainly needs to simplify the Code and strongly support the President's effort to analyze and reform the current system.

While the IRS Commissioner will not be able to stay for the entire hearing, Kevin Brown, the Commissioner of the Small Business Self-Employed Division and other staff will stay for the entire hearing so that they can listen to the testimony of the other witnesses. We appreciate that very much.

Commissioner Everson, it is a pleasure to have you here today as well as Mr. Sullivan. Mr. Everson, you are up first. Go ahead. I am not going to set the clock here.

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

STATEMENT OF THE HONORABLE MARK W. EVERSON, INTERNAL REVENUE SERVICE

Mr. EVERSON. I don't think I will use too much time, sir. Mr. Chairman, thank you for the opportunity to discuss the important subject of the tax gap and in particular, the portion of the gap relating to small businesses and self-employed individuals.

I very much appreciate your interest in and efforts to increase compliance with the tax laws.

Simply put, the tax gap is the difference between the tax that taxpayers should pay according to law and what they actually pay on a timely basis.

Our research confirms that the vast majority of Americans pay their taxes honestly and accurately, but the findings also show that even after IRS enforcement efforts and late payments, the government is being shortchanged by over a quarter trillion dollars each year, because some pay less than their fair share.

People who aren't paying their taxes shift their burden to the rest of us. In this time of budget deficits, a dollar not received by the government becomes debt, the burden of which will be felt by future generations.

Our research shows the gross tax gap to be between $312 billion and $353 billion. The old tax gap estimate for 2001 was $311 billion, a figure based on studies conducted in 1988 and earlier.

So there has been what I would term a modest deterioration in tax compliance among individual taxpayers since the last study was conducted in 1988.

IRS enforcement efforts, coupled with late payments, recover about 55 billion of the total gross tax gap, leaving a net annual tax gap of between $257 billion and $298 billion. Current data are preliminary, so our tax gap estimates are shown as ranges.

As refinements are made to the analyses, some estimates may change. It is unlikely, but possible, that the final estimates of the total tax gap will fall outside the established range.

There are two views of the tax gap: By type of noncompliance, that is non-filing, underreporting and underpayment and by type of tax. The new research for 2001 addresses the underreporting of income and self-employment taxes by individual taxpayers. It is based on audits of 46,000 individual returns.

As you indicated, Mr. Chairman, the study did not address compliance for either small or large businesses organized as corporations.

Preliminary findings include: Underreporting noncompliance is the largest component of the tax gap. Preliminary estimates show underreporting accounts for more than 80 percent of the total tax gap, with non-filing and underpayment at about ten percent each.

Individual income tax is the single largest source of the annual tax gap, accounting for about two-thirds of the total.

For individual underreporting, more than 80 percent comes from understated income, not overstated deductions. Most of the understated income comes from business activities, not wages or investment income.

Compliance rates are highest where there is third party reporting or withholding. For example, preliminary findings show less than 1.5 percent of wages and salaries are misreported.

The next stage of our research will be to finish the data analysis and refine the tax gap data by late 2005. The IRS will use the data to update its statistical tools for selecting individual returns for audit.

Our tax gap research confirms two key points involving tax enforcement and simplification. The IRS needs to enforce the law so that, when Americans pay their taxes, they are confident that their neighbors and business competitors are doing the same.

At the same time, this research underscores the President's call for tax reform. Complexity obscures understanding. Complexity in the Tax Code compromises both the Service and enforcement missions of the IRS.

Those who try to follow the law, but cannot understand their tax obligations, may make inadvertent errors or ultimately throw up their hands and say, why bother?

Meanwhile, individuals who seek to pay less than what they owe often hide behind the Code's complexity in order to escape detection by the IRS and pay less.

Mr. Chairman, as I have said before, enforcement activity to close the tax gap is only part of the equation. We must also provide good service to taxpayers to help them understand their tax obligations.

Small businesses in particular struggle to deal with an increasingly more complex Tax Code. We view our goals of reducing taxpayer burden and helping small businesses understand our very complicated and I would note ever changing Tax Code as a cornerstone of the services we provide.

We are very cognizant of the fact that small business owners have unique needs. In recognition of the fact that different groups of taxpayers have different characteristics, the IRS is currently organized around four taxpayer segments.

Our small business and self-employed operating division's mission is to address the tax compliance needs of small businesses and self-employed individuals through education, outreach, assistance and where necessary, enforcement.

I was pleased to note that the NFIB, in its written statement, observed that "One of the lesser known successes over the past five years has been that with the assistance of the staff of the small business, self-employed division at IRS, the concept of common sense rules for smaller business owners has taken root."

Through the small business, self-employed division, we are able to focus on initiatives to reduce the burden of tax compliance on small business.

For example, we recently increased the Federal Unemployment Tax deposit threshold from $100 to $500, reducing burden for over 2.6 million employers.

We also simplified the Schedules K-1 for partnerships and S corporations, reducing burden by an estimated 95 million hours for the 20 million taxpayers who file these forms.

In addition, we are actively considering allowing very small employers to file their employment tax returns annually instead of quarterly.

We estimate this action alone could reduce burden on approximately one million businesses by some 50 million hours.

Finally, I would like to point out that our system of tax administration is fundamentally one of self-assessment and enjoys a high compliance rate.

The IRS is moving aggressively to reduce the tax gap. With proper funding over a number of years, we will be able to close a significant portion of the gap, but no one should think we can totally eliminate the gap. That would take Draconian measures and make the government too intrusive.

We have to strike the right balance. Thank you.

[The Honorable Everson's statement may be found in the appendix.]

Chairman MANZULLO. Thank you, Commissioner.

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

Mr. Sullivan, we look forward to your testimony.

STATEMENT OF THE HONORABLE THOMAS M. SULLIVAN, US SMALL BUSINESS ADMINISTRATION

Mr. SULLIVAN. Thank you, Mr. Chairman. Thank you for giving me the opportunity to appear before the Committee this afternoon. My name is Tom Sullivan, the Chief Counsel for Advocacy at the Small Business Administration.

My office is an independent office within the SBA and therefore, the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA.

With the Chair's permission, I would like to submit my written statement for the record.

Chairman MANZULLO. The entire written statements of all the witnesses will be made part of the record without objection.

Mr. SULLIVAN. Thank you, Mr. Chairman.

The Office of Advocacy shares with the Commissioner the view that the tax gap is a serious problem. The funding shortfall is not the only problem created by the tax gap.

As National Taxpayer Advocate Nina Olson stated in her 2004 testimony before the Senate Committee on Finance, "It comes down to a simple issue of fairness."

The fact that 85 percent of taxes are paid in full reinforces the view that the remaining 15 percent needs to be paid by those who owe it.

The Office of Advocacy, however, does not agree with the view that prioritizing enforcement will necessarily close the tax gap. We believe, like the Commissioner stated in his oral statement, that a balanced approach, relying on a combination of compliance, assistance, taxpayer education and enforcement, is likely to close the gap in an efficient manner.

Most small businesses pay their taxes in full and on time. However, doing so is never easy for them, as the cost of complying and the difficulty in following the Tax Code can be overwhelming.

In 2001, my office released a report on the regulatory costs faced by small firms. That study contained an estimate of tax paperwork compliance costs and in 2000, the typical small business, with fewer than 20 employees, spent over $1,200 per employee to comply with tax paperwork, recordkeeping and reporting requirements.

This is over two times the compliance costs faced by larger firms, but the estimated burden hours for filling out forms do not tell the whole story of how difficult compliance can be for small business.

Most small firms do not have full-time personnel to handle tax compliance issues. Many hire outside assistance and many more

small business owners devote valuable time to taxes that is not then available for them to run their business.

This Committee certainly knows the contribution of small business to the United States' economy. Small businesses make up over 99 percent of all businesses in the United States and employ just over half of the American workforce.

Perhaps even more importantly, small firms create over two-thirds of the net new jobs annually and recently led the American economy out of a recession.

Yet, small business accomplishes this even while facing a regulatory compliance burden that is roughly 60 percent greater per employee overall than that faced by larger firms and a tax compliance burden more than twice as large.

At issue then is how compliance can be improved and the tax gap narrowed without adding to the burden of small business?

My office favors a balanced approach, one that includes commensurate doses of education, compliance assistance and enforcement.

In order to focus its efforts, the IRS did develop the National Research Program to measure reporting, filing and payment compliance for different types of taxes and different groups of taxpayers.

The final report isn't available, but IRS has published 17 pages of preliminary results. The release generated a flurry of comments coinciding with the weeks preceding April 15, when Federal tax filings were due.

I think that this Committee and really all the folks and policy leaders in Washington, D.C. should be clear that these results are preliminary.

Let me also caution that the connection between enforcement and compliance is not necessarily clear either. Research by economist Bruno Frey and Lars Feld suggests that excessive enforcement can lead to less compliance.

Compliance cannot be increased only through enforcement, but rather the more balanced approach that was mentioned by the Commissioner and myself.

Although tax rates have declined over recent years, the costs of complying with taxes has increased. Noncompliance is a more subtle, hidden cost of tax complexity, but the direct costs in time and effort to maintain the necessary records and complete the proper forms is the more obvious direct cost.

According to OMB paperwork burden estimates, the number of hours Americans spend on taxes has grown by 24 percent over the last ten years.

I believe in the honesty of the majority of small businesses and their willingness to comply with the Tax Code and contribute their fair share.

Additional taxpayer education, compliance assistance and a more simple Tax Code are key ingredients to increased compliance. If small businesses are able to understand and easily follow the rules, they probably will.

Thank you for allowing me to present these views and I am looking forward to questions.

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

Chairman MANZULLO. Thank you. I guess what concerns me is that the last IRS report done addressing the tax gap was done in 1988. The latest update by the National Research Program excludes C corporations and the extent to which they may be underreporting or cheating.

Our concern here at the Small Business Committee is that if you are talking about more enforcement and the only study that has been done as to noncompliance or updated study as to noncompliance are small businesses and individuals, then why are we having enforced compliance if we don't know the extent to which the C corporations may be ripping off the taxpayer? That is sort of a loaded question.

Mr. EVERSON. No. But I am happy to explain why I think the sequencing is what it was. This program was all laid out about three or more years ago and the decisions taken at the time was that this was the place to start. It wasn't a view that you would never get to C corporations.

For the last several years, Mr. Chairman, we have articulated four enforcement priorities that have been in the heart of the President's budget request for more enforcement monies. The very first element of that is to detect and deter abusive activities by corporations, high income individuals and other contributors to the tax gap.

The more monies that have been requested for the IRS, up to this point for enforcement, have been largely targeted towards abusive tax shelters, towards corporations and high income individuals.

We can show you the rate of increase in the high income audits that have taken place over the last several years. It has been doubled basically in terms of the total number of returns.

You can see what happened here was a very precipitous decline that was coincident with the Roth hearings, the bashing that the Service took in the 1990's. Real efforts were made to increase services and those efforts were successful by any measure.

But what happened was we backed away from enforcement generally. What is happening now is a recovery of enforcement. This is the high income piece.

Chairman MANZULLO. If I could interrupt you.

Mr. EVERSON. Yes.

Chairman MANZULLO. I accept that, but my question deals with new energy at the IRS for increased audit, et cetera. But the study excludes C Corporations. These could be small businesses.

Mr. EVERSON. You are exactly right. Let us go to the tax gap map if we could, Bill. The map will show you that of that estimated gross gap of $312 to $353 billion, the corporations, using that old methodology from the 1988 study that you talked about and updating it for changes in economics and demographics, the corporate piece would be about 30 billion.

Now, you are right. If you—

Chairman MANZULLO. I have to interrupt you on it, because I am concerned that there is not a new study updating the 1988 study for C corporations.

Mr. EVERSON. Yes.

Chairman MANZULLO. As to everybody, except the C corporations, but you are making conclusions here and you are also going to step up your enforcement, as to those people to whom you find are involved in the tax gap.

Mr. EVERSON. We knew there were problems with corporations and we have been devoting the additional resources to that. That has been the very top line item of the President's budget request to get more auditors for corporations.

We have been working aggressively on that. Congress has not provided all the money. You may know that we asked for an additional 500 million last year. We got 50 million.

But we have been devoting more to corporations. The rough point I would say is even if you believe that there is more noncompliance there and I do, I am on the record repeatedly, as you may know, to go after these areas. We are devoting more resources to that.

Even if you look at 2001 as you indicate, there is a change in receipts mix, by the way, too. Since 2001, receipts have recovered for corporations. The individual rates have resulted in income taxes going down for individuals as a portion of the two trillion we get.

Even if you double this though, sir, in terms of the corporate number, you get 60 or 70 billion. You are still left, even if the total gross gap approaches 400 billion, with over half of it coming from small business and by small businesses. That would be the combination of the individuals with the Schedule C, it would be the Subchapter S corps, those C corps and as you know the C corps for small businesses and by small businesses for C corps we say those are less than $10 million in assets.

Those numbers have been coming down over the years. They have been replaced by more partnerships and more S corps.

If you take all that, you are right. That number is understated. It is no doubt understated. But still half that gap, even if you inflated these numbers, would still be in the small business area. So it needs to be addressed.

Chairman MANZULLO. It needs to be studied before we can enforce it.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Mr. Everson, thanks for your testimony today.

Mr. EVERSON. Thank you, sir.

Mr. FITZPATRICK. My district is in Pennsylvania. I don't have a lot of big businesses. We have a ton of small businesses. We like to say in Bucks County, Pennsylvania, small business is big business. So a lot of people are watching this.

Mr. EVERSON. Yes.

Mr. FITZPATRICK. I would be happy to report back to them. I have a question on the tax gap. I think it was reported that back in the 1970's the tax gap was about ten percent, but by 1984 it had risen 40 percent to about 14 percent, but by the time President Reagan's tax cuts and his Tax Reform Acts were fully implemented and realized, the tax gap had come back down to below ten percent. That it was easier I guess for small business, you could conclude, to comply—

Mr. EVERSON. Yes.

Mr. FITZPATRICK. —with the simpler Tax Code.

Is it your belief that there is a relationship between the tax gap and the simplification of the Tax Code and lower taxes specifically?

Mr. EVERSON. Yes, absolutely, sir. I think you may have come in after I started to give my oral statement.

I believe that what has happened here is the enforcement has fallen off. You have to recover there and have a balanced approach, but that the second piece of this and the President has got it right, is a call for tax reform.

I have testified before the Tax Panel and made this very clear. Complexity obscures understanding. There is a real element of this where if people don't understand the law, they make inadvertent errors. Some throw up their hands and say, why bother?

At the same time, those who seek to avoid detection or not comply and here you get to the Chairman's point, largely the more sophisticated corporations who have been led into these structures by attorneys and accountants, they profit from the complexity.

At the IRS, we are absolute advocates of simplification of the Code. Yes, sir.

Mr. FITZPATRICK. How much time and effort is spent on advocacy and education I guess is the better word? An awful lot of small businesses get to the end of the quarter and they are struggling. They have got to make their quarterly payment. The resources aren't there and so some just sort of drop out of compliance.

This is Small Business Week. I think this is financial literacy month. What does the IRS and perhaps Mr. Sullivan, from the SBA, can comment as well, what is the plan for a greater education of small business on the importance of and obvious benefits of compliance?

Mr. EVERSON. At this stage, what happened was, as I indicated, the IRS, it was reorganized after these hearings in the mid 1990's to have four business units, as well as our criminal investigation unit. That is the bulk of the employees.

One of the units that was established was the small business, self-employed unit, to focus on this basket of taxpayers, if you will.

I think that that has been a successful reorganization, because it has allowed a targeting, if you will, just along these lines.

We have got about 400 people who work full-time. They do do the work of education, working with practitioner groups, working with the various organizations, if you will.

I meet from time-to-time with some of these groups as well and we try to get the word out through publications, a whole series of things.

I think that has been successful, frankly and made a difference, in terms of the relationship. I quoted the NFIB's statement in my oral remarks and I think that there is a rather positive story here.

Now I will be clear. At this stage, because of the absolute problem on the enforcement side, the incremental resources we are putting into this are on the enforcement side.

The President has asked for a bump up of eight percent in the budget. I would like to say that is supported by GAO. If the Chairman will indulge me for just a minute, I will tell you what GAO has said on this subject.

It says on service that the IRS has made significant progress in improving the quality of its taxpayer services. For example, IRS now provides many Internet services that did not exist a few years ago and has noticeably improved the quality of telephone services.

This opens up the possibility of maintaining the overall level of taxpayer service but with a different menu of service choices.

Cuts in selective services could be offset by the new and improved services. On the other hand, they have listed enforcement of the tax laws as one of their high risk areas.

I don't know if you are familiar with this, but every two years they issue a list of about two dozen high risk areas for government and what they have said on enforcement is, this is a quote from the GAO's report, "Given the broad declines in IRS' enforcement workforce, IRS' decreased ability to follow up on suspected noncompliance, the emergency of sophisticated evasion concerns and the unknown affect of these trends on voluntary compliance, IRS is challenged on virtually all fronts in attempting to ensure that taxpayers fulfill their obligations."

"IRS" success in overcoming these challenges becomes ever more important, in light of the nation's large and growing fiscal pressures. Accordingly, we believe the focus of concern on the enforcement of tax laws is not confined to any one segment of the taxpaying population or any single tax provision.

Our designation of the enforcement of tax laws as a high risk area embodies this broad concern.

So we are not suggesting we wouldn't want to do more in services, but this is a tight fiscal situation for the country, but the greater need frankly is in enforcement.

Chairman MANZULLO. Mrs. Kelly.

Ms. KELLY. Thank you, Mr. Chairman.

Thank you both for speaking today. Mr. Everson, you are talking about going out and essentially the way it is going to read to the public, lowering the boom on small businesses.

I want you to tell me some things now that you are going to do to make sure that if an IRS agent walks into a small business, it

isn't going to be a "gotcha" attitude, but it is going to be a helpful attitude.

Our tax laws are so complex. Our small businesses are taxed. Some people who own small businesses are taxed twice. This is hardly fair to small businesses carrying a huge tax load of huge tax burden in this nation. We need our small businesses. We are creating the new jobs.

Mr. EVERSON. Yes.

Ms. KELLY. Tell me, sir, what you are doing to bring across an attitude and ensure that the people who enter a small business will be there saying, "I am from the IRS and I am going to help you figure out how you can do this right."

Most people want to live by the law. Most people don't want to evade, but they eventually throw up their hands, because it costs small businesses much more to file than it does large businesses. You know that, sir.

What can you tell me? How can you help me go back and tell my small businesses that you aren't going to come in and really just wrap the rules around their neck?

Mr. EVERSON. I think those are all valid points and the first thing I would say is obviously the experience of the 1990's where there were the difficult hearings and the great focus on the service issues. They have had a very clear effect.

First of all, the Congress wrote in a whole series of new procedures that protect taxpayer rights. If our people get out of line, rest assured they get into pretty significant trouble quite quickly. So that is very important. The procedures are different.

The second thing I would say, and this is where the research will be very helpful, right now the audit rate is around one percent. This is not a very high rate and when an audit takes place, the no change rate within the audits, that is to say what happens you go in and then do you assess tax or not, the no change rate, where we are not assessing more tax, it is about 12 percent.

As we update this research, it better helps us to find out, based on what is on the return or third party information we have received, where we should go so that we are not going into a business that is or looking at a Schedule C return where it doesn't look pretty likely, frankly, that there is a problem. So that is a very important part of this as well.

Ms. KELLY. Excuse me, sir, but you really didn't answer my question. I want to know what you in particular are doing to tell the people when they arrive, because you have suspicion that there may be a problem there. I was here. I voted on that law.

Mr. EVERSON. Yes.

Ms. KELLY. Mr. Manzullo was here. He voted on that law.

Mr. EVERSON. Yes.

Ms. KELLY. What I want to know is what you are doing right now? If you are going to push this enforcement, to make sure that when people come in, the person from the IRS doesn't walk in and say, "Look I am sorry, but I have got to find something, because they think you have hidden something?"

Mr. EVERSON. Sure. All I can tell you, ma'am, is that we constantly emphasize this in our meetings with executives and other employees that, as we rebuild enforcement, we have to pay absolute attention to taxpayer rights and to not letting anybody go overboard thinking that this is a license to act inappropriately. We talk about—

Ms. KELLY. Have you ever—

Mr. EVERSON. I am sorry?

Ms. KELLY. Have you ever fired anybody for abusing taxpayer rights?

Mr. EVERSON. We fire people all the time. I can get you data on what happens, and I don't want to give you a precise answer on what the history is on this. Since RRA98, what has happened is there is a series of ten deadly sins that you wrote into the law and there is a Committee that is below me that looks at this.

There are things where they are automatic firings and they bring up to me cases where they are asking for some mitigation and typically they are not in this area. That is not an area where we would count as a problem.

You wrote in standards where somebody might presumably be fired for late filing their own tax return, even if it was a refund to a return. Those are the kinds of things that are brought to my attention, to mitigate the automatic presumption of firing.

Ms. KELLY. Thank you.

Mr. EVERSON. Certainly.

Chairman MANZULLO. I am still intrigued by the study that is incomplete and yet the results of this incomplete study are being used to increase enforcement upon what is apparent to be small business people.

Let me tell you how bad this study is and why there may be a limitations amendment to the appropriations bill to not give you any more money for enforcement until this is taken care of.

This was a study of 45,000 taxpayers. In the general population, six percent of the returns have a Schedule C, but in the sample through this study, 46 percent of the returns had Schedule C.

I can only come to the conclusion that this thing was targeted right at the small business people. Can you or perhaps your aide with you who did the study, explain to us why this sampling is so grossly out of proportion to the normal people that have, normal number of taxpayers that file a Schedule C?

Mr. EVERSON. Certainly, sir. If my answer is too general, my director for research will answer that. This was intentional and it was intentional both for high income individuals and Schedule C filers, because of the more complexity.

Just because you over sample, it helps you make sure you have the right results. This was looked at by GAO. GAO has reviewed the National Research Program three times as to how it was set up and their initial review of this in 2002, they concluded, "NRP's design is likely to yield the sort of detailed information that IRS needs to measure overall compliance, develop formulas to select likely noncompliant returns for audit and identify compliance problems for the agency to address. The sample is adequately sized for these tasks" and they go on from there.

Just because you take a larger sample doesn't mean you don't adjust that for when you extrapolate or do the research. That is what they are doing.

Chairman MANZULLO. It still doesn't make sense. Six percent of the general population files a Schedule C, but 46 percent of the returns in your sample has Schedule C's. Therefore, the IRS purposely aimed its guns at small businesses.

Mr. EVERSON. I don't share that assessment of that.

Chairman MANZULLO. Let me ask you a question. If 46 percent of the returns had Schedule C's attached to them, what does that indicate to you? I mean who files Schedule C's?

Mr. EVERSON. I am sure you are aware there about 18 or 19 million Schedule C filers at present. So it is a big number. It has increased to almost 15 percent of the 1040 returns.

Chairman MANZULLO. Wouldn't you agree that small business people are more likely to file a Schedule C?

Mr. EVERSON. Absolutely. Yes, sir. Yes, sir, but—

Chairman MANZULLO. That is the whole point.

Mr. EVERSON. But it is not blown out of proportion. The statistics they are using this to get a better handle. I would have thought you would be happy about it, because statistically, as I understand it, you are going to get a more reliable projection from this.

Chairman MANZULLO. I can't accept that. The sample has seven times more people with Schedule C than the general population.

If you are going to do a sample, you go all the way across the breadth on it. This survey was intended and aimed at small business people.

Mr. EVERSON. It was aimed at the more complex. The overstatement was in the more—

Chairman MANZULLO. Those are small business people.

Mr. EVERSON. Not only small business people. Not only small business people.

Chairman MANZULLO. One thing that the work has not been done is on the C corporations. I would suggest before the IRS lowers the hammer on going after small business people, who have enough problems in this world, that you do your research on C corporations so instead of extrapolated and whatever the words that were used on there, we know exactly what is going on with the gross tax gap. Because the resources that you are going to take, the additional resources are going to be aimed at those small business people and not at the C corporations.

Mr. EVERSON. That is not true, sir.

Chairman MANZULLO. That is—

Mr. EVERSON. That is not what the budget request has provided. We asked for—

Chairman MANZULLO. That may be the budget request, but I can assure you that this is the gravamen of your whole study. It is the small business people.

Mr. EVERSON. We are seeking to do more in this area, but as I say, the allocation of resources has been—

Chairman MANZULLO. You know, Commissioner, allocation of resources—I mean this is not a class in English. If you don't have enough money, you don't have enough money. But you know what? There isn't one agency in this city, there isn't one Committee, there isn't one member of Congress that says I have more than sufficient money to run my operation.

To say we don't have enough money for audits, I mean there are what, 97,000 IRS employees?

Mr. EVERSON. That is about right.

Chairman MANZULLO. And it is down. It is down.

Mr. EVERSON. It has come down because of the electronic filing, you don't need as many—

Chairman MANZULLO. Right.

Mr. EVERSON. —people to process returns.

Chairman MANZULLO. Of that, 400 are involved in education, is that correct?

Mr. EVERSON. No, sir. That is a number that is within this business unit for the small business, self-employed piece. That unit is maybe something like 28,000 people.

Chairman MANZULLO. Okay. Mr. Fitzpatrick, do you have some more questions?

Mr. FITZPATRICK. Yes. I just want to get back to the issue of how to get small businesses into compliance, those who have fallen out of compliance and I heard the Commissioner talk about some of the programs.

I thought maybe, Mr. Sullivan, from the Administration, you may have—

Mr. SULLIVAN. I would love to respond and give the Commissioner just a little breathing room, if I may. I think what you have heard, Congressman, not only from me and the Commissioner, but also GAO, the Taxpayer Advocate and the Inspector General on April 14 on the Senate side, talked about balance.

I think the balance has got to be based on data. That is what the Chairman was just referring to making sure that that data is as best possible, before directing the IRS where to direct its resources, whether it be education or enforcement.

A problem, Congressman Fitzpatrick, is there does not seem to be that type of data on whether or not the education, the taxpayer education is producing compliance benefit.

Now there is positive news on this side. The Treasury IG in his statement on April 14 does say that taxpayer education has led to many improvements and I quote, "Individual taxpayer satisfaction rates with IRS have increased since the law's passage, rising from 51 to 64 percent, between 1999 and 2004."

If you put that type of statistical analysis on top of economic work, like those that are contained in my written statement by Dr. Bruno Frey, it shows that that type of satisfaction has a direct correlation into greater compliance.

So what I think is missing in part of this balance is more data that shows that taxpayer education is in fact working and if better prioritized will also help fill the gap, commensurate with increased or greater attention to enforcement.

Now that is lacking and so I am hopeful that now that Congress has their attention on the President's budget, the Commissioner, my office and others have already done our work in presenting the President's budget to Congress. Now it is your chance to look at that and how you prioritize.

I am hoping that the IRS will focus on creating data that documents whether or not taxpayer education will fill in that tax gap. Because as of now, aside from the IG, there really isn't information that documents all the hard work from the taxpayer education, whether or not it is making a positive or negative difference.

Mr. FITZPATRICK. Do you, Mr. Sullivan, have any recommendations as to how we could get non-filers back into the system?

Mr. SULLIVAN. I believe that again—

Mr. FITZPATRICK. Through education.

Mr. SULLIVAN. Congressman, I believe that the way to approach the tax gap is through the balance. It is the balanced approach. It is one, reducing the complexity and the President has absolutely made that a priority and many of us are looking forward to the bipartisan Tax Panel's recommendations to reduce complexity.

I should also point out that behind the scenes there is a division at IRS. Mr. Chessman, who heads the Office of Burden Reduction, is behind me. They actually look at administrative ways to reduce complexity. The Commissioner mentioned some great success stories there.

So one is reduce complexity. Two is obviously prioritize enforcement as an important ingredient. Three is to bring in an equal and balanced way of taxpayer education and I think through a balanced approach, through all of those three, you will see the tax gap reduced.

Mr. FITZPATRICK. Is there the possibility though over reliance on the enforcement piece of the three-pronged approached you just talked about, could have the maybe unintended consequence of driving more small businesses underground?

Mr. SULLIVAN. Yes, Congressman. Not only does this seem to be the case, you know where is that fine balance between just enough enforcement and too much?

That was detailed out by Dr. Bruno Frey in a paper that I cite in my written statement. It does show that too much enforcement actually does drive more folks underground.

So you would have, despite good intentions, you would have the exact opposite consequence. So again, I will just restate that the real key to reducing the tax gap is a balanced approach.

Mr. FITZPATRICK. Thank you. I yield back.

Chairman MANZULLO. For every one dollar in revenues that is collected by the IRS, how much of that is represented by employees? How much by small businesses? Then how much by large businesses? Do you have—

Mr. EVERSON. Yes. The small—

Chairman MANZULLO. I guess on that pie—

Mr. EVERSON. The IRS collects about two trillion dollars a year. Probably, Mr. Chairman, about a quarter of that comes from small businesses. By small businesses, I am taking that whole family of the Schedule C filers, the 1120 filers, the S filers, the partnership filers, that whole group.

Now what is different about this population, sir, is that it is the mix of taxes within that total. The preponderance of those monies that I am talking about are employment taxes. They are not the income taxes.

If you look at the whole two trillion, employment taxes are a little less than 40 percent or so of what is the budgeted receipts this year, but if you look at this population that you are concerned

about, the small business population, the biggest driver in there is in the employment tax area, where I think that is about two-thirds of the total, sir.

Chairman MANZULLO. The National Taxpayer Advocate, Nina Olson, suggested in her 2003 annual report to Congress that implementing non-wage withholdings, in particular, withholding for income reported on Form 1099, by the small business people, would greatly enhance compliance among independent contractors and help to close the tax gap.

Same question to both of you. Do you agree this reform would help close the gap?

Mr. EVERSON. I have stated, Mr. Chairman, I am not an advocate of going down the withholding path. I just think that it would be very burdensome and I stick by the perhaps unpopular desire to do more in the enforcement area with those who are noncompliant, rather than have that withholding regime, which I think would be quite burdensome.

Chairman MANZULLO. Mr. Sullivan?

Mr. SULLIVAN. I think the idea first stated by Nina Olson in her annual report, then picked up by GAO and then the IG, is absolutely the wrong way to go.

It would be a disaster for small business and coincidentally a disaster for the economy primarily for two reasons. First of all, the recommendation of proprietors withholding for folks who use their premises as independent contractors punishes the very population of small businesses that recovered America from a recession.

So here we are after pulling ourselves out of recession, where small businesses are literally the only entities hiring new employees and their reward is, according to this recommendation, you will now be responsible for withholding from another set of taxpayers.

I think that would be a disaster and you would unbelievably stifle the economic engine that is created by small business.

The second reason why it is a terrible idea is that it further blends, it further blurs the distinction between employer and independent contractor.

Now this could be a whole other Congressional hearing, and in fact, there have been plenty of Congressional hearings on this issue. In the construction field in particular, there still are, in the small business community, the folks who talk with me every day. They still are very, very troubled by the confusion that exists over whether you are an employer or an independent contractor and if something bad happens, who is responsible?

The idea that withholding then become the responsibility of the proprietor further blurs and confuses the distinction between employer and independent contractor. It would be a terrible way to go, Mr. Chairman.

Chairman MANZULLO. The Commissioner agrees with you. It took him 20 seconds to say so. It took you three minutes, but that is okay.

The Office of Burden Reduction, how many employees are in that?

Mr. EVERSON. It is not a large office. It is a highly skilled office. I am not sure. Half a dozen, dozen people. Ten people.

Chairman MANZULLO. Ask him if he needs more people to help reduce the burden of reduction.

Mr. EVERSON. I think you have done fine in asking the question, sir. Let me tell you something though, Mr. Chairman. What we did do here was in order to increase the prominence of this effort. When Kevin took over from this business division, we asked Mike to report directly to him so that it gets enough prominence within that business unit. Those issues are addressed on an ongoing basis. I think that has helped this area.

Chairman MANZULLO. Thank you very much for coming this afternoon. Sorry we were running late. I appreciate the testimony. I appreciate your candor. If we could get the second panel ready.

Mr. Sullivan, is there somebody from your office that might be able to stick around?

Mr. SULLIVAN. Yes, I will.

Chairman MANZULLO. Thank you. We will recess for about five minutes until we can set up the table.

[Whereupon, a short recess was taken.]

Chairman MANZULLO. We are starting our second panel. First witness is John Satagaj, testifying on behalf of the Small Business Legislative Council. We look forward to your testimony.

The complete written statements will be made part of the record, without objection and I will set the five-minute clock here.

You need to push the button and then pull the—

Mr. SATAGAJ. I am used to talking without the microphone. I don't need it normally.

STATEMENT OF JOHN SATAGAJ, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Mr. Chairman, it is great to be here. I am John Satagaj. I am the President and General Counsel for the Small Business Legislative Council, which is a coalition of about 60 trade associations, all of which have common interests that they represent the interest of small business.

For us, this comes down to a pretty simple equation in regards to what needs to be done and what we can accomplish to help small businesses.

Number one, we have got to simplify. We heard it here in the first panel of testimony today about the need for simplification. We think a lot of the problems that small business has with Tax Codes

and with complying has to do with the complexity of the Code. So if we can simplify, we can solve a lot of these problems.

Secondly, we need to educate. We are particularly concerned about where things are going at the IRS in general and in the small business sector in particular, as it relates to education.

There is taxpayer education and communication. They call it TEC, which has done a marvelous job. You talked today about it—I think you used the hammer.

Representative Kelly used the boom. For me the metaphor is the pendulum and the pendulum is coming right at small business again. What is remarkable for me is how quickly the pendulum has swung back.

In Washington terms, it has been like a nanosecond since we recognized that there was a lot of burdens being imposed on small business. That we were really aggravating the small business taxpayer with the audits. That it was unfair and in that nanosecond it switched back already to where we are coming back to that.

We had eased off on it and now we are right back to the point where we are very aggressively going to pursue small businesses.

We needed to give taxpayer education more time. We haven't given it enough time. We hear some rumors that over at the IRS they are even cutting back further on taxpayer education.

Mr. Chairman, if you could see one of the cool sessions that we are all involved in, in the small business community, once every two months we get together in a session hosted on a rotating basis by NFIB, the Chamber and SBLC.

Our partner is TEC at the IRS. We have a meeting every two months. They bring in different folks. We talk about problems.

You should see all the material we are getting from them that we then use for our members, but you can't change that overnight. It takes time.

We are working hard. We are making a lot of progress. If they are, in fact, diverting resources elsewhere instead of that education, I fear we are going to lose everything we built up when the pendulum was going our way. We are going to lose it in a nanosecond and that is where we are right now.

For us, simplification is number one. Number two, taxpayer education. We do those two things, we are going to do great.

The last thing I want to mention—I don't know if he has come back in the room or not, you noted at the beginning that Kevin Brown was going to stay for the entire—

Chairman MANZULLO. Kevin's here.

Mr. SATAGAJ. Kevin's here. He has come back in the room. He is behind me. I want to mention, because you know you don't get too many chances to say, you got a friend at the IRS. I can tell you I have had my share of non-friends at the IRS. This is a good person for small business running that section.

Chairman MANZULLO. The record will note your friendship.

Mr. SATAGAJ. Good friendship. Maybe I won't get audited next year if I am lucky. But it is important to have somebody there who

understands small business and Kevin does do that. I think he is a great asset for us to have over there.

With that, Mr. Chairman, that concludes my testimony. Thank you.

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

Chairman MANZULLO. Thank you.

Our next witness is Keith Hall. He runs the Tax Talk service for the National Association of Self-Employed. He is a resident of Texas, where he is also partner in Hall and Hughes, a local accounting firm.

We look forward to your testimony, Mr. Hall.

STATEMENT OF KEITH HALL, HALL AND HUGHES

Mr. HALL. Mr. Chairman, members of the Committee, I appreciate the opportunity to be here today, both as a small business owner and as a member of the National Association for the Self-Employed.

I hope to provide a small business owner's perspective on the existing tax gap and various proposals for reducing that tax gap.

Through the NASE Tax Talk service, I help answer over 8,000 questions every year from small business owners across the country. I think that gives me a unique opportunity to share the small business perspective.

A vast majority of the questions that we answer are based on some specific complexity in the Tax Code. For example, many small business owners operate out of their home, but they are intimidated by a very complicated home office deduction form.

Most use their personal vehicle in operating their business, but are confused regarding that deduction as well.

Some hear that they can fully deduct the cost of their vehicle, but only if it weighs over a certain number of pounds. Then they find out that there is a different set of rules for SUVs and then still a different set if it is purchased before October 22 or after October 22.

Now these issues directly contribute to the tax gap, since the small business owner doesn't know what they owe. That leads to incorrect estimated tax payments, late filing of returns and late payment of tax that is due.

It is my opinion that the number one reason for noncompliance among small business owners is the complexity of the Tax Code.

Further, I believe that reducing that complexity will lead directly to increased compliance and therefore a reduced tax gap.

There are a number of other proposals, besides reducing complexity, that have been proposed. As mentioned earlier, the National Taxpayer Advocate has proposed withholding requirements on payments made to independent contractors.

This is the most troubling of any proposals so far for the small business owner. First, by adding another level of reporting and complexity, another level of potential noncompliance is also added.

But more importantly, withholding based solely on gross payments disregards the expenses that are incurred to generate those gross payments.

Consider an independent painter of office space who has a $5,000 contract. They have no employees but do all the work themselves.

After the cost of paint and supplies, they may have about $4,000 in gross profit. Withholding five percent right off the top, about $250, may make some sense, but what about a second painter who uses other contractors or employees to do the work?

They may have only a ten percent gross profit or about $500 in taxable income. Withholding the same $250 straight off the top represents a 50 percent withholding on their taxable income. Treating those two small business owners the same just doesn't make sense.

Further, the current proposal would only apply to sole proprietors. A painter who happens to operate as a corporation would not be subject to the requirement. The same painter, the same issues, the same headaches would have a different set of rules solely based on business structure.

Another proposal is based on increased IRS enforcement. This proposal does have merit. Those taxpayers who willfully disregard their tax liability should be held accountable.

I certainly support efforts to make sure they are held accountable. My concern is at what cost? The Commissioner mentioned, and has mentioned before, that he believes that service plus enforcement equals compliance. My concern is that budget dollars added to enforcement might be taken away from service.

The complexity of the Tax Code clearly contributes heavily to noncompliance, especially for the small business owner. Over the last several years, the IRS has done a tremendous job in providing service to the small business taxpayer.

Their website is unparalleled in depth of information and ease of navigation. Their commitment to developing comprehensive publications to address complex tax issues has been unbelievable and I truly believe that their commitment has made a real difference.

Diverting the attention of the IRS to enforcement, at the cost of service, would be devastating.

Another option is to increase the level of compliance data and the efforts to review that data. As a professional accountant, I always think it is a good idea to look at the numbers.

Knowing which taxpayers are noncompliant, whether intentional or unintentional, can only improve efforts to increase compliance, therefore reducing the tax gap.

However, the data can only be effectively analyzed in connection with the why related to that noncompliance. It is my concerted opinion that the why is in fact the complexity of the Tax Code itself.

Tax compliance and its effect on the tax gap is clearly a significant issue. However, efforts to close that gap and reclaim missing revenue must be based on balanced and equitable measures.

I believe that these efforts should avoid adding new levels of complexity, but instead focus on overall simplification of the Tax Code.

Most taxpayers want to comply with tax laws and pay their fair share. Simplifying the Code will give them the ability to do that.

Thanks again for the opportunity to be here.

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

Chairman MANZULLO. Thank you.

Our next witness is Abraham Schneier. Mr. Schneier is a tax consultant for the National Federation of Independent Businesses and a certified financial planner.

I look forward to your testimony.

STATEMENT OF ABRAHAM SCHNEIER, ABRAHAM SCHNEIER & ASSOCIATES

Mr. SCHNEIER. Thank you, Mr. Chairman, members of the Committee. My name is Abraham Schneier and I am a tax consultant to the National Federation of Independent Business and a self-employed business owner.

On behalf of the 600,000 members of NFIB, I appreciate the opportunity to offer views on the tax gap and to express the concerns of small business owners over IRS attempts to address this gap.

Let me first state that NFIB does not defend or attempt to rationalize that portion of the tax gap that is created by willful violation of our tax laws.

Clearly, the tax gap is caused by different factors and NFIB agrees with others that tax complexity continues to be responsible for a significant portion of the tax gap.

As Nina Olson, Taxpayer Advocate for the IRS, stated in her testimony before the Senate Finance Committee on April 14, "Tax law complexity provides gray areas and loopholes for taxpayers who are not trying to comply. Complexity also trips up taxpayers who are trying to comply. It is just too hard to figure out what the law requires and honest efforts to comply can result in a gotcha situation."

Since the Commissioner was kind enough to mention some of my testimony, I figure it is only right that I mention some of his previous testimony.

At the same hearing, the Commissioner said, "The tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance, due to complexity of the tax laws that results in ignorance, confusion and carelessness. We do not have sufficient good data to help us know how much of the tax gap arises from willfulness, as opposed to innocent mistakes."

We have heard both Commissioner Everson and Tom Sullivan from SBA's Office of Advocacy talk about the cost of compliance to the government. But there is also a heavy cost to the small business owner, in terms of the cost of advice that he is required to obtain on a regular basis, in terms of the cost of not knowing whether he or she is doing the right thing.

Too often they get tripped up on footfalls and too often they get tripped on just not knowing that there is a certain requirement coming.

Granted some of them do get into difficulties because of financial issues and at that time, you certainly don't want to be in debt to the IRS, which unfortunately too often can happen.

But we seriously believe that the tax gap is being driven in a major portion by the complexity. In that regard, I would like to echo some of John Satagaj's thoughts about the efforts of the small business, self-employed and the TEC division, in terms of the out-

reach and the communications that has been going on with the small business community over the last several years.

It has been a long time since small business has had the opportunity to have input on the front end of items that were going to come out before the small business community. That has been a major benefit of having this regular communications.

Too often we hear this is what you have to do and maybe we can't change that, but on a more regular basis we were having an opportunity to have input on the front end on new forms that were going to be put forward and on new rules.

I guess probably the best example is maybe the cash method of accounting changes that we all worked on so hard several years ago.

There is an increased reliance as well on technology, which I think we have to be a little concerned about. NFIB does regular surveys of its members on a variety of issues and despite everything we read in the news, not all taxpayers, which includes small business owners, use or are comfortable with computer technology.

17 percent of small employers are not even on the Internet. The issue is not just relevant to those who are not on the Internet. Many questions simply require talking to a real person who can sometimes ask the appropriate follow up question that will lead to a correct answer.

Sometimes the taxpayer will call up Taxpayer Service and ask a particular question or look up something on the Internet. Unless he has a live person on the other end who can maybe ask a follow up question to really help him get to the kernel of the issue, he is going to come up with the wrong answer more often than not or come up with no answer, which can also lead to unfortunate events.

Recently NFIB asked a sample of small employers if they had contacted government to learn about or clarify an existing rule or obligation, such as a tax rule.

60 percent indicated that they had. Of that number, only five percent said that their primary means of contact was the Internet. The most frequent was by telephone.

It is highly likely that the proportion using the Internet and using it effectively will increase, but to the extent that reliable, readily accessible and easily understandable information reduces the tax gap, mismatches between the way IRS—

Chairman MANZULLO. Mr. Schneier, I am going to cut you off here. I want to get this testimony and we have got a bunch of votes and a big fight going on, on the floor. I am going to cut you off right there and go to our next witness, Mr. Steinberg.

Mr. SCHNEIER. Thank you, Mr. Chairman.

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

Chairman MANZULLO. I look forward to your testimony.

STATEMENT OF LEONARD STEINBERG, THE STEINBERG GROUP

Mr. STEINBERG. Thank you, Mr. Chairman.

Chairman MANZULLO. I am going to reduce your time to four minutes. I just want to get everybody in and get this completed, because we may be gone for an hour, an hour and a half on a floor fight.

Mr. STEINBERG. All right. Thank you, Mr. Chairman. I appreciate it very much and I will be as brief as possible.

Chairman MANZULLO. If you could move the mike closer to you, Mr. Steinberg. Thank you.

Mr. STEINBERG. Thank you, sir. I am here to talk about the how and why of the tax gap and although everyone has talked about the complexity of the tax gap, I will give you a classic example.

There are some people that will form a business as a limited liability corporation. According to the IRS rules, if you are a single person limited liability corporation, you are considered a sole proprietor.

If you are a two-person limited liability corporation, you are considered a partnership. These kinds of complexity drives small business people nuts, because they really don't understand the difference in the type of organizations that they are really forming.

Another reason for the tax gap is the effect of the alternative minimum tax. Although this is not a hearing on the alternative minimum tax, many small business owners and self-employed individuals will intentionally underreport their income in order to specifically avoid the AMT. This is accomplished by not reporting all cash transactions and by not reporting all income derived from other sources.

The AMT is specifically devastating to those small business owners and taxpayers who live in high tax states, such as New York, my home state of New Jersey, California and Massachusetts.

Another reason for the tax gap is operating a cash business. As an example, a small business owner may operate a pizzeria. The store is open six days per week from Tuesday through Sunday.

The business has been in the same location for many years and though the ownership has changed twice, the business has a wonderful reputation.

On very busy days, the owner and helpers prepare pizzas and other foods as quickly as they can. Orders are phoned in. Customers come to pick up their orders.

The people behind the counter do not have either the time or the proximity to get to the cash register in order to record the sale. The cash is held and then placed in the register at the end of the busy period and each cash sale is not accurately reported.

So the mathematics of this non-reported cash will work as follows: If there are five unreported transactions with a value of $10 each day, the total amount of unreported sales transactions will equal $15,600 for a year, based on a six-day week for 52 weeks.

If the money goes into the owner's pockets, that is $15,600 of unreported income and there is also an effect on state and local sales tax.

Another reason for the tax gap is that many people do not understand the tax laws. As an example, I had a case of a client who did not understand why he could not expense his entire franchise fee.

His franchise fee was $40,000. Why can't I expense it? I had to explain to him that it has to be amortized over 15 years, over the life of the business.

Here again, the franchisor received the $40,000, which is claimed as income, but the franchisee can only take a portion of it.

Lastly, I would like to talk about unenrolled preparers. I know Nina Olson has talked about this. This is a pernicious affect on unreported income. There are unscrupulous, unenrolled preparers who will prepare tax returns and take undue deductions and not claim all the income for the people. I know my time is almost up.

So I would like to thank the Committee for the opportunity.

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

Chairman MANZULLO. Thank you very much.

Mr. Hegt, we look forward to your testimony. I am sorry about the rushed up time. Please.

STATEMENT OF RONALD HEGT, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. HEGT. Thank you, Mr. Chairman. The AICPA thanks you for the opportunity to appear before you today. I am Ron Hegt, a member of the AICPA Tax Executive Committee.

The AICPA is the national professional organization of CPA's comprised of more than 350,000 members, many of whom provide services to America's small businesses.

It is from this broad base of experience that we offer our comments today. The AICPA has long been an advocate for tax simplification. Small business in particular needs advocates to collect and voice their concerns about the burdens imposed on them.

We are committed to helping make our tax system as simple and as fair as possible. Unfortunately, we believe that the law's complexity in certain key areas may be strangling voluntary compliance.

The lack of deliberation in the legislative process, the frequent law changes in recent years and the increasing magnitude and complexity of the Internal Revenue Code creates serious compliance issues for small businesses.

The end result is the erosion of voluntary compliance. By and large, small businesses obey the law, but it is only human to inadvertently disobey a law if you do not or cannot understand the rules.

The dynamic American economy is changing and moving rapidly against an unnecessarily cumbersome income tax system. The AICPA has long understood the consequences of tax law complexity and has supported efforts to move toward a simple system.

More recently, the AICPA has developed three tax policy concept statements guiding principles for good tax policy, guiding principles for tax simplification and guiding principles for tax law trans-

parency, which are intended to aid in the development of tax legislation in a direction that we believe is in the public interest.

Simplification must be given a prominent position in the tax process on an ongoing basis. Although it should not take precedence over revenue and tax policy objectives, simplification must be an integral part of the tax legislative regulatory and administrative process.

We recognize that a tax system that is simple for all taxpayers may never be designed, but we do believe a simpler system is attainable.

For a number of years we have joined our professional colleagues from the ABA tax section and the Tax Executive Institute in this simplification effort.

We have, on many of occasions, submitted simplification recommendations to Congress, which specifically address a number of issues that add to the difficulties small businesses have in complying with the tax laws.

Some of these suggestions have particular interest to small businesses include eliminating the alternative minimum tax, clarification in worker classification area, developing objective, administrable tests relating to capitalization, expensing and recovery of capitalized costs, simplifying capital gains provisions and rationalizing estimated tax safe harbors.

In addition, we suggest allowing small business start ups an additional tool to successfully navigate their start up life cycle by providing the flexibility to adopt any fiscal year from April through November.

The AICPA supported the Small Business Tax Flexibility Act of 2003, HR 3225, which would have increased small business prospects for survival.

Moving to another area, I would like to address two critical topics. One, how the IRS can help taxpayers in its own enforcement efforts through administrative simplification and two, how the IRS can leverage its external stakeholders to achieve a more highly compliant tax population.

We are well aware of the substantial decline in the number of income tax return examinations conducted by the Service in recent years.

We support the Service's efforts to reverse this trend by hiring new revenue agents and implementing a number of administrative simplification measures within its four operating divisions.

Over the years, the AICPA has urged full funding of the IRS budget and continues such support. Commissioner Everson recognized that any increase in enforcement funding must be balanced with positive responses to the taxpaying public, his customers. We encourage—

Chairman MANZULLO. I have to enforce the clock, which I can't stop.

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

Chairman MANZULLO. What I would ask is this: I am going to formally end the hearing. I will come back personally and we will have about a 20-minute or so town meeting so the people here can

ask questions and we can get more input from you, especially those of you that have traveled far distances.

The stenographer would be excused, because at this point the hearing is formally adjourned.

[Whereupon, at 3:30 p.m., the Committee meeting was adjourned.]

Committee on Small Business
Hearing: *Closing the Tax Gap and the Impact on Small Business*
Room 311, Cannon House Office Building
April 27, 2005, 2:00 PM

Opening Statement of Chairman Manzullo

Good afternoon and welcome to this hearing on a very important topic for small businesses around the country – closing the "tax gap." There would be no "tax gap" without the income tax code. Interestingly, almost 92 years ago to the day and in this very hearing room, then Ways and Means Chairman Oscar Underwood with the assistance of Representative Cordell Hull reported the first income tax out of committee shortly after the ratification of the 16th Amendment. This income tax consisted of only eight pages in an 814-page tariff bill. Today, the income tax code spans more than 60,000 pages.

As we sit here today, President Bush is delivering a speech during the Small Business Administration's 2005 Small Business Expo. No doubt his speech includes the statistics and data on the ever-increasing importance of small businesses to our economic well-being. However, his speech will likely not include anything about the topic of the hearing today. The "tax gap" is something not many want to talk about but is nonetheless real. There is a difference between what is owed by many taxpayers and what is actually paid to the Treasury.

Beginning in 1999, former Commissioner Rossotti tasked some of the best minds in the IRS with measuring tax compliance by U.S. taxpayers. The goal of this study, named the National Research Project, was to identify those taxpayers with the largest problems and to develop strategies to get people to pay all of the taxes they owe. The tax year selected for the study was 2001 and just last month the preliminary results from the study were released. To no one's surprise, the study validated that there was a big "tax gap" in the magnitude of $300 billion. A large portion of this gap has been attributed to small businesses and the self-employed.

The purpose of this hearing is to review with the Commissioner and other witnesses where to go with this data. Before we begin that process, it is important to point out that the preliminary data is woefully incomplete because it provides no estimate of the "tax gap" for C corporations or flow-through entities, such as partnerships. The data for these entities is still from the 1980's – a time that is far removed from the aggressive tax strategies that many "blue chip" accounting and law firms developed during the late 1990's.

While the data has some deficiencies, no one can argue that there is not a big problem. The question becomes what is the appropriate response? How do we make small business taxpayers more compliant while at the same time minimizing burden? The Commissioner has suggested that this can be accomplished by having a greater police

force on the beat. However, increasing the police presence means nothing if those being policed don't understand the laws or the nature of the violation. While I understand the push to lower the budget deficit and the readily-available statistics that support increased enforcement, imposing increased burdens on small businesses through more audits cannot be the only answer.

Small businesses are dealing with a patchwork quilt of regulations. It is simply not realistic to assume these businesses have the necessary resources to comply with every regulation, including those issued by the Treasury and IRS. Many times, small business owners are attempting to the best of their ability to comply with the complex tax code. It is not that they don't want to comply; rather, the system and paperwork are so complex that it's difficult to comply.

No matter how many additional auditors and collection agents are added to the IRS, there will still be a more pressing need to educate taxpayers about their obligations. The IRS will never have enough resources to police everyone and thereby enforce compliance. This realization was the very reason the IRS's mission statement was changed several years ago to be simple and direct: "Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." For no segment of taxpayers is the implementation of this mission statement more critical than small businesses. Many times these business owners begin with a thought or idea that leads to a successful product or innovation. These men and women are typically not tax experts. The method used by the IRS to interact with these individuals can be the difference between success and failure. It is much easier for a small business owner to learn how to comply with the tax laws through taxpayer education and outreach than the adversarial audit and collections process.

I would be remiss if I didn't discuss the need for simplification. I strongly support the President's effort to analyze and reform the current tax system. I intend to work with the small business community to ensure that the tax reforms proposed by the Tax Reform Panel lessen the tax burden on our small businesses while also increasing compliance. Maybe these proposals will again return the tax code to all of eight pages!

I now yield to the ranking minority Member, Rep. Velázquez of New York, for her opening comments.

STATEMENT
of the
Honorable Nydia M. Velázquez, Ranking Democratic Member
House Committee on Small Business
Hearing on "The Tax Gap"
April 27, 2005

Thank you, Mr. Chairman.

With April 15 only a few days behind us, the challenges of filing taxes is still fresh in the minds of all U.S. taxpayers – particularly small businesses. However there is clearly an emerging problem with our tax system – the tax gap in this country is now estimated to be around $350 billion a year – and growing.

This is an issue that impacts every taxpayer, and the reality is that there is simply no room for such a gap to exist. With a budget deficit nearing $427 billion, ensuring that everyone is paying their fair share of taxes is a good thing. To allow someone to avoid paying punishes honest taxpayers – especially this nation's entrepreneurs who are having to work extra hard to keep their businesses afloat.

Closing this massive tax gap could be the difference between cutting this country's growing budget deficit in half. In 1981 it was reported by the IRS commissioner that the tax gap had risen from $29 billion in 1973 to $87 billion in 1981.

Clearly, today's $350 billion tax gap is reason for alarm. This is a gap that we cannot afford to let grow any further. IRS statistics show the shortfall is largely due to unpaid or

unreported income. The IRS reports also indicate that a significant number of those who underreported are this nation's small businesses and self-employed.

The Bush administration has taken the approach that the best way to deal with this issue is enforcement and more enforcement. The IRS has spent a lot of their efforts on stricter enforcement through audits while cutting funding for assistance that may allow taxpayers to pay their fair share. The latest IRS budget requests even more money for enforcement to address this problem.

I am concerned that there is a lack of balance with the actions that have been taken. The increased enforcement efforts do not come without a cost to the private sector. It increases the administrative costs for entrepreneurs who are honest taxpayers. I am also troubled that some of the enforcement efforts are overly focused on small businesses. There are a large number of small firms who have not been underreporting – and they should not be overly burdened by these enforcement efforts.

The small business community knows very well just how complex the tax code already is. In fact, witnesses will testify today about how the complexity of the tax code has led to increased non-compliance. It is not a matter of avoiding taxes; it is that entrepreneurs cannot decipher the tax code.

The last two tax bills in 2003 and 2004 provided little small business relief and only exacerbated the problem when it comes to complexity. The FSC/ETI legislation passed in 2004 provided for 561 changes and added 250 pages of tax law changes.

The burdens of compliance have long been an issue for this nation's entrepreneurs who simply do not have the same types of resources that their corporate counterparts do in order to comply. According to an Office of Advocacy report, for small businesses with less than 20 employees, the cost of tax compliance is nearly double that of their larger counterparts. The costs of compliance are staggering – taxpayers now spend over $100 billion per year in accounting fees to complete their returns. Something is not right here.

Many small businesses who have been trying to pay their taxes have been subjected to an audit and have had to hire outside accountants. Further compounding this problem is the fact that largely used resources for small businesses – the local taxpayer assistance offices – are being shutdown due to budget shifts from assistance to enforcement by the IRS.

It makes little sense to work to close the gap by increasing compliance, while at the same time ridding entrepreneurs of the tools they rely on in order to comply.

There is no question that there should be negative consequences for failing to play by the rules. However, in doing so – and in implementing stricter enforcements – we need to ensure that this nation's main job creators are not once again overly burdened. With the

IRS already contributing to 80 percent of the regulatory burdens small businesses face – these additional enforcements only continue to add on.

Today's hearing is an opportunity for us to evaluate solutions on ways to reduce the existing skyrocketing tax gap. It is also a time for us to ensure that small businesses will not be unfairly burdened in the process. As the drivers of this nation's economy – we cannot afford to put the costs of collecting taxes on small businesses. We need balanced solution to close the tax gap.

WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE
MARK EVERSON
BEFORE
THE HOUSE COMMITTEE ON SMALL BUSINESS
ON THE TAX GAP AND SMALL BUSINESSES
APRIL 27, 2005

Introduction

Chairman Manzullo, Ranking Member Velázquez and members of the committee, I am pleased to be here today to discuss the tax gap with you.

As you know, the tax gap is the difference between the amount of tax imposed on taxpayers for a given tax year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws.

Early Estimates

Today, I will share with you some preliminary results of our analysis of the compliance data recently compiled by our National Research Program (NRP). The bottom-line results are similar to those we previously observed: although American taxpayers remain substantially compliant with the tax laws, the tax gap is nonetheless quite large in dollar terms. The preliminary results for Tax Year 2001 indicate that individual income tax reporting compliance may have gotten a little worse, but not alarmingly so, since 1988, the last time we performed a similar study.

Historically, there have been three types of income that are not well represented in compliance audits: informal supplier income, tip income, and unreported income that is not detected by auditors. Our detailed analysis of the NRP data will be supplemented with other data and special analyses to account more accurately for these three income types. These supplemental analyses in the past have taken several years to complete after the audit data have become available. We plan to apply new technologies this time, and we expect to have detailed, more reliable estimates of the tax gap available by the end of this year.

In the meantime, we have developed a set of preliminary updates to our tax gap estimates based on an initial analysis of the NRP data. We derived these estimates using a simple and quick approach that reflects the historical magnitudes of adjustments made to the raw audit data to account for informal suppliers, tips, and undetected noncompliance.

Our preliminary updates employ a range of estimates, reflecting different assumptions and levels of certainty. To give an idea of the magnitudes involved, our old projection of the overall Tax Year 2001 gross tax gap (i.e., for all types of tax, and all forms of noncompliance) was $311 billion, based on data from the 1980s projected forward. Our initial updated estimates, incorporate data from the recently completed study, and range

from $312 billion to $353 billion. The range for the net tax gap (i.e., the amount of the tax gap left after enforcement efforts and collection of late payments) is from $257 billion to $298 billion. The corresponding noncompliance rate associated with our old projection was 14.9 percent, while the new estimates range from 15 percent to 16.6 percent. I want to emphasize at this early stage in our analysis that these ranges are not upper and lower bounds; our final estimates could conceivably lie outside that range, and it is even more likely that our estimates for specific components of the tax gap (e.g., specific line items) will change significantly once we complete the detailed analysis. The range of estimates we are providing today also does not represent a statistically-based confidence interval, although we do plan to include such intervals with our comprehensive estimates at the end of the year.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely return. We have separate tax gap estimates for each of these three types of noncompliance. Our preliminary estimates of underreporting by individuals appear to be consistent with previous studies, indicating that the underreporting portion is about 80 percent of the overall tax gap, with nonfiling and underpayment splitting the remaining 20 percent.

The National Research Program

Before providing more detail about these new estimates, I want to put them in context. I will start by summarizing the features of the new NRP data upon which the estimates are based, and then explain what the estimates do and do not include.

The NRP data that were ready for analysis in early January represent the first comprehensive reporting of compliance data since Tax Year 1988. We conducted several much narrower studies since 1988, but nothing that would allow us to update our estimates of the tax gap. All of our estimates of the tax gap in recent years have been rough projections that assume no change in compliance rates among the major tax gap components; the magnitude of these projections merely reflected growth in tax receipts in these major categories. Like the compliance studies of the past, the NRP was designed to allow us to meet certain objectives: to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas. I will focus today on the first of these objectives.

Regular audits have two important shortcomings as a basis for compliance measurement. First, returns selected for regular audits are not intended to be representative. Second, the audits are not exhaustive, but instead focus on issues that appear to be most in need of checking. In the past, IRS overcame these shortcomings by conducting thorough, exhaustive audits on a representative sample of returns. From the early 1960s through 1988 we periodically conducted the Taxpayer Compliance Measurement Program (TCMP), consisting of line-by-line audits of random samples of returns, which provided us with information on compliance trends, and allowed us to update audit selection formulas. By the 1990s, however, it became apparent that we needed to find a less intrusive way to measure compliance with the tax laws. The National Research Program grew out of that need, and introduced several innovations

designed to reduce the burden imposed on taxpayers whose returns were selected for the study.

The first NRP innovation was to compile a comprehensive set of data to supplement what was reported on the selected returns. The sources of the "case building" data included third-party information returns from payers of income (e.g., Forms W-2 and 1099) and prior-year returns filed by the taxpayers. Also, for the first time we added data on dependents from various government sources, as well as data from public records (e.g., current and prior addresses, real estate holdings, business registrations, and involvement with corporations). Together, these data reduced the need to ask taxpayers for information, with some of the selected taxpayers not needing to be contacted at all by the IRS. In effect, these data allowed us to focus our efforts where the return information could not otherwise be verified. This pioneering approach was so successful it is being expanded into our regular operational audit programs.

A second major NRP innovation was to introduce a "classification" process, whereby the randomly selected returns and associated case-building data were first reviewed by experienced auditors, referred to as classifiers, who identified the best way to handle each return in the sample. In this way, each return was either: (1) accepted as filed, without contacting the taxpayer at all (though sometimes with minor adjustments noted for research purposes); (2) selected for correspondence audit of up to three focused issues; or (3) selected for an in-person audit where there were numerous items that needed to be verified. In addition, the classifiers identified compliance issues that the auditors had to evaluate, though the examiners had the ability to expand the audit to investigate other issues as warranted.

Other NRP innovations included streamlining the collection of data, providing auditors with new tools to detect noncompliance, and involving stakeholders (including, representatives of tax professional associations) in the design and implementation of the study. Moreover, a more focused selection process resulted in the NRP sample including around 46,000 returns—somewhat fewer than previous compliance studies, even though the population of individual tax returns had grown over time. Clearly, the NRP approach was much less burdensome on taxpayers than the old TCMP audits, which examined every line item on every return. At the same time, we expect that the data collected through the NRP will be about the same quality as that collected under TCMP. A portion of the sample was designed to allow us to test the reliability of this methodology.

The new NRP data relate only to the accuracy of timely filed individual income tax returns. We are therefore able to use the data to update our estimates of only the individual income tax underreporting gap and the self-employment tax underreporting gap. All other components of our individual tax gap estimates are the same projections to Tax Year 2001 that we have been using for the last few years. Specifically, we do not yet have a new estimate for the individual income tax nonfiling gap, though we anticipate having an update later this year. We also are not changing our Tax Year 2001 figures for the underpayment gap, because these are actual amounts tabulated from our Master File records rather than estimates or projections. (The underpayment gap is the one exception to the rule that the tax gap cannot be observed, and therefore must be estimated. That is because the underpayment gap is the amount that is

reported on timely filed returns, but is not paid on time—information that is available from IRS records.) Furthermore, it is important to emphasize that the other components of the overall tax gap remain unchanged. In particular, we do not yet have new estimates for other taxes such as the corporate income tax or the estate tax.

Distinguishing the Tax Gap from Related Concepts

The tax gap is not the same as the so-called "underground economy," though there is some overlap (particularly in the legal-sector cash economy). For example, the tax gap does not include the illegal sector of the economy, and the underground economy does not include tax noncompliance problems such as overstated deductions or improper filing status.

Equally important, the tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to complexity of the tax laws that results in ignorance, confusion, and carelessness. This distinction is important, though at this point, we do not have sufficiently good data to help us know how much arises from willfulness as opposed to innocent mistakes.

The New Estimates

Our preliminary estimates of the individual income tax underreporting gap based on the new NRP data range from $150 to $187 billion, representing about half of our overall tax gap estimates of $312-$353 billion. This is consistent with the fact that the individual income tax accounts for about 46 percent of all tax receipts. Moreover, these figures are roughly in line with our earlier projections from compliance data compiled in the 1980s, though they suggest that reporting compliance among individuals has worsened slightly since Tax Year 1988. It is important to note, however, that the data represent a single point in time for Tax Year 2001 and so cannot tell us whether compliance trends today are improving or getting worse.

Preliminary NRP-Based Tax Gap Estimates, Tax Year 2001

Tax Gap Component	*Gross Tax Gap ($ billions)*	*Share of Total Gap*
Individual income tax underreporting gap	**150-187**	**48-53%**
Understated non-business income	42-57	13-16%
Understated net business income	83-99	27-28%
Overstated adjustments, deductions, exemptions, and credits	25-30	8-9%
Self-Employment tax underreporting gap	**51-56**	**16%**
All other components of the tax gap (not updated yet)	111	
Total Tax Gap	**312-353**	
Note: Detail does not add to totals due to rounding		

As in previous compliance studies, the NRP data suggest that just over half

($83-$99 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). About 30 percent ($42-$57 billion) came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $25-$30 billion came from overstated subtractions from income (i.e., statutory adjustments, deductions, and exemptions), and from overstated tax credits.

The corresponding NRP-based preliminary estimates of the self-employment tax underreporting gap range from $51 to $56 billion, and account for about one sixth of the overall tax gap. Self-employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self-employment tax together, then, we see that individual underreporting contributes about two-thirds of the overall gross tax gap.

Early indications are that the sections of the Form 1040 where the most noncompliance occurs have not changed dramatically since the last compliance study in 1988. The amounts least likely to be misreported on tax returns are subject to both third-party information reporting and withholding, and are therefore the most "visible" (e.g., wages and salaries). Amounts subject to third-party information reporting, but not to withholding (e.g., interest, dividend income, and 1099 compensation), exhibit a somewhat higher misreporting percentage. Amounts subject to partial reporting by third parties (e.g., capital gains and mortgage interest payments) have a still higher misreporting percentage. And, as expected, amounts not subject to withholding or to third-party information reporting (e.g., certain sole proprietor income, and the "other income" line on the 1040) are the least "visible" and, therefore, are most likely to be misreported.

We expect to be able to provide good estimates of these misreporting rates for each line of the 1040 once we complete our detailed analysis of the NRP data at the end of this year. In the meantime, early indications are that reporting rates have remained fairly stable, with a few exceptions. First, the underreporting of net income from "flow-through" entities such as partnerships and S-corporations appears to be on the rise. This is consistent with what we have been finding in our regular audits, as taxpayers use increasingly sophisticated abusive schemes to reduce or eliminate their tax liability. With this in mind, we are exploring how to conduct our next NRP reporting compliance study on flow-through entities—not just to monitor compliance in this area, but also to help develop better audit selection methods and other creative interventions. Second, the reporting of sole proprietor income and expenses (e.g., gross receipts, bad debts, and vehicle expenses) appears to have worsened. With transactions that are less "visible" to the IRS, and with very low audit rates by historical standards, some sole proprietors may have become emboldened to cut corners on their taxes. Other small business owners may simply be swamped by the cost and complexity of meeting their tax obligations and other business requirements. Third, early indications are that taxpayers in 2001 tended to overstate their deductions somewhat more than in 1988, the last tax year for which we have comparable compliance data. Like most business income and expenses, many of these deductions are not subject to third-party information reporting.

What We Are Doing Today to Address the Tax Gap

Most Americans pay their taxes honestly and accurately, and have every right to be confident that when they do so, their neighbors and competitors are doing the same. Let me provide an overview of the steps we have taken over the past year to bolster this confidence, turning briefly to each of our four Servicewide enforcement priorities.

Our first enforcement priority is to discourage and deter non-compliance, with emphasis on corrosive activity by corporations, high-income individuals, and other contributors to the tax gap.

- In 2004, audits of high-income taxpayers jumped 40 percent from the year before. We audited almost 200,000 high-income individuals last year – double the number from 2000.
- Overall, audits for individuals exceeded the one million mark last year, up from 618,000 four years earlier.
- In 2004, the number of audits of the largest businesses – those with assets of $10 million or more – finally increased after years of decline.

As I mentioned earlier, individual underreporting makes up about two-thirds of the overall gross tax gap. To address this, during FY 2005, our Small Business/Self-Employed (SB/SE) division will devote about two-thirds of its face-to-face audit resources to the noncompliance of small businesses, including Schedule C taxpayers, Form 1120 filers with assets under $10 million, and flow-through entities. Current results show that our examiners propose changes in more than eight out of ten Schedule C audits performed, with an average recommended tax change in FY 2005 of almost $15,000 per return. In addition, the no-change rate for Schedule C audits (percent of audited returns for which no change in tax is recommended) has been quite consistent for the past two to three years – in the range of 12-14 percent annually. We expect the results of the NRP study will allow us to detect noncompliance among Schedule C taxpayers with even more precision, further minimizing the burden for compliant taxpayers.

In addition to traditional audits, the IRS also uses computer matching of information returns, such as Forms W-2 and 1099s, in its Information Returns Program, or document matching as it is often called. For Tax Year 2001, for example, IRS received over 1.4 billion information documents on individual taxpayers, of which more than 1.3 billion were processed and matched. This technique is very effective for verifying income items reported on individual returns against those reported by third parties, including wages, interest, dividends and miscellaneous payments. During FY 04, the IRS closed more than 3.7 million document matching cases and collected about $2.7 billion as a result of these taxpayer contacts. Furthermore, on April 14, 2005, we published Temporary and Proposed Regulations under Internal Revenue Code Section 3402(f) in connection with establishing a withholding compliance program that will use Form W-2 information to target serious withholding noncompliance by some employees.

Historically, a majority of small business taxpayers depend upon tax practitioners to prepare and file their tax returns. Hence, small businesses are benefitting from our joint efforts with the Department of Justice to obtain civil injunctions against abusive tax scheme promoters and abusive return preparers. In 2001, the Government also stepped up the use of its authority to seek civil injunctions to prohibit promoters from selling illegal tax schemes on the Internet, at seminars or through other means. Such actions promptly stop these promoters from continuing to prey on unsuspecting taxpayers, many of whom own small businesses. Since 2001, the courts have issued permanent or preliminary injunctions against more than 100 abusive scheme promoters. They have issued injunctions against 17 abusive return preparers – all permanent injunctions. And an additional 49 suits have been filed by the Department of Justice seeking injunction action – 28 against scheme promoters and 21 against return preparers. Injunctions issued have involved schemes such as:

- Using abusive trusts to shift assets out of a taxpayer's name while retaining control
- Misusing "corporation sole" laws to establish phony religious organizations
- Using frivolous "Section 861" arguments to evade employment taxes
- Claiming personal housing and living expenses as business expenses
- Filing tax returns reporting "zero income"
- Misusing the Disabled Access Credit

The IRS has another 1,000 investigations ongoing for possible referral to the Department of Justice; and individual examinations are being conducted on thousands of scheme participants. Most of the investigations and examinations are being conducted by the SB/SE Division.

Our second enforcement priority is to assure that attorneys, accountants, and other tax practitioners adhere to professional standards and follow the law.

Our system of tax administration depends upon the integrity of practitioners. Altogether, there are approximately 1.2 million tax practitioners and return preparers. The vast majority of practitioners are conscientious and honest, but even honest tax professionals suffered from the sad and steep erosion of ethics in recent years by being subjected to untoward competitive pressures. The tax shelter industry had a corrupting influence on our legal and accounting professions.

We have done quite a bit since March 2004 to restore faith in the work of tax professionals. We have strengthened regulations governing the standards of tax practice to discourage the manufacturing of bogus legal opinions on the validity of tax shelters. The Treasury and IRS standards set forth rules governing what does and does not qualify as an independent opinion about a tax shelter.

Last year, the government won a series of court opinions on privilege. The cases confirm that promoters who develop and market generic tax shelters can no longer protect the identity of their clients by hiding behind a false wall of privilege.

Abusive tax shelters often flourished because penalties were too small. Some blue chip tax professionals actually weighed potential fees from promoting shelters, but not

following the law, against the risk of IRS detection and the size of our penalties. Clearly, the penalties were too low. They were no more than a speed bump on a single-minded road to professional riches.

But these speed bumps have become speed traps. Last fall, Congress enacted and the President signed into law the American Jobs Creation Act of 2004. The legislation both created new penalties and increased existing penalties for those who make false statements or fail to properly disclose information on tax shelters. Under the new law, the IRS can now impose monetary penalties not just on tax professionals who violate standards, but also on their employers, firms, or other entities if those parties knew, or should have known, of the misconduct.

Our third enforcement objective is to detect and deter domestic and off-shore based criminal tax activity and related financial criminal activity.

Last year, the IRS referred more than 3,000 cases to the Justice Department for possible criminal prosecution, nearly a 20 percent jump over the previous year. We continue our active role in the President's Corporate Fraud Task Force. We are going after promoters of tax shelters – both civilly and, where warranted, criminally. This tactic is a departure from the past. Previously, during a criminal investigation, all civil activity came to a halt. The result was that our business units were reluctant to refer matters for criminal investigation lest they lose their traditional turf. But, we are now moving forward on parallel tracks with the Department of Justice. We have a number of important criminal investigations underway. The enforcement model is changing.

Our fourth enforcement priority is to discourage and deter noncompliance within tax-exempt and governmental entities, and misuse of such entities by third parties for tax avoidance purposes.

Consider, for example, tax-exempt credit-counseling agencies. These organizations are granted tax-exempt status because they are supposed to be educating and assisting troubled debtors. Unfortunately, it appears that some credit counseling organizations are inappropriately enrolling debtors in proprietary debt-management plans and credit-repair schemes for a fee. These activities may be disadvantageous to the debtors and are not consistent with the requirements for tax exemption. Further, a number of these organizations appear to be rewarding insiders by negotiating service contracts with for-profit companies owned by related parties. We are carefully scrutinizing these organizations. We currently have over half the tax-exempt credit counseling industry – in terms of gross receipts – under examination.

In the tax shelter area, abusive programs often require a "tax-indifferent party" to make the scheme work. Some shelter promoters use tax-exempt organizations to create abusive shelters where, for a fee, the tax-exempt entity lets the promoter exploit its tax-free status. We believe that the tax-exempt organization that participates or allows itself to be used in an abusive transaction may be inappropriately trading on its privileged tax-exempt status.

As we move forward with these priorities, we will leverage our success to achieve greater results within our FY 2006 budget request.

President's FY 2006 Budget Seeks Increase in Enforcement to Address Growing Tax Gap

The President's fiscal year 2006 budget requests $10.679 billion for the IRS, a 4.3 percent increase over the fiscal year 2005 enacted level. This request represents a one percent decrease in Taxpayer Service and a two percent decrease in Business Systems Modernization, but an eight percent increase in enforcement.

The additional $446 million increase requested for enforcement includes $265 million for initiatives aimed at enhancing the enforcement of the tax laws and $182 million to fund the pay raise and other cost adjustments. It is important that Congress fully fund these new enforcement investments and cost adjustments. The President's budget proposal to fund them through an adjustment to the discretionary caps reflects the importance of this investment to the Administration.

Since 2001, the tax year covered by the NRP, we have taken a number of steps to bolster enforcement. We are ramping up our audits of high-income taxpayers and corporations, focusing more attention on abusive shelters, and launching more criminal investigations. Audits of high-income taxpayers — those earning $100,000 or more — topped 195,000 in fiscal year 2004, which is more than double the number conducted in 2001. Total audits of all taxpayers topped 1 million last year — a 37 percent jump from 2001. The nearly eight percent increase for enforcement activities in the Administration's 2006 IRS budget request will allow IRS to reduce the tax gap further by continuing to increase audits of corporations and high-income individuals and by expanding collection and criminal investigation efforts.

These investments will yield substantial results. The IRS collects more than four dollars in direct revenue from its enforcement efforts for every dollar invested in its total budget. In FY 2004, we brought in a record $43.1 billion in enforcement revenue — an increase of $5.5 billion (or 15 percent) from the year before. Beyond the direct revenues generated by increasing audits, collection, and criminal investigations, our enforcement efforts have a deterrent effect on those who might be tempted to skirt their tax obligations.

Program Performance

The IRS expects to achieve the following levels of performance after attaining full performance of the requested FY 2006 initiatives:

- Increase in field examinations for high-income individuals with complex returns; significant increase in collection processed; and closing of over 40 percent more delinquent balance-due accounts in FY 2008 than in FY 2004;
- Nearly double the audit coverage for individuals with income between $250,000 and $1 million, from 1.5 percent in FY 2004 to 2.8 percent in FY 2008;

- Auditing 15 percent more individuals earning above $1 million, from 3.4 percent projected for FY 2004 to 3.9 percent in FY 2008;
- Significantly more collection cases processed, closing 50 percent more delinquent accounts in FY 2008 than FY 2004;
- Double the audit coverage for mid-size corporations, from 7.6 percent in FY 2004 to 16 percent in FY 2008; and
- Increased efforts to deter abusive tax shelters among corporations

Providing Service to Small Businesses

Mr. Chairman, as you know, enforcement activity to close the tax gap is only part of the equation. In fact, my mantra is Service + Enforcement = Compliance. To achieve our overall goal of full participation in our self-assessment tax system, our enforcement efforts against non-compliant taxpayers need to be complemented by our efforts to minimize the burden for all taxpayers. We view our goals of reducing taxpayer burden and helping small businesses understand our very complicated and ever changing tax code as a cornerstone of the services we provide. Furthermore, we believe the steps we are taking to reduce burden and improve taxpayer outreach also will have a positive impact on small business compliance.

The IRS Strategic Plan, outlining our vision for 2005-2009, articulates the goal of imposing the least amount of burden necessary for taxpayers to meet their tax obligations. In 2002, we established the Office of Taxpayer Burden Reduction (TBR) to lead cross-Service burden reduction efforts. Since its inception, that office has aggressively pursued reduction initiatives and enabled us to reduce taxpayer burden by over 200 million hours. TBR has reduced burden by focusing on simplifying forms, publications and notices; streamlining internal policies, processes and procedures; promoting less burdensome rulings, regulations and law; assisting in the development of a burden reduction measurement methodology and model; and partnering with internal and external stakeholders to more effectively and efficiently identify and address burden reduction initiatives.

Examples of recently implemented burden reduction accomplishments include:

- Increasing the threshold for Forms 1040 EZ and 1040A filers from $50,000 to $100,000, enabling more than 1 million taxpayers to file Form 1040 EZ or 1040A instead of a long Form 1040, and reducing their burden by more than 5 million hours (effective for tax year 2004);
- Increasing the Form 1040 Schedule C-EZ business expense threshold from $2,500 to $5,000, enabling approximately 500,000 eligible taxpayers to file a Schedule C-EZ instead of the regular Schedule C, and reducing burden for more than 1 million taxpayers by more than 5 million hours (effective for tax year 2004);
- Simplifying Schedules K-1 for Partnerships and S Corporations to reduce common errors and the burden associated with preparation and filing, and reducing 95.1 million hours of burden for over 20 million taxpayers (effective for tax year 2004);

- Increasing the Federal Unemployment Tax (FUTA) deposit threshold from $100 to $500, reducing 3.2 million hours of burden for 2.6 million taxpayers (effective for January 2005); and,
- Redesigning Form 941, Employer's Quarterly Federal Tax Return, making it easier for the 6.6 million employers who file 23 million Forms 941 a year to understand and complete (effective for the 2005 tax year).

Some additional efforts we are actively considering for implementation include:

- Simplifying Schedules K-1 for Trusts (effective for tax year 2005);
- Redesigning the forms and processes associated with obtaining extensions to file tax returns (effective for tax year 2005);
- Establishing an Annual Filing and Payment of Employment Tax Returns (Form 944) for all Form 941 filers with $1,000 or less in total Employment Tax Liability per year (effective for tax year 2006);
- Redesigning Form 940, Employer's Annual Federal Unemployment Tax Return, and its associated processes (effective for tax year 2006); and,
- Developing a Form 941X to amend Forms 941, 943, 944 and 945.

It is important to note that most of the significant taxpayer burden reduction initiatives require a considerable commitment of resources to accomplish. Systems must be reprogrammed, processes must be changed, and personnel must be reeducated. Taxpayers, practitioners, federal and state agencies, and software developers must be included in the process so that changes are as transparent and helpful as possible. I remain committed to continuing this substantial investment in promoting efforts to reduce unnecessary burden

Last fall, I commissioned a comprehensive study of our two major outreach functions for small businesses and individuals. It probably will not surprise you that the major conclusion reached by the study is that there should be closer alignment between the Communication and Liaison functions in our SB/SE and Wage and Investment (W&I) Divisions, as well as between the outreach functions in both Divisions. Working more closely across Divisions will ensure end-to-end accountability for creating and delivering quality communications and education products to taxpayers and our partners in tax administration, including state tax officials, practitioners and industry groups, just to name a few.

We also examined what we are accomplishing in our Communications, Governmental Liaison and Taxpayer Education programs. One key issue for us was the fact that, since stand-up of our Taxpayer Education and Communication (TEC) organization, we have taken most of the workforce offline for nearly six months of the year to answer questions submitted through our call centers. While this is important work, I believe that small businesses and our stakeholder partners need and deserve our full assistance throughout the year. Therefore, I am shifting filing season responsibility to our W&I Division , which will allow us to keep our outreach and education staff engaged year round with small business issues.

The members of the Committee are well aware of the many good things that have been done by our education and outreach program. However, I have found that the efforts

varied across the country. As a result, I have instituted a more strategic approach whereby our national stakeholders and partners in tax administration at the local level will receive consistent information from a single source. This change should ensure that key messages are communicated more effectively with your constituents. This is the level of service that all small businesses deserve. It will also make us more effective in achieving the goals the Congress has set for us in increasing the numbers of small businesses that file and pay electronically, because we will be able to present more effectively the benefits of these important services.

In addition to small businesses, there is another stakeholder group that will benefit from this realignment -- tax practitioners. This Committee knows well the important role that tax practitioners play in assisting small businesses in complying with the tax code. As I mentioned earlier, more than 75 percent of small business taxpayers use practitioners. Accordingly, we will be stepping up our level of interaction with this stakeholder group.

We want to make sure that practitioners fully understand any new policies and procedures the IRS undertakes to continually improve its practices and efficiency. We also want to ensure that practitioners are fully aware of the many services we offer -- such as the E-Services we provide to those practitioners who file electronically on behalf of their clients -- to help them help their clients file accurate returns. Since I have revitalized our Office of Professional Responsibility, practitioners have been seeking more information and education on ethics for the profession. Our new stakeholder liaison function will spearhead and enhance our delivery of education on ethics and IRS practices through stakeholder groups, universities, and other channels.

Issue resolution is another major element I am introducing to our relationship with small business and practitioner stakeholders. To have a true partnership with these groups, the Service must be willing to listen as well as communicate. As the Committee knows, I have a number of panels of advisors from the tax practitioner community who provide input on all our major programs. We have been able to improve countless numbers of programs through the counsel of knowledgeable practitioners. I want to take this model a step further and increase the feedback we receive from practitioners who are spread throughout your districts and the rest of the country. As our field staff collects, catalogues, and resolves issues via a revitalized software application we are launching, we will be able to make improvements in our examination, collection, and campus operations that will benefit not only the Service but also small businesses and tax practitioners. I have secured a strong commitment throughout the IRS to assure the success of this program.

Finally, let me take a moment to discuss the core of this program -- education for small businesses. Like any good educational institution, we have built a curriculum for what small businesses need to know. With every change in the tax code, the curriculum is updated. In addition, we have taken advantage of our partnerships and technology to disseminate that information as broadly as possible. Our website, dedicated to small businesses, contains about 10,000 pages of content arranged by major industry groups and by major tax areas, such as employment taxes and depreciation. The response to the site has been overwhelming. In January 2005, for example, we had 1.7 million visitors, more than double the number from January 2004.

U.S. Small Business Administration

Office of Advocacy

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Testimony of
Thomas M. Sullivan
Chief Counsel for Advocacy

U.S. House of Representatives
Committee on Small Business

Date: April 27, 2005
Time: 2:00 P.M.
Location: 311 Cannon House Office Building
Topic: Closing the Tax Gap and the Impact on Small Business

Chairman Manzullo and Members of the Committee, good afternoon and thank you for giving me the opportunity to appear before you today. My name is Thomas M. Sullivan and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). The Committee has asked for Advocacy's view on the Internal Revenue Service's (IRS) assessment of the federal tax gap, and for suggestions on how the IRS intends to deal with the portion of the tax gap attributable to small business and self-employed filers. 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 office within the SBA, and therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA.

The tax gap is the difference between the taxes owed by all taxpayers and the taxes actually received by the IRS. The Office of Advocacy shares with the IRS the view that the tax gap is a serious problem. Even though the difference between what is owed and what is paid is bound to diminish as more funds are received by the IRS from late payments and existing enforcement activities, a significant portion will always remain outstanding. This differential between what is owed and what is paid is a cost to the Federal government, and a resource that could help fund government operations. The funding shortfall is not the only problem created by the tax gap; as National Taxpayer Advocate Nina Olson stated in her 2004 Testimony before the Senate Committee on Finance, "it comes down to a simple issue of fairness."[1] The fact that 85 percent of taxes are paid in full reinforces the view that the remaining 15 percent needs to be paid by those who owe it. The Office of Advocacy, however, does not agree with the view that

[1] Testimony of Nina Olson, National Taxpayer Advocate, before the Senate Committee on Finance on *the Tax Gap and Tax Shelters*, 21 July 2004.

prioritizing enforcement will necessarily close the tax gap. We believe a balanced approach, relying on a combination of compliance assistance, taxpayer education, and enforcement is likely to close the gap in an efficient manner.

Most small businesses pay their taxes in full and on time. However, doing so is never easy for them, as the costs of complying and the difficulty in following the tax code can be overwhelming. In 2001 Advocacy released a report on the regulatory costs faced by small firms that contained an estimate of tax paperwork compliance costs. In 2000 the typical small business with fewer than 20 employees spent over $1,200 *per employee* to comply with tax paperwork, recordkeeping, and reporting requirements.[2] This is over two times the compliance cost faced by larger firms. But the estimated burden hours for filling out forms do not tell the whole story of how difficult compliance can be for small business. Most small firms do not have full time personnel to handle tax compliance issues; many hire outside assistance and many more small business owners devote valuable time to taxes that is then not available for running their business.

This Committee certainly knows the contribution of small business to the U.S. economy. Small businesses, as defined by the SBA size standard, make up over 99% of all U.S. businesses and employ over one-half of the American workforce. Perhaps even more importantly, small firms create over two-thirds of the net new jobs annually, and recently led the

[2] *The Impact of Regulatory Costs on Small Firms*, Crain, W.M., and Hopkins, T.D., October 2001, U.S. Small Business Administration, Office of Advocacy (SBAHQ-00-R-0027), available at http://www.sba.gov/advo/research/rs207tot.pdf.

American economy out of a recession.[3] Yet, small business accomplishes this even while facing a regulatory compliance burden that is roughly 60 percent greater per employee than that faced by larger firms, and a tax compliance burden more than twice as large.[4]

At issue then is how compliance can be improved and the tax gap narrowed without adding to the burden of small business. My office favors a balanced approach-- one that includes commensurate doses of education, compliance assistance, and enforcement. In other words, IRS must be careful to produce an appropriate carrot to go with the stick. Ms. Olson suggested that, "[I]n developing a long-term strategic approach towards noncompliance, the IRS must remember that the "stick" is not the only effective tool for addressing the tax gap; the "carrot" has a critical role to play, too."[5]

In order to focus its efforts, the IRS developed the National Research Program (NRP) to measure reporting, filing, and payment compliance for different types of taxes and different groups of taxpayers.[6] The final report on the NRP is not yet available, but IRS has published 17 pages of preliminary results. The release has generated a flurry of comments, coinciding with the weeks preceding April 15th when federal tax filings are due. We should be clear that that the results are preliminary.

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[3] U.S. Small Business Administration, Office of Advocacy, *Small Business Frequently Asked Questions*, available at http://www.sba.gov/advo/stats/sbfaq.pdf.
[4] *Supra* note 2.
[5] Testimony of Nina Olson, National Taxpayer Advocate, before the Senate Committee on Finance on *the Tax Gap*, 14 April 2005, p. 6. Also see the Environmental Protection Agency Small Business Ombudsman's *Small Business Compliance Policy* (SBO Items #I-13 and B-22) and *Enforcement Response Policy* (SBO Item #I-13), available at http://www.epa.gov/compliance/incentives/smallbusiness/index.html.
[6] See http://www.irs.gov/privacy/article/0,,id=131231,00.html for an overview of the NRP.

Let me also caution that the connection between enforcement and compliance is not necessarily clear. Research by economists Bruno Frey and Lars Feld suggests that excessive enforcement can lead to less compliance.[7] Compliance cannot be increased only through enforcement, but rather by the more balanced approach I am suggesting here today.

Advocacy and others have long held that the complexity of the tax code is a prime reason why compliance rates are not higher. Indeed, those with the most complicated individual filings, small business owners, *should* be expected to have higher non-compliance rates if in fact non-compliance is increasing with complexity. Furthermore, the complexity of the tax code has been increasing each year, which should further be expected to drive up non-compliance rates, and enhance the need for greater taxpayer education and assistance. Advocacy urges the IRS to investigate whether measured non-compliance today might not be better explained by the complexity of the code, especially for complicated small business returns.

I would like to suggest that simpler tax rules and greater taxpayer assistance are complementary, and that some mix of the two would greatly enhance the ability of small businesses to comply with tax regulations. It would be helpful to receive data on the effects of the taxpayer assistance programs that IRS has enacted over the past several years, for many small business groups believe data could demonstrate that education and assistance programs produce increased compliance.

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[7] Frey, B.S. and Lars, PF. "Deterrence and Morale in Taxation: an Empirical Analysis." *CESifo Working Paper No. 760, 2002*, available at http://www.cesifo.de/pls/guestci/download/CESifo%20Working%20Papers%202002/CESifo%20Working%20Papers%20August%202002/760.pdf.

The GAO Controller General, along with National Taxpayer Advocate Nina Olson, recently testified that simplification was the top priority for fixing what ails the tax code and increasing tax compliance.[8] The Office of Taxpayer Burden Reduction within the IRS has also recognized the need for burden reduction, and I would like to take this opportunity to recognize their efforts in listening and investigating the complaints of small businesses about harsh and unfair burdens resulting from IRS policies.[9]

The Treasury Inspector General also cited simplification of the tax code as a priority. In the Inspector General's (IG) internal audits of IRS compliance assistance personnel, they found that only 62% correctly answered compliance questions that an individual filer might face. The IG laid the blame for this poor performance not on inadequate training of IRS personnel, but on the complexity of the tax code and the difficulty in determining "one" correct answer for many tax questions.[10] Simply put, in many cases there are no single correct answers, or if there are, even the experts cannot identify them with regularity across all cases. This widespread ambiguity leads many small business filers to make a seemingly rational choice: when there are two or more possible outcomes that appear correct, choose the one that minimizes the taxes you owe. The IRS defines this as underreporting, but it is better described as confusion brought about by the difficulty even experts have in determining how to comply with the tax code.

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[8] Hearing of the United States Senate Committee on Finance on "The $350 Billion Question: How to Solve the Tax Gap." April 14, 2005

[9] See http://www.irs.gov/irm/part22/ch04s01.html for a description of the mission and responsibilities of the Office of Taxpayer Burden Reduction.

[10] *Supra* Note 10.

Although tax rates have declined over recent years, the cost of complying with taxes has increased. Non-compliance is a more subtle hidden cost of tax complexity, but the direct costs in time and effort to maintain the necessary records and complete the proper forms is the more obvious direct cost. According to OMB paperwork burden estimates, the number of hours Americans spend on taxes has grown by 24% over the last 10 years. Much of that burden may stem from an increase in the number of filings, but a significant portion emanates from increased complexity faced by each individual filer. Importantly, only 24% of the total burden is directly attributable to Form 1040, further demonstrating that small businesses, who must file many additional forms, pay much of the cost of compliance.[11]

As I already mentioned, it costs small firms more than two times as much per employee as larger firms to comply with the tax code. However, it is the uncertainty and confusion in how to comply that creates the biggest compliance burden. It is also this uncertainty that increases non-compliance rates for small business filers over what they would be under a simpler code. The best way to ensure that small business compliance rates increase is to simplify the tax code, thereby removing the ambiguity filers face when determining what to report, and to increase education and assistance programs aimed at informing small business owners what the IRS expects them to do when preparing their taxes.

Conclusion

[11] "A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens," National Taxpayers Union, NTU Policy Paper 116. Calculation of total burden hours increase is based on the change in annual hours in 1995 to projected annual burden hours in 2004, the most recent year for which information is available. Data taken from Office of Management and Budget, *Information Collection Budget*, various years.

I believe in the honesty of the majority of small businesses and their willingness to comply with the tax code and contribute their fair share. Additional taxpayer education, compliance assistance, and a more simple tax code are key ingredients to increased compliance. If small businesses are able to understand and easily follow the rules, they probably will. Increasing education and assistance will remove ambiguity, while simplifying the rules will reduce the costs of compliance.

Thank you for allowing me to present these views. I would be happy to answer any questions.

Statement of John Satagaj
President of the Small Business Legislative Council
Before the
House Small Business Committee
Legislative Hearing
On
The Tax Gap

April 27, 2005

Mr. Chairman, Ranking Member Velázquez, and members of the Committee, my name is John Satagaj and I serve as President and General Counsel for the Small Business Legislative Council (SBLC). SBLC is a permanent, independent coalition of nearly 60 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views. I wish to thank the Committee for the invitation to testify on the issue of the tax gap.

While we all can agree that there is a tax gap and there are individuals, large corporations and small businesses out there that are not paying their fair share of the tax burden, we do believe the statistics tell the story of "why" that is so and as a result it appears we and the IRS have different views on what to do about it.

SBLC firmly believes that education is of vital importance when it comes to collecting taxes. While enforcement is also needed, it should not be at the expense of education. We believe that most people are law-abiding citizens who want to do the right thing. The Regulatory Flexibility Act, with which everyone in this room is familiar, was passed to stop the federal government from painting everybody with the same broad brush when it comes to "fixing" a problem. One has to strike the right balance between making everybody miserable just to catch a few bad "apples," and accomplishing a public policy goal.

The IRS needs to find the balance between enforcement of the tax code and tax education. No amount of enforcement is going to result in 100 percent compliance with the tax code; and over aggressive enforcement or unfair burdens placed on small businesses stifle innovation and growth in the small business community, the leading creator of jobs in our country.

Education and Enforcement

The logical goal of any tax collecting agency is to collect money from taxpayers to fund the government. However, the IRS has an addition goal, to motivate taxpayers to pay their taxes voluntarily. Former IRS Commissioner Mortimer Caplin expressed this over forty years ago when he said;

> "We cannot forget that 97 percent of our total revenue comes from self assessment or voluntary compliance, with only 3 percent coming directly from enforcement. Our chief mission is to encourage and achieve more effective voluntary compliance. Accordingly, we should concentrate our attention and efforts on getting the greatest possible number of taxpayers to voluntarily file returns, to report what they should report, and to pay their taxes in the amount they should pay. In turn, the activities of our professional people in Audit, Collection, and Intelligence should be aimed primarily at securing voluntary compliance--not primarily at quantitative goals in terms of cases and dollars.

It was this feeling that was reaffirmed by the National Commission on Restructuring the IRS when they published their report in 1997 that led to the "Tax Payers Bill of Rights" also known as the "IRS Restructuring and Reform Act of 1998." In their report the Commission stated that "The Commission believes that good customer service and taxpayer education, which assists taxpayers in meeting their tax obligations to the government, leads to increased compliance."

The message now being delivered to the small business community from the IRS is that education is no longer a priority and that enforcement is the way to increase compliance. We at SBLC fear that by focusing on enforcement, at the expense of education, the pendulum will swing back to the days of the 1990s and before when taxpayers were guilty until proven innocent.

From our perspective, the pendulum swing in favor of the taxpayer was of short duration, the pendulum swing now proposed by the IRS appears to be long and steep!

One of the great successes of the IRS Restructuring and Reform Act of 1998 was the creation of the Small Business/Self Employment Division and its Taxpayer Education and Communication (TEC) section. We at SBLC believe that a greater emphasis on education can have a significant impact by helping to bring in those individuals that want to pay their taxes but for one reason or another are not doing so. That is why we were disheartened recently to learn that TEC is being cut substantially and many of the employees there will be moving into enforcement roles.

TEC's mission is to educate and inform small business and self-employed taxpayers and representatives about their tax obligations by developing educational products and services focusing on the needs of small businesses and the self-employed. In doing this they have consistently provided top quality pre-filing services to help taxpayers

understand and comply with the often complex tax laws.

TEC also provides leadership and direction in the design, development, and delivery of services for small business stakeholders. Activities of TEC staff include formulating short and long-range program policies, strategies, and objectives to educate and inform stakeholders. TEC also coordinates program activities with other top level IRS executives to prepare Service-wide policies, address cross-functional issues, develop strategies, and ensure consistency of approach. TEC collaborates with major stakeholders to identify, develop, and maintain leveraged partnerships through negotiated voluntary agreements.

For this reason and many more TEC was named the Small Business Administration's (SBA) Agency of the Year in 2002 for its outstanding progress in creating an effective education and compliance assistance program for small businesses and the self-employed.

Over the past few years TEC and SBLC, with our colleagues at NFIB and the Chamber, have hosted a bi-monthly small business forum where small business leaders come together to meet with the IRS and hear about their latest programs. It also serves as a valuable resource for small business leaders to discuss issues affecting the small business community. Will this staff and resource reduction force TEC to end these forums? What will be the impact of this restructuring on a state by state level and at any given time how many people will be available to assist the small business community? How many people will be doing education and research on the state level? I urge Congress to make these inquires. With these reductions we fear that the successes over the years of the IRS through the Small Business/Self Employment TEC Division will be turned back and those seeking assistance will be turned away. All for the sake of greater enforcement that may not have been necessary if someone had been there to answer a question or proactively reach out.

Withholding

We believe that proposals that call for withholding from independent contractors, either contracted by the government or small businesses, place unfair burdens on both the small business person and the independent contractor. This idea would threaten the very existence of independent contractors and be a burden to those that engage independent contractors. We at SBLC firmly believe that individuals should have the right to choose to be independent contractors, and those small businesses that choose to engage independent contractors should have the free and unfettered ability to do so.

In a recent Joint Committee on Taxation (JTC) report to Congress, the JTC recommends a three percent withholding on all payments for goods and services made by all branches and agencies of the Federal government and all units of state and local governments, including counties and parishes. Why is this needed? If the proper paperwork is filed by the government doesn't the IRS then know who should be paying and who isn't? In the case of a small business engaging an independent contractor, an IRS form 1099 is filed

for all payments made. Does the IRS match up the 1099s to taxes paid? What percentage of 1099s are checked for compliance? To require that a small business withhold say five percent, as was suggested by Taxpayer Advocate Nina Olson in her 2004 report to Congress would, be unfair to the small businesses engaging the independent contractor as well as to the independent contractor. Many small businesses are one person operations and to be burdened with the task of collecting money for the government would be time consuming. Also, in some cases the amount withheld would be more than the profit on the service performed thus making some jobs a money losing proposition for the independent contractor.

Simplicity

Does the IRS have any figures on how much income is underreported because people do not understand the tax code? It is important to understand why there is noncompliance with the tax code. The complicated and often contradicting laws that make up the tax code form a barrier in many cases to compliance with the tax code. Inadvertent errors and confusion are often caused by complex laws. These same complex laws also contribute to intentional noncompliance. Many that do not understand the tax code may perceive unfairness in the code. Studies have shown that these same people use this feeling of unfairness to justify their noncompliance to themselves.

One action that would go a long way to make tax return preparation easier and increase compliance would be to eliminate the alternative minimum tax.

The President's Commission on Tax Reform is currently studying the tax code and we look forward to their recommendations. It is our hope that through reform suggestions from the panel and action from Congress that the code will be simplified.

Conclusion

Mr. Chairman, in conclusion I wish to once again thank you for the opportunity to be here today. The SBLC looks forward to working with the Committee in the future to find ways to increase compliance through education and also to help small businesses grow so that they can create more of the jobs that our nation depends on.

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Testimony of

Keith Hall, CPA
Hall & Hughes, PLLC

On behalf of the
National Association for the Self-Employed

House Committee on Small Business
"Closing the Tax Gap and the Impact on Small Businesses"

April 27, 2005

Chairman Manzullo, Ranking Member Velazquez and Members of the Committee, thank you for allowing me to testify today regarding the issue of the tax gap and the affect proposed resolutions would have on the self-employed and micro-business. As you are aware, the Internal Revenue Service recently released preliminary results from the National Research Program (NRP), a study to gather compliance data on individual income tax. According to the IRS, the data indicated that the nation's tax gap, the difference between what taxpayers should pay and what they actually pay on a timely basis, falls somewhere between $312 billion an $353 billion. The tax gap has three key components which include underreporting of income, underpayment of taxes and non-filing of returns. There have been numerous proposals regarding how to effectively address the tax gap and increase compliance. The IRS, the National Taxpayer Advocate, the Joint Committee on Taxation, the Treasury Inspector General, the General Accounting Office and various Members of Congress have all weighed in on this issue.

As a self-employed certified public accountant for 15 years and as a tax consultant for the National Association for the Self-Employed's TaxTalk program, I am in the unique position of conveying to you both my perspective as a business taxpayer as well as that of a tax professional dealing regularly with the self-employed, regarding the affect that proposals to reduce the tax gap will have on the self-employed and micro-business.

Minimizing the complexity of the tax code is one of the unanimous solutions mentioned by key policymakers and taxpayers alike. Through the National Association for the Self Employed TaxTalk service we answer specific personal questions for thousands of small business owners every year. As you might expect, a vast majority of those questions are based on a lack of understanding of some specific point related to their tax compliance. Many operate their business out of their home but have a great deal of difficulty with the calculation of the home office deduction. Most use their personal automobile in the business but don't know how to include that cost on the tax return. They are told that they can fully deduct the cost of the vehicle, but later find out that is true only if the car weighs over a certain number of pounds. Later still they find out the limit is different for SUVs. Perhaps the most common question is related to their estimated tax payments that must be made each quarter. The main issue here is that they must be able to understand all of the tax laws that affect their situation in order to make

an accurate estimated tax payment. Each of these headaches is based on the complexity of the exiting Code.

In addition to reducing complexity, leading suggestions for mitigating the tax gap include:

- imposing withholding of somewhere in the range of two to five percent on non-employee payments, specifically payments made to independent contractors;
- increasing IRS enforcement;
- regularly gathering more extensive compliance data.

I have yet to hear commentary from any group or individual that did not include the goal of providing a fair and equitable solution to the existing tax gap. I believe everyone agrees that any solution should include at it core the goal of providing equity for all taxpayers. However, we also feel that any recommendations seeking to increase compliance and lessen the tax gap should also seek to refrain from increasing the regulatory burden on taxpayers. Thus, it is very important as we discuss and evaluate the issues surrounding the tax gap and any proposed solutions to make certain we choose the right course of action which will be effective yet does not increase complexity or intensify the burden on the key drivers of our economy such as micro-business owners and the self-employed.

Withholding on Non-employee Payments

I first want to address the recommended proposal of withholding on non-employee payments because the NASE and I as a tax practitioner feel that this suggestion would be the most burdensome to the self-employed and micro-businesses. For sole proprietors and business owners hiring independent contractors, the proposals for imposing withholding in the range of two to five percent on payments made to contractors will only add to the compliance burden with a whole new set of perplexing and – for many – unmanageable and costly filing requirements.

We have concerns of potential requirements associated with the implementation of an additional withholding mechanism. Specifically, in the withholding proposal put forth initially by the National Taxpayer Advocate in 2003-04, I have serious concerns regarding the requirement to withhold based on gross versus taxable income, a technical flaw that would overstate employers'

liability, since gross income often includes legitimately deductible business expenses. For example, assume a small business owner who paints office space for various builders but has no employees. The business owner does all of the painting themselves and only has the cost of the paint and supplies in operating their business. This painter may have an 80% margin in a $5000 contract meaning they may only have $1000 in total costs. Withholding 5% of the payment to send directly to the IRS may make some sense. But what about the painter who uses employees or other contractors to help? This painter may have several jobs going on at the same time and will have must higher costs for each job. They may only have a 10% margin in this job. Now requiring a 5% withholding would represent half of the gross profit. Treating these two small business owners the same would not be fair and equitable and worst of all would penalize that painter who is out their creating jobs in their community.

Beyond this, since the withholding requirement put forth by the Advocate would only apply to sole proprietors (Schedule C filers) it would clearly discriminate against this type of legal business structure. Incorporated firms would not be held to this requirement. Thus, if the painter is a sole proprietor and is hired by a business to paint their office, the business would have to withhold approximately five percent of payment. However, if the same painter was to incorporate, the withholding requirement would not apply. It's the same painter with the same compliance issues and the same headaches but different rules based solely on business structure.

The NASE feels that rather than adding to the burden of compliance faced by micro-business taxpayers through increased regulations, the goal should be to simplify the tax regulations surrounding independent contractors. The GAO Comptroller General pointed out in his testimony to the Senate Finance Committee recently, that compliance rates are highest where there is a third party reporting system in place. We currently have this reporting mechanism on independent contractors through the issuing of 1099 forms. We feel that rather than continue to shift both the cost and overall burden of compliance to business owners already fulfilling their tax responsibilities, the IRS should focus on fair and balanced education and enforcement efforts for those individuals that they have submitted 1099 forms on, yet have either unintentionally or willfully not complied with their tax liability.

Increased Enforcement

Accurate tax reporting and compliance is extremely important to small business. Those who make a good faith effort, yet are inaccurately complying should be assisted through education and tax simplification efforts. Those willfully disregarding their tax liability should be held accountable. However, a key concern with increased enforcement is taxpayer rights and the extent to which funds and manpower are diverted from taxpayer education to enforcement efforts.

The IRS Commissioner Mark Everson has stated numerous times that the mantra of the IRS is service plus enforcement equals compliance. We believe in the past few years with restructuring and enhanced outreach and educational efforts, there has been positive changes at the IRS which have had positive affects. Their commitment to their website and the availability of information has been very good and certainly recognized by the NASE and many small business owners. We are concerned that due to extensive federal budget responsibilities and the current shift towards enforcement that there will be a detrimental affect on taxpayer services. In looking at the FY2006 IRS budget, we see funds being increased for enforcement activities, yet in the areas of taxpayer services, specifically tax assistance and outreach there have been budget cuts. We are also concerned about possible reallocation of manpower from taxpayer education and outreach to enforcement.

Ensuring comprehensive, effective taxpayer services is essential to accomplish taxpayer compliance. The more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. However, increased enforcement at the expense of taxpayer education will not in the long term accomplish sustained, improved compliance.

Compliance Data

Prior to the implementation of the National Research Program compliance study in 2002, the IRS's most recent efforts to review taxpayer compliance was through the Taxpayer Compliance Measurement Program (TCMP) in 1988. We do believe it is important to consistently study

compliance issues faced by taxpayers. However, though the National Research Program is a much improved, less intrusive method of studying compliance than TCMP, it is important the IRS in their efforts to study compliance place taxpayer rights in the forefront. Research efforts should be completed in a manner that is least invasive to the taxpayer.

It would also be highly beneficial for the IRS to conduct research on the effectiveness of taxpayer services and education efforts. Through understanding why taxpayers are noncompliant, unintentionally or intentionally, and what services have been most effective and helpful to taxpayers, the IRS would be able to more efficiently focus their outreach efforts and financial resources. Additionally, evaluating and testing tax forms and instructions before use would improve compliance significantly.

Complexity of the Tax Code

It is my concerted opinion that the ultimate culprit of the tax gap is the complexity of the tax code. The most effective, least damaging way to increase compliance and mitigate the tax gap is to focus efforts on the simplification of our tax system.

According to a study conducting by the Joint Committee on Taxation in 2001, at that time a taxpayer filing an individual income tax return (Form 1040) could be faced with 79 lines on their return, 144 pages of instructions, 19 separate worksheets as well as the possibility of filing numerous other forms. In 2005, the IRS has estimated that taxpayers will have to spend on average over 19 hours filing a 2004 Form 1040 and the associated Schedule A. With over 1.4 million words, the tax code is so convoluted that is extremely difficult for both taxpayers, tax practitioners and the IRS to reliably and accurately comply with or enforce the breadth of tax regulations.

As I mentioned before, thousands of taxpayers ask the NASE each year how to deduct the cost of their home office. How much of their personal vehicle is deductible, and how do they depreciate their new computer. How do they calculate their quarterly estimated tax payment and where do they send it. The NASE has long stood with other small business organizations in advocating for simplification of the tax code to address confusion which we believe is the root cause of

reporting and filing errors as well as overall noncompliance. It is the systemic and well chronicled problem of code complexity for sole proprietors that policy makers should be targeting rather than proposing new levels of regulatory burdens on micro-businesses.

Conclusion

Tax compliance and its affect on the tax gap is a significant problem faced by our nation. Yet, in the fervent drive to recoup revenues for our fast depleting federal coffers, we must take the necessary steps to make certain the path we choose is balanced and effective, rather than detrimental.

From independent shopkeepers to consultants, maintenance workers and farmers, the 16 million Americans who are self-employed are key drivers of our economy. Our collective focus should be on supporting their efforts for survival, growth and innovation as a foundation for long-term economic vitality.

The complexity of the IRS tax code is particularly troublesome for the self-employed business owner and is a snare for unintentional noncompliance. Vague rules and poorly defined regulations understandably result in mistakes. We believe efforts to address the tax gap must focus on overall simplification, eliminating issues of inequity within the tax code, and enhancing taxpayer education and outreach. It is my belief that small business built our economy and will continue to sustain that economy. It is also my belief that most taxpayers want to comply with existing tax laws and that making those tax laws easier to understand is the most effective and equitable way to improve compliance and to reduce the tax gap.

Testimony of

Abraham Schneier
On Behalf of the National Federation of Independent Business

before the

House Committee on Small Business

on the subject of

Tax Gap

on the date of

April 27, 2005

Thank you, Mr. Chairman. My name is Abraham Schneier, and I am a tax consultant to the National Federation of Independent Business (NFIB) and a self-employed business owner. On behalf of the 600,000 members of NFIB, I appreciate this opportunity to offer views on the "tax gap" and to express the concerns of small business owners over Internal Revenue Service (IRS) attempts to address this gap.

Let me first state that NFIB does not defend or attempt to rationalize that portion of the tax gap that is created by willful violation of our tax laws.

The tax gap is caused by different factors, and NFIB agrees that tax complexity continues to be responsible for a significant portion of the Tax Gap. As Nina Olson, Chief Advocate for the IRS, stated in her testimony before the Senate Finance Committee on April 14, 2005:

"Tax law complexity provides grey areas and loopholes for taxpayers who are not trying to comply. Complexity also trips up taxpayers who are trying to comply – it is just too hard to figure out what the law requires, and honest efforts to comply can result in a "gotcha" situation."

At that same hearing, Commissioner Everson noted:

"The tax gap does not arise solely from tax evasion or cheating. It includes a significant amount of noncompliance due to complexity of the tax laws that results in ignorance, confusion, and carelessness. ... *we do not have sufficient good data to help us know how much [of the tax gap] arises from willfulness as opposed to innocent mistakes.* "

I agree that an undetermined portion of the tax gap results from errors and disputes arising from the Tax Code's complexity, which too often trips up tax-compliant small business owners. The burden on keeping current with the many tax law changes is too daunting for the typical small business owner, and the cost of competent advice continues to increase as does the cost associated with failing to recognize the impact of a tax rule change on your business.

Simplifying the Tax Code would therefore reduce the tax gap, and re-channel resources previously used for non-productive purposes. While the IRS estimates that about half of the tax gap is associated with small-business owners and self-employed people, in percentage terms, current IRS estimates are nearly identical with the 1988 statistics.

If the percentage of noncompliance has remained virtually constant since the last time IRS analyzed compliance rates in 1988, then something must be working right. Since 1988, thousands of new pages have been added to our growing tax code, yet noncompliance rates have held relatively firm. I believe that better communications and some clearer rules have had a lot to do with this result and have led to some benefits in compliance.

Another cautionary note is that efforts at reducing compliance need to be measured against the costs imposed on small business owners. Any efforts to increase compliance need to be measured against the cost of compliance and must not make the cost of being an honest taxpayer so high that some selective level of noncompliance becomes an undesirable option.

It is our belief that a one-size-fits-all compliance approach will unfairly punish compliant taxpayers. Let's not make the cure worse than the disease.

IRS has for years tried to have a one size fits all compliance approach. We know that this approach places an unfair burden on small business owners. Small business owners do not have the resources to be fully aware of each and every requirement in the tax code, let alone the regulations and other forms of published guidance. Of course this also means that small business owners are not spending resources on way-out tax avoidance schemes as some of their large business competitors have been.

One of the lesser-known successes over the past five years has been that with the assistance of the staff at the Small Business/Self-Employed (SB/SE) division at IRS, this concept of having common sense rules for smaller business owners has taken root. Successful examples of this include changes to the Cash Method of Accounting rules as well as the small business exceptions in the manufacturers tax credit under Section 199, amended guidance on Vehicle Depreciation Rules.

Different compliance standards do not create different standards in the law, but simply allow common sense to dictate the imposed burden of a rule. Another case in point is the recently simplified Form 941's, and a project that is looking at that would allow annual 941 filings for small business instead of the quarterly filings. We look for continued progress in this area.

RECOMMENDATIONS

Tax Problems List

Tax simplification is one of those good government issues everyone favors in theory. When faced with real live choices however, other considerations, such as equity or special breaks for one "deserving " group or another always seems to trump simplicity. Still, reducing the tax gap adds a powerful, visible argument in simplification's favor.

There are a number of candidate provisions for simplification. The Joint Committee on Taxation published a three-volume compendium in 2001 containing a number of candidate provisions for simplification, although a number of its suggestions appear focused on changing tax policy rather than simplifying the tax code. Yet familiar

simplification ideas, such as redefining independent contractor rules, have often been presented to this and other congressional committees with limited action. Clearly action on the independent contraction issue is long overdue.

A useful way to identify simplification candidates is to locate areas in the Code that are associated with the most frequent errors, a project undertaken in the Taxpayer Advocate Annual Report. However, the compliance divisions within the IRS seem unwilling to provide similar information in this area. NFIB asked the IRS for such a list a few years ago. The list IRS provided was not responsive, and merely indicated that the most common errors were simple math mistakes. It did not identify parts of the Code that were problematic from a compliance perspective, and the effort proved fruitless. Perhaps with the completion of the National Research Program, such a list now exists. But if it does not, the list logically remains a useful exercise. The most inadvertent errors (and hence a good place to try closing the tax gap) are likely associated with parts of the Code where the most errors are currently found.

While the annual report of the Taxpayer Advocate does provide a list of the most litigated issues, perhaps the new data provided by the NRP will allow for a more direct review of these issues. Although even with the list, tax simplification will not be easy. That is particularly true when budget pressures are less conducive to an accompanying tax cut.

New Mandates

In 1999, the IRS started the Electronic Federal Tax Payment System or EFTPS, for businesses to pay and deposit their payroll taxes. It was originally introduced as a mandate for many business owners and as a result was nearly relegated to the scrap heap. In a compromise the IRS relented and required that the mandate only apply to larger employers who most likely were or soon would be putting their payroll on computers. This resulted in a successful program.

Since then many small business owners, some on the advice of their accountants or payroll processors, have joined this system, and I believe that IRS is seeing substantial benefits from this change. Other changes designed to encourage electronic filing should take these cues and realize that a common sense program that saves time and money will achieve the desired results, not mandates for small business.

Taxpayer Information

The corollary to simplification is greater taxpayer information. Better taxpayer information will result in fewer errors and mistakes. In this regard, I specifically mention the helpfulness of outreach efforts of the Service's Small Business and Self-Employed Division SB/SE). The division has vetted new ideas and programs through the small business community allowing a different perspective to reach decision-makers. Positive results have been achieved although they are limited due to the tentativeness of the researchers.

One specific area of concern, however, is the pending reorganization at SB/SE. We are very concerned over efforts to cut these services that might lead once again to a one-size-fits-all compliance approach.

Small Business Regulatory Enforcement Fairness Act (SBREFA) Compliance

Clearly if SBREFA were extended to all IRS regulations, it would provide additional impetus for improvements in this area. NFIB is aware of the efforts by this committee to strengthen SBREFA, and we thank the committee for its efforts.

Single Wage Reporting Systems and Simplified Payroll Reporting

Another area begging for action are long delayed efforts for a single file payroll tax return that incorporates both federal and state filing requirements for employers. While it is not possible to quantify the impact of proposals like these in terms of the tax gap, the reduction in paperwork and errors in filing would be welcome. We need to continue to find ways to limit paperwork and simplify these filings that regularly burden the business owner. Congress has renewed test programs for this several times in the last few years, but we appear to be no closer to achieving a rolled out national program.

Limitations of Technology

A note of caution is that relying on technology has its limits in this effort. Despite everything we read in the news, not all taxpayers, which include small business owners, use or are comfortable with computer technology. Seventeen (17) percent of small employers are not even on the Internet.

The issue is not just relevant to those who are not on the Internet. Many questions simply require talking to a real person who can sometimes ask the appropriate follow up questions that lead to a correct answer. Recently, we asked a sample of small employers if they had contacted government to learn about or clarify an existing rule or obligation such as a tax rule. Sixty (60) percent indicated that they had. Of that number, only five percent said that their primary means of contact was the Internet. The most frequent was by telephone.

It is highly likely that the proportion using the Internet and using it effectively will increase over time. But, to the extent that reliable, readily accessible, and easily understandable information reduces the tax gap, mismatches between the ways IRS delivers its service and the way small-business owners access relevant information are likely self-defeating.

Business Systems Modernization

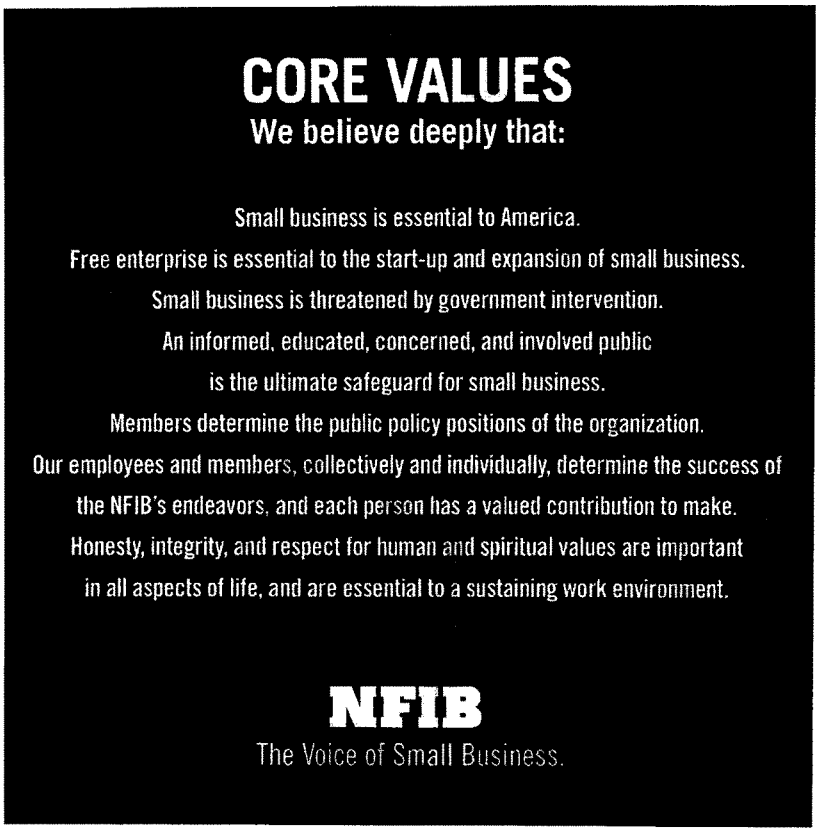
Congress is well aware that the IRS has invested notable resources over the past several years to modernize its information technologies as part of its Business Systems Modernization (BSM) program. While the BSM is still a work in progress, the agency

expects that its new system capabilities will upgrade its services in a number of functional areas. One of those is compliance, particularly the Filing and Payment Compliance (F&PC) project. Eventually, the Service expects to internally house information on more than 200 million individual and business taxpayers. Given this commitment, the administrative emphasis should be on successfully completing BSM and using it to effectively manipulate the data already available. That implies determination of need for additional taxpayer information (and hence taxpayer burden) should await the outcome of an assessment of existing capabilities.

For example, the 1099 was devised several years ago precisely to permit computerized checks. How well are we using our systems to realize its purpose, let alone the other data points available? These are questions that need to be answered before additional burdens are added.

In conclusion, I offer a warning. Not long ago, the Senate Finance Committee held important hearings on the conduct of some individuals in the Service who were charged with enforcing the law. The hearings yielded spectacular headlines and sickening stories. Though the individuals engaged in such conduct were the exception rather than the rule, they illustrated the extent to which unbridled power abets taxpayer abuse. The IRS will reemphasize compliance, at least in the near term, to narrow the tax gap. When it does, it should also remember the lessons from the Bad Old Days.

Thank you for the opportunity to testify today on this important issue for small business.


CORE VALUES
We believe deeply that:
Small business is essential to America.
Free enterprise is essential to the start-up and expansion of small business.
Small business is threatened by government intervention.
An informed, educated, concerned, and involved public
is the ultimate safeguard for small business.
Members determine the public policy positions of the organization.
Our employees and members, collectively and individually, determine the success of
the NFIB's endeavors, and each person has a valued contribution to make.
Honesty, integrity, and respect for human and spiritual values are important
in all aspects of life, and are essential to a sustaining work environment.
NFIB
The Voice of Small Business.

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

On

The "Tax Gap" and Small Business

Before the

Small Business Committee
U.S. House of Representatives
Donald A. Manzullo, Chairman

April 27, 2005

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Chairman Manzullo, Ranking Member Velazquez and Members of the House Small Business Committee, thank you for the invitation to participate in today's hearing to examine the implications for small businesses with respect to the recent announcements by the Internal Revenue Service that greater emphasis will be placed on enforcement to close the "Tax Gap."

My name is Leonard Steinberg and I am principle of the Steinberg Group, a consulting practice located in West Windsor, New Jersey that concentrates in accounting, financial and administrative operations, and Board of Directors development for nonprofits and small businesses.

As this Committee well knows, taxes and tax system complexity are top issues of concern for our nation's small business owners and entrepreneurs. A simple and fair tax code -- one that fosters certainty in business planning and operations -- is highly desired by our nation's small business owners and entrepreneurs.

Such a system will enhance greater knowledge by all taxpayers with regards to their compliance responsibilities. Clearly, we need to vastly improve educational and outreach programs to better develop a culture of compliance with respect to the individual's tax responsibility in our country. Moving towards a more fair and simple system – one that individuals can actually understand and comprehend – would foster such compliance along with targeted initiatives that focus on non-filers.

Complexity of the tax code Though small business owners and the self-employed have benefited from a variety of tax reform and relief measures enacted since 1986, these tax code changes have created significant complexity, and therefore cost and compliance burdens. The additional complexity and requirements for accurate and timely filing, reporting and payments --compounded by internal and operational issues at the Internal Revenue Service (IRS) – have created significant taxpayer confusion and compliance challenges.

I was a member of the Taxpayer Advocacy Panel (TAP) and chair of the committee on Small Business/Self Employed Payroll Tax from 2002 through 2004. Prior to this position, I was a member of TAP's predecessor, CAP, for one year from New York. Our committee was charged with researching and recommending policies and procedures for reducing taxpayer, i.e., small businesses, burden regarding compliance with accurate

and timely filing, reporting and payment of payroll taxes. During this period of time, our committee reviewed IRS documentation showing the extent of the "Tax Gap," which is generated mostly from individuals and small business owners who for a variety of reasons do not file, report, or pay (or underpay) their payroll and personal income taxes.

There has been a suggestion that small businesses should be mandated to withhold taxes and FICA payments from all independent contractors and part-time employees working less than 20 hours per week in order to close the Tax Gap. From my perspective, this would endanger the concept of sole proprietorships and independent contractors as well as impose additional and severe reporting, filing, and payment burdens on small businesses. Imposing additional requirements upon law-abiding self-employed individuals and small business owners is not a sound solution. It is important to tread lightly with respect to imposing even more burdens on a sector that already shoulders enormous regulatory and compliance cost obligations from government at all levels.

As it already stands, the tax code is neither easily readable nor understandable to the nonprofessional. Even some professionals have a hard time understanding not only the content but also the intent of the code. This complexity leads to the taxpayer receiving IRS letters requesting additional information or, perhaps, an explanation as to why the taxpayer reported in a certain way. These letters cause fear in the taxpayer. This fear can either lead to inaction, or perhaps the acknowledgement that they now have to hire a professional to interpret the letter and obtain the necessary information in order to respond in a timely manner. Of course, seeking outside consultation from a tax expert can be costly for a small business owner just starting up, or the many that operate on thin margins.

Many small businesses simply do not have the financial resources to pay for professional advice and assistance. In the attempt to save financial resources, many small business owners attempt to comply on their own. Some, for example, may decide to use off-the-shelf software. But learning to properly use software, and understanding the intricacies of the tax code, is critical in order to avoid tax problems for the small business owner.

Ignorance of the tax code causes many small business owners and sole proprietors to either overpay or underpay their taxes; not file on a timely basis because of business obligations; or simply don't file due to frustration

with compliance rules and regulations. As an example, there are six definitions of a "dependent."

Small businesses are usually family-owned and operated. These businesses are either incorporated as Limited Liability Corporations, Limited Liability Partnerships, S-Corps, or sole proprietorships. As just one example of complexity, the IRS rules state that a single person Limited Liability Corporation is treated as a sole proprietorship and a two-person Limited Liability Corporations is treated as a partnership. Many small business owners do not understand the significant differences among these different organization forms, or the impact they may have on their businesses or tax obligations.

Complexity really is the key issue that must be addressed in closing the "Tax Gap." Like most taxpaying Americans, small business owners are throwing up their hands in disgust and frustration with the nation's tax code.

Thomas Donlan, the Editorial Page editor for Barron's wrote in his April 18th, 2005 editorial regarding tax code complexity: "The tuition tax credit rolls back for persons above income level A, but the tax credit for electric vehicles continues in full effect until income level B. Other credits also vanish slowly, like the Cheshire cat's smile, at income levels C through ZZZ, and at different rates of reduction."

Taxpayers are rightly scratching their heads and becoming increasingly frustrated and bitter at a system that is both incomprehensible and costly.

The Effect of the Alternative Minimum Tax The impact of the Alternative Minimum Tax (AMT) has recently received widespread media attention, and with good reason. While this hearing is not specifically about the AMT, it does play a role in the underreporting of income. The AMT is inconsistently pernicious to the taxpaying public. The AMT is specifically devastating to those small business owners and taxpayers who live in high tax states such as New York, New Jersey, California, and Massachusetts.

As an example, I have a client who started a business during the last calendar quarter of 2004. When he resigned from his employer, he exercised his Incentive Stock Options. When filing his 2004 tax returns, the exercise of these options immediately threw this individual into the AMT trap resulting in an additional tax of nearly $5,000. This is money that now

could not be used to invest in or grow the new business nor hire additional personnel. The business owner was forced to take a personal bank loan to compensate for the loss of these needed funds.

Of course, some small business owners and self-employed individuals will intentionally underreport their income in order to specifically avoid the AMT. This is accomplished by not reporting all cash transactions, or by not reporting all income derived from IRS Forms 1099-Miscellaneous.

Underreporting – done inadvertently or not – of course, is a serious issue. It not only adversely effects federal income taxation, but also those states with their own income taxing authorities. This also affects state and local sales tax issues.

Don't understand the tax laws As I wrote in the section on tax code complexity, many small business owners and sole proprietors do not fully comprehend all the rules, regulations, and requirements regarding filing, compliance and payment of income and payroll taxes. That does not mean that their intent is not to ultimately comprehend what they are supposed to be doing, and then comply.

Many small business owners attempt to keep their books manually and place all their bank statements and receipts in a folder or box. If the small business owners are computer literate, they will purchase off-the-shelf software to assist them with their tax preparation rather than hiring professionals.

Although Benjamin Franklin is credited with the statement, "A penny saved is a penny earned" -- in the case of tax code compliance, this simply might not be the case with do-it-yourself software, or even manual entry.

Take the example of the small business owner who buys equipment for the business. Does the small business owner understand that some expenses can be deducted while others must be depreciated? In my experience, most small business owners don't understand the concept of depreciation. A client of mine this past tax year did not understand why his $40,000 franchise fee had to be amortized over 15 years and not written off entirely in the year expended. After all, didn't the franchisor receive the full amount of $40,000 in one year?

Tax software is great at performing the calculations, but it is up to the user to understand what numbers to enter and what forms to use. The results can be either underpayment or overpayment of taxes.

Quoting again from Thomas Donlan's editorial, "Though confused and inane and devoid of reason, these complexities (as stated above) are no longer painful." He could have been referring to the use of tax preparation software. Unless the user has an understanding of the intricacies of the tax code, errors of omission and co-mission will be inherent in the process.

Our TAP committee, for example, analyzed various IRS instructions regarding the Form 941 (payroll tax reporting) and instructions for other forms. While we are quite proud that our input was instrumental in having the IRS revise Form 941 to make it easier to use, there are still some business owners who do not understand their responsibilities.

Unenrolled Preparers The complexities and vagaries of the tax code and the availability of commercial tax preparation software have given rise to questionable tax preparers. These preparers can make significant and costly mistakes adversely affecting the unknowing taxpayer. The National Taxpayer Advocate has reported to Congress in each of her last two annual reports on the need to require legislation to address this issue.

As an example, some unenrolled and unlicensed preparers will prepare the taxpayer's return but not sign the return. This makes the taxpayer responsible for all actions taken when the IRS requests that errors be corrected.

There are tax season storefronts that open up for tax season and then close as of April 16th. The taxpayer has no recourse to the preparer when contacted by the IRS.

As of this testimony, the Senate has passed the Taxpayer Protection and Assistance Act (S. 832). This legislation includes language for the taxpaying public to be confident in their respective preparer's professional credentials. I hope this proposed legislation is a beginning for correcting this aspect of the system's inadequacies.

General Conclusions

The problems related to the Tax Gap are both external and IRS related. Driven by complexity and the sheer size of the tax code, the IRS will probably never be staffed adequately, or be thoroughly equipped to deal with the volume of irregularities, problems and issues.

Again, I quote from the Thomas Donlan editorial: "With April 15 just past, do we not know that we have a mess on our hands? Universal taxation of income is inherently unfair to somebody, but attempting to make it fair to everybody results in making it fair to nobody."

The complexity of the current tax code, the effects of the AMT, the lack of an adequate understanding of the tax laws, regulations and procedures, the presence of unethical preparers, non-filers, and cash businesses all add to the extent of the Tap Gap. I fear that making the tax system more complex by adding new requirements on employers -- particularly the small business sector -- will only exacerbate the problem and hurt entrepreneurship.

The point is simply that the Tax Gap is a multifaceted problem and the burden cannot be placed on small businesses alone.

Small businesses are the backbone of this great country. Small businesses are already overburdened with rules and regulations that stymie true American entrepreneurship. Small businesses create jobs. Any additional burdens can only be viewed as anti-small business. If small businesses cannot succeed, then America cannot succeed. It is the American dream that every small business has the potential to be the next Microsoft or the next General Electric or, through innovation, give birth to the next "new" industry.

I strongly urge this esteemed body to make every effort to find alternatives to closing this Tax Gap. We are the greatest nation on the face of the earth. Surely, if we can put a man on the moon and split the atom and travel faster than the speed of sound, then surely we have the ingenuity to successfully resolve this issue.

Aggressive educational and outreach efforts by the IRS that help build a culture of compliance and help individuals understand the personal consequences of non-compliance (for example, the future impact it will have on growing a business, homeownership, retirement security, etc.), as well as starting the educational process at the high school level are important

solutions that will help narrow the gap, rather than widening it where it may reach crisis levels.

Moving towards and addressing fundamental tax reform – real tax simplicity and fairness – is a critical undertaking that must be fully addressed by the U.S. Congress. This can be done if the will exists to actually just do it. A more simple system will increase taxpayer understanding and therefore compliance.

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

Thank you.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

STATEMENT OF
RONALD B. HEGT

TO

THE HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

HOLDING HEARINGS ON

CLOSING THE TAX GAP
AND THE IMPACT ON SMALL BUSINESSES

APRIL 27, 2005

INTRODUCTORY COMMENTS

Mr. Chairman and members of this distinguished committee; the American Institute of Certified Public Accountants thanks you for the opportunity to appear before you today. I am Ronald B. Hegt, a member of the AICPA Tax Executive Committee. The AICPA is the national, professional organization of certified public accountants comprised of more than 340,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, large and medium-sized businesses, as well as America's small businesses. It is from this broad base of experience that we offer our comments today which will focus on both: (1) tax law simplification, and (2) IRS's efforts to increase compliance within the small business community.

TAX LAW STATUTORY SIMPLIFICATION

The AICPA has long been an advocate for tax law statutory simplification. Small business in particular needs advocates to collect and voice their concerns about the burdens imposed on them. We are committed to helping make our tax system as simple and fair as possible. Unfortunately, we believe that the law's complexity in certain key areas may be strangling voluntary compliance. The lack of deliberation in the legislative process, the frequent law changes in recent years, and the increasing magnitude and complexity of the Internal Revenue Code creates serious compliance issues for small businesses.

Because of this shared concern, we have been pleased to join with the American Bar Association Section of Taxation and the Tax Executives Institute over the past number of years to work toward the common goal of suggesting ways to make the tax system simpler and more rational for a broad range of individual and business taxpayers. In collaboration with our professional colleagues, we have developed a number of tax simplification recommendations that we submitted to Congress.

The AICPA sees significant problems for small businesses arising from the increasing complexity of the tax law. For example:

- a growing number of taxpayers perceive the tax law to be unfair;
- it greatly impedes the continuing efforts of the Internal Revenue Service to administer and enforce the tax law;
- the cost of compliance for small businesses is increasing; and
- complexity interferes with economic decision making for small businesses;

The end result is the erosion of voluntary compliance. By and large, small businesses obey the law, but it is only human to inadvertently disobey a law if you do not or can not understand the rules. The dynamic American economy is changing and moving rapidly against an unnecessarily cumbersome and, in some areas, outdated income tax system.

There are various types of simplification that if enacted would update the existing tax system, such as: (1) simplification that reduces calculation complexity; (2) simplification that reduces the

filing burden; and, (3) simplification that reduces the chances of a dispute between the IRS and the taxpayer. The first two types of simplification are sometimes the easiest to identify and fix, although sometimes the repairs involve hard choices. Computers help. Forms help. But this is not just about math. The last type of problem, adding certainty to the law and thereby reducing the likelihood of disputes, is the most difficult to effectuate yet, perhaps, the most important. Clarifying law that is hard to understand must be a priority if we are to achieve a simpler system.

1. AICPA Tax Simplification Activities

The AICPA has long understood the consequences of tax law complexity and has supported efforts to move toward a simpler tax system. In 1992, the AICPA Tax Division published *The Blueprint for Tax Simplification* and identified a need for the following:

- A visible and vocal constituency to communicate the need for tax simplification
- A set of principles to guide the design of a simpler tax system
- An understanding of the factors that contribute to complexity
- A thorough consideration of the need for simplification at all stages of the legislative and regulatory process
- A meaningful method for routinely analyzing or scoring proposed legislation and regulations to assess the impact on complexity/simplification

Over the last decade, the AICPA has drafted proposals for tax law simplification, developed an index for assessing the complexity of proposed rules, testified before Congress concerning the potential complexities of pending provisions, and worked with other professional organizations to support simplification efforts.

Tax Policy Concept Statements

More recently, the AICPA has developed Tax Policy Concept Statements which are intended to aid in the development of tax legislation in directions that the AICPA believes are in the public interest.

A good tax system – one that facilitates and encourages compliance – needs to be understandable to those who are expected to pay the tax and by those who administer the tax. In Tax Policy Concept Statement No. 1, *Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals*, the AICPA sets forth ten guiding principles - Equity and Fairness, Certainty, Convenience of Payment, Economy of Collection, Simplicity, Neutrality, Economic Growth and Efficiency, Transparency and Visibility, Minimum Tax Gap, and Appropriate Government Revenues.

Statement No. 1 identifies simplicity as one of the 10 attributes of a good tax system and states: "The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner." In Tax Policy Concept Statement No. 2, *Guiding Principles for Tax Simplification*, the AICPA explores the importance of reducing complexity in the law. In this document, the AICPA reaffirms its support of efforts to reduce complexity in existing federal and state tax laws and to curtail incremental complexity in the future. Although

an absolutely simple tax system may not be feasible in today's complex business and economic environment, a relatively simpler system is possible. Further, a simpler tax system will benefit individual taxpayers, businesses, federal and state tax agencies, and the economy. The simplification principles are: (1) *make simplification a priority,* (2) *seek simplest approaches*, (3) *minimize compliance burdens*, (3) *reduce frequency of tax law change*, (4) *use consistent concepts and definitions,* (5) *consider administrative burdens*, and (6) *avoid limited applicability.*

One of the principles, transparency, is the basic notion that taxpayers should know, namely, (1) that a tax exists; and, 2) how and when the tax is imposed on them and others. Tax Policy Concept Statement No. 3, *Guiding Principles for Tax Law Transparency*, indicates that if taxpayers and their advisers cannot understand the tax system, they cannot evaluate the impact of that system. Beyond the fundamental aspect of actual and perceived fairness, proposing understandable changes to an understandable tax system would result in broader consensus on whether a change is necessary, wise, or effective. A tax that is not understandable can be easily retained or raised with little awareness among taxpayers about how the tax affects them. Without transparency, "gimmicks" such as deduction, exemption and credit phase-outs for raising revenue flourish and more appropriate, fundamental approaches such as increases in statutory tax rates are avoided.

Transparency is an important partner with tax simplification. The more complex a tax system is, the less transparent it tends to be. Complexity obscures how, when, and on whom a tax is imposed, which increases confusion, frustration, and the perception that the tax is unfairly imposed and thereby decreases compliance. Transparency is critical for understanding the impact of any given tax.

The complete tax policy statements may be found at:

No. 1: http://www.aicpa.org/download/members/div/tax/Tax_Policy_stmt1.pdf
No. 2: http://www.aicpa.org/download/members/div/tax/Tax_Policy_stmt2.pdf
No. 3: http://www.aicpa.org/download/members/div/tax/Tax_Policy_stmt3.pdf

The tax system is a primary link between citizens and their government, with a significant influence on citizen attitudes toward government. In 1972, Americans rated the income tax as the *fairest tax*; but by 1979, most people rated it as the *most unfair tax.*[1] This downward trend continues. If taxpayers cannot clearly "see" their tax burdens, they view the entire system as unfair. Some taxpayers have come to believe that they are entitled to a lower tax bill and resist in the only way they can – by exerting more effort to find ways of reducing their tax bills, legitimately or otherwise. These efforts put additional pressure on our self-assessment system that depends heavily on taxpayers' willingness to comply.

Simplification must be given a prominent position in the tax process on an on-going basis. Although it should not take precedence over revenue and tax policy objectives, simplification must be an integral part of the tax legislative, regulatory and administrative process. We recognize that a tax system that is "simple" for all taxpayers may never be designed, but we do

[1] *The Decline [and Fall?] of the Income Tax*, by Michael J. Graetz, New York, NY: W.W. Norton & Company, Inc., 1997.

believe a "simpler" system is attainable. It will, however, require both a complexity analysis of new legislative proposals and simplification review of existing tax law.

2. ABA, AICPA and TEI Joint Efforts to Simplify Existing Tax Law

Complexity is manifested by Internal Revenue Code provisions which contain either vague or highly technical requirements. These requirements are often riddled with exceptions, limitations, and other special rules that even the most sophisticated of tax advisers can find difficult, if not impossible, to decipher. Added to that is the fact that many provisions, complex on their own, often must be applied in tandem with other complex provisions. Constant changes and amendments to the tax laws, along with accompanying effective date and transition rules, also breed complexity, as well as uncertainty, confusion, and frustration throughout the taxpayer population. The constant changes, moreover, spawn a steady stream of new and often voluminous Treasury regulations, which require an enormous expenditure of time on the part of IRS National Office and Treasury Department personnel, and, unfortunately, sometimes exacerbate rather than ease the complexity of the underlying statutory provision. Short term extensions of popular provisions or relief from unpopular provisions cause administrative difficulties for the Internal Revenue Service and make it impossible for taxpayers to plan with a reasonable degree of certainty.

In joining our professional colleagues in this simplification effort, we encouraged Congress to change fundamentally the way it considers tax legislation and tax simplification. We recognized that most complex provisions of the Internal Revenue Code have had behind them laudable goals. In many cases, however, the burdens the complex provisions impose on taxpayers and the Internal Revenue Service quite simply outweigh the benefits of attaining those goals. Also, many times goals are superseded by changes in society or the economy or by other changes in the law so that complex provisions no longer serve their intended purpose, yet the provisions remain in the law.

The jointly developed package of recommendations for reform include provisions ranging from the earned income credit to the alternative minimum tax to the worker classification rules, all of which affect a significant number of taxpayers. The effort does not purport by any means to have compiled an exhaustive list of all areas in need of simplification. Indeed, it no more than touches the tip of the iceberg. The order listed is not intended to suggest any particular order of priority among the various recommendations made. The three organizations do agree, however, that implementation of simplification measures in the areas identified would significantly reduce complexity for large numbers of both individual and business taxpayers, and have the concomitant effect of making the tax laws far more administrable.

On a number of occasions, the ABA, AICPA and TEI have submitted simplification recommendations to Congress which specifically addressed a number of issues that add to the difficulties small businesses have in complying with the tax laws:

Worker Classification

One obvious example of an area in need of clarification is that of worker classification. The costs and paperwork burden associated with having employees (e.g., income tax withholding, unemployment tax, benefits, etc.) often pushes small businesses towards the use of independent contractors. Yet subsequent determination that workers should have been considered employees, rather than independent contractors, leave many small businesses with an even greater burden. We suggest that the current 20-factor common law test for deciding whether workers are employees or independent contractors should be replaced with a more objective test. The current test contains factors that are subjective, given to varying interpretations, and offers precious little guidance on how or whether to weigh the factors. An objective test provides certainty, while balancing the needs of service recipients and the rights of service providers. If such a change to an objective measure is not possible, Congress should at least reduce the differences in tax treatment of employees and independent contractors.

Capitalization, Expensing and Recovery of Capitalized Costs

Another area where small businesses become confused is the capitalization or expensing of costs. The tax treatment of some business expenditures depends on whether they are classified as business expenses – and are therefore deductible in the current year – or capitalized, in which case they are either deducted over time as the asset depreciates or when it is sold. The classification depends on whether the expenditure produces a "future benefit." But, that determination is rarely obvious or easy. It is imperative that the enormous drain on both government and taxpayer time and resources in making these determinations be alleviated. This could be accomplished by the development of objective, administrable tests governing the deduction of recurring and routine business expenses or the capitalization of clearly defined categories of expenditures.

Capital Gains Provisions

The capital gains regime applicable to individuals is excessively complex. The system imposes difficult record-keeping burdens on small business taxpayers who may recognize the sale of business assets on their personal tax returns (e.g., Schedule C sole proprietor). It is a system where each special rule has been developed in isolation for a specific, defensible goal, yet the cumulative effect has been the creation of a structure that is incomprehensible to taxpayers and to the people who prepare their tax returns. The taxation of capital gains would be simplified by establishing a single preferential rate.

Alternative Minimum Tax

Notwithstanding the reasonably large average annual gross receipts exemption, the corporate AMT requires many corporations to keep at least two sets of books for tax purposes; imposes a myriad of other burdens on taxpayers, especially those with significant depreciable assets; and has the perverse effect of taxing struggling or cyclical companies at a time when they can least afford it. The corporate AMT should be repealed. If repeal leaves specific concerns unaddressed, those concerns should be addressed directly by amending the Code provisions

causing the concerns, not by preserving a system that requires all taxpayers to compute their tax liability twice.

Likewise, the individual AMT, which impacts many small business owners, should also be repealed. It no longer serves the purpose for which it was enacted, produces enormous complexity, and has unintended consequences. The AMT continues to spin a web of mind-bending complexity.

Estimated Tax Safe Harbors

We also suggest a proposal to rationalize estimated tax safe harbors. In order to avoid interest on underpayments of tax, individual taxpayers, who are generally self-employed small business owners, make quarterly estimated tax payments based on a percentage of the prior year's tax liability -- a "safe harbor" amount. The availability and computation of the prior year safe harbor has been adjusted by Congress repeatedly during the past decade, thus making it difficult for a taxpayer to know what they must pay during the year. We recommend that an appropriate safe harbor percentage, perhaps 100 percent, should be established and applied for all years. In addition to rationalizing the individual safe harbor, we recommend that consideration be given to simplifying estimated taxes for all corporations.

3. Giving Small Business an "Early Leg Up"

Small businesses are one of the main drivers of the Nation's job creation and economic growth. Start-up survivability is a critical area of concern that has been studied by the Small Business Administration[2] and others. Census data, as shown in the figure below, indicate that after only one year, 20 percent of start-up businesses have disappeared. After 10 years, 70 percent of these businesses no longer exist.[3] SBA research indicates that most small businesses struggle with operational, financial, and tax problems. These problems dominate bankruptcy-filing statistics.[4] Complexity of the tax system clearly exacerbates these problems. The AICPA supports the *Small Business Tax Flexibility Act of 2003*, H.R. 3225, which proposes giving most small business start-ups an additional tool to successfully navigate its start-up life cycle by providing the flexibility to adopt any fiscal year-end from April through November. Such flexibility would increase their prospects for survival by:

- Allowing start-ups to be more productive during their busiest period by spreading their workloads and easing recordkeeping burdens.
- Increasing their access to professional advisors by smoothing workloads over the year.
- Providing them with marginal amounts of additional operating resources.

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[2] FY 2001-2006 SBA Strategic Plan

[3] "The Estimated Revenue Effect of H.R. 3225, the Small Business Tax Flexibility Act of 2003," PricewaterhouseCoopers LLP, October 2003.

[4] *Financial Difficulties of Small Businesses and Reasons for Their Failure*, SBA-95-0403, 9/98

IRS'S EFFORTS TO INCREASE COMPLIANCE WITHIN THE SMALL BUSINESS COMMUNITY

The AICPA would like to address today two critical topics affecting tax administration and its impact on small businesses: (1) how the IRS can help taxpayers and its own enforcement efforts through administrative simplification; and (2) how the IRS can leverage its external stakeholders to achieve a more highly compliant taxpayer population.

1. Streamlining Tax Administration Through Administrative Simplification

The AICPA believes administrative simplification, which could yield significant tax administration enhancements, could result in administrative efficiencies for the IRS and an overall increase in voluntary compliance among small businesses.

As previously discussed, we have been a strong supporter of tax simplification for many years, and we view administrative simplification as a way of fostering fewer errors on tax returns. Simplification would mitigate taxpayers' need to rely on vague, contorted interpretations of the law that have resulted in the marketing of abusive transactions.

Administrative Simplification Should Enhance Enforcement

We are well aware of the substantial decline in the number of income tax examinations conducted by the Service in recent years. For example, the percentage of individual returns examined by the IRS fell from a rate of 1.67 percent in 1996 to a low of 0.49 percent in 2000, followed by a modest upturn in the audit rate to 0.65 percent in 2003.

Much of this decline can be attributed to fewer IRS compliance personnel and the increased workload resulting from the *IRS Restructuring and Reform Act of 1998*. We support the IRS's efforts to reverse this trend by (1) hiring new Revenue Agents and (2) implementing a number of administrative simplification measures within the four operating divisions and Appeals.

Focus on Flow-Through Entities

SB/SE and LMSB have established a Flow-Through Compliance Committee to identify issues for return examinations, potentially leading to an increase in flow-through examinations and a higher rate of compliance for S corporations and partnerships. The goal is to increase the examination coverage of middle-market flow-through entities.

A sub-component of this focus on flow-through entities is the Service's Schedule K-1 matching program, a significant initiative within SB/SE. While we support the K-1 matching program, we stress that program success will be achieved only if the Service continues to consult on a regular basis with the practitioner community about any potential or unresolved implementation issues.

As the IRS moves forward with the K-1 matching program, we continue to recommend that the Service (1) reduce the agency's short-term goals for the program, and instead, phase-in

implementation of the program over an extended period of time; (2) actively seek input from key practitioner and stakeholder groups; (3) improve the training of employees involved with the K-1 program; (4) develop new outreach programs and education materials to better inform taxpayers and practitioners about IRS expectations for the program; and (5) design improvements in forms, like Schedule K-1 and Schedule E. We are pleased the IRS has taken steps to implement many of these recommendations, including redesigns of Schedules K-1 and E.

The AICPA commends the IRS for the release, on January 10, 2005, of the revised Schedule K-1 for the 2004 tax year. While the revised form was based in part on input from stakeholders, like the AICPA, we have received some reports that the form may still prove difficult for certain specialized industries, with distinct needs and characteristics. A more targeted Schedule K-1 may be necessary for such industries.

Administrative Simplification Demands a Vibrant IRS Budget

Over the years, the AICPA has urged full funding for the IRS budget, and continues such support as Congress and the Administration begin their deliberations on the fiscal year 2006 budget. Absent proper funding, administrative simplification is unlikely to yield any significant results.

Giving the Service the necessary resources to properly enforce the tax laws is vital to maintaining our voluntary compliance tax system. Obviously, we expect the Service to identify responsible ways to allocate any additional resources it receives over prior year funding, and Congress will, through its oversight responsibilities, ensure that those resources are properly utilized.

Commissioner Everson recognizes that any increase in enforcement funding must be balanced with positive responses to the taxpaying public as customers. We encourage this type of balanced approach and stand ready to work with the Service to ensure that the needs of America's taxpayers are fulfilled.

Many AICPA members are tax practitioners. As such, we have seen first-hand the problems caused by an IRS that is not responsive to the taxpayers as customers. We have also witnessed the improvements initiated by Commissioner Everson, particularly with respect to enforcement. Any lack of attention to IRS funding needs will only undercut simplification efforts, and the nation's taxpayers will suffer as a direct result.

2. Leveraging External Stakeholders

The IRS can use tax practitioners to increase taxpayer compliance in two ways. First, the Service should take advantage of each profession's efforts to encourage pro bono tax assistance, bolster professional ethics, and develop continuing professional education. The AICPA's efforts in these areas are detailed below. Second, the IRS must continue to focus on retaining, replacing, and developing the professional expertise of its own personnel.

Pro Bono Activities

AICPA members have a long-standing track record of becoming active in their local communities through pro bono activities. From a tax perspective, this involves volunteering to serve at Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites, community and academic-based low-income tax clinics, and other non-profit organizations. The AICPA's Tax Division has established a pro bono task force to foster CPA volunteers for federal, state, and local tax programs and clinics.

Our members routinely provide free seminars to local associations on tax, accounting, and finance topics. They regularly write articles and serve on non-profit organization boards. CPAs volunteer for reasons of personal satisfaction; and such opportunities provide avenues for developing or sharpening their professional and communication skills, and developing their practices.

We view pro bono activities by tax practitioners as one of the best opportunities for the Service to leverage its resources and, at the same time, foster an increase in tax compliance. For example, the IRS has asked CPAs within our state societies to teach local tax practitioner courses and small business tax workshops that IRS staff may have otherwise taught in the past.

Professional Ethics

The AICPA is encouraged by Commissioner Everson's commitment to high professional standards for tax professionals, as exemplified by the final regulations revising Circular 230 (as released on December 8, 2004), and his efforts to upgrade the Office of Professional Responsibility. We view this commitment as one of the best leveraging opportunities for the Service with external stakeholders. Ultimately, high professional standards have a direct and indirect impact on all taxpayers, including small businesses.

We have a longstanding track record of establishing high professional standards for AICPA members, including the AICPA Code of Professional Conduct and enforceable *Statements on Standards for Tax Services* (SSTSs). These standards provide meaningful guidance to members in performing their professional responsibilities.

The AICPA is actively communicating with our membership and state CPA societies regarding the new Circular 230 provisions governing "best practices" for tax advisors and tax shelter ("covered") opinion standards. We agree with the preamble of the final regulations, which states: "Tax advisors play a critical role in the Federal tax system, which is founded on the principles of compliance and voluntary self-assessment. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice."

With respect to abusive tax transactions, the AICPA has a clear position – we unequivocally support their eradication. We have consistently supported the protection of the public interest and prohibitions against the misuse of our tax system. Our enforceable SSTSs are a clear example of this. We continue to be actively engaged in proposing and evaluating various

legislative and regulatory measures designed to identify and prevent taxpayers from undertaking, and tax advisers from rendering advice on, transactions having no purpose other than the reduction of federal income taxes in an abusive manner.

In addition to any governmental sanctions imposed (e.g., as a result of the February 2003 reportable transaction regulations or the *American Jobs Creation Act of 2004*), our own disciplinary process will be (and has been) invoked where our rules of professional conduct are violated. The AICPA's Tax and Professional Ethics Divisions are in close consultation regarding the scope of the SSTSs and how to best implement the standards' enforceability. Most recently, the AICPA adopted an Interpretation to SSTS No. 1 that outlines members' ethical obligations and responsibilities in connection with tax planning and clarifies how these standards apply across the tax practice spectrum, including situations involving tax shelters (regardless of how that term is defined).

We also support initiatives focused on ethics training for Service employees. We believe that IRS examination and collections employees must be able to "step into the shoes" of tax professionals and vice versa. Government workers and professional tax practitioners must be able to understand each other in order to ensure greater strides in tax compliance.

Commitment to Continuing Professional Education (CPE)

Our commitment to "raising the bar" for CPAs in the area of continuing professional education (CPE) is consistent with our strong support for high professional standards. We firmly believe that this commitment helps ensure positive technical competency, values, and ethics among CPAs.

In general, the state boards of accountancy mandate CPE under the purview of protecting the public, particularly given the complexity of the field of accountancy in general, and the scope of the tax law in particular. Due to the dynamics of the tax profession, continuing education helps CPAs to maintain and learn the skills necessary to perform in the business world.

The AICPA and the state CPA societies work closely to develop appropriate continuing professional education programs for CPAs that address the technical competencies and standards of professional conduct demanded by the marketplace. Training programs on professional ethics is one critical area in which the AICPA is working closely with state CPA societies, highlighted by the strong trend by state societies to include ethics training as a component of their fall taxation seminars. In this context, the Institute has developed training materials on our Statements on Standards for Tax Services for use at these seminars.

In fact, we are one of the leading developers and sponsors of tax training for CPAs across the country. Our primary goal is to provide top quality training to help ensure the highest level of technical proficiency. The training focuses on both tax planning and compliance matters, and is authored and technically reviewed by a host of highly qualified CPAs and attorneys.

To ensure the highest quality, our training meets the rigid requirements of both the joint AICPA/National Association of State Boards of Accountancy (NASBA) Statement on Standards

for Continuing Professional Education Programs and the NASBA Quality Assurance Service program. And, to ensure the maximum outreach to CPAs, the training is offered in a variety of media, including paper-based self study, online training, video training, webcasts, conferences, onsite live training, and live training offered via state CPA societies throughout the country. Moreover, to ensure the cost of high-quality training does not become an issue for CPAs, we offer all of our online training programs at a low annual subscription price (approximately $150) and provide the course materials to the state societies at no cost in exchange for their agreement to offer members a discount on each live program offered.

Similarly, the IRS has developed a series of yearly National Tax Forums designed to address the knowledge and ethics base of mainstream tax professionals. We support the IRS's National Tax Forum program, and, as we did last year, we look forward to participating in the Service's tax forums in 2005. Clearly, a strong commitment to continuing professional education is one of the best ways of influencing and "raising the bar" for tax compliance among small businesses and the public overall.

Addressing the IRS's Aging Workforce

The recruitment, development and retention of a quality workforce are essential for the IRS, and we commend the Service for its recruitment in recent years of senior executives from outside the agency. In our experience, effective leadership results when these new executives are partnered with internally developed executives who have critical institutional knowledge. We are also encouraged by the quality of the outside technical experts who were brought into the four operating divisions. We encourage continued recruiting from outside the Service.

The IRS is experiencing a higher than normal attrition rate among its mid-level and rank-and-file employees, primarily through retirements. These retirements are clearly having an impact on the Service's ability to implement the reorganization[5], including the ability to increase productivity among its employees overall. Replacing these retirees and the resulting loss of "institutional memory" is a major challenge for the IRS.

We support full funding for the Staffing Tax Administration for Balance and Equity program (STABLE), the initiative to restore IRS staffing to mid-1990s levels and strengthen the Service's tax compliance and customer service functions. We continue to applaud the STABLE initiative as a means to achieve the balance between taxpayer service and the enforcement necessary for effective tax administration.

The AICPA stands ready to support the IRS in achieving its goals for staffing over the coming years. There are a number of CPAs and recent accounting graduates who are interested in government and public service.

[5] Due in large part to passage of the IRS Restructuring and Reform Act of 1998, the IRS has changed its structure to include four operating divisions, organized around four major customer segments; specifically the Wage & Investment, the Small Business/Self-Employed, Large & Mid-Size Business, and Tax Exempt & Government Entities Divisions. This change in the IRS structure is commonly referred to as the "reorganization."

In order to help facilitate the hiring of new agency employees, we recommend that the IRS study its current salary/grade level structure. The study should take into account the salaries for comparable employees in other federal agencies and in comparable private sector positions. Also, the IRS should continue its recruitment efforts on college campuses, and possibly introduce an advertising campaign regarding agency job openings.

We welcome the opportunity to help the IRS identify qualified CPAs for employment within the Service.

IRS Employee Training

The AICPA also believes that there are significant leveraging opportunities for the Service and stakeholders in the area of IRS employee training. Some of the most frustrating experiences realized by taxpayers and tax practitioners in dealing with the IRS occur because of a lack of training on the part of IRS employees. It is much easier to work out a solution that is fair to both the tax system and the taxpayer if the IRS personnel resolving the issue are knowledgeable and well-trained.

The IRS needs to target meaningful resources toward training Service employees, including training needed to overcome any inertia of mid-level and rank-and-file personnel that works against the reorganization or new agency programs. The AICPA strongly supports such efforts.

We believe we can be of immense help to the Service with employee training. First, we suggest that the Service seek prior input from key stakeholders on the details and development of the program, including suggestions from the AICPA and other stakeholders regarding training materials for the new initiative. Second, we recommend that the Service utilize CPAs and other stakeholders in teaching parts of the training curriculum for IRS personnel.

We firmly believe private sector involvement in the training process helps IRS employees to conduct new programs effectively for the tax administration process, while minimizing intrusion and taxpayer burdens.

The Service has taken positive steps to ensure stakeholder input on new IRS programs and initiatives. During 2004, our CPA members provided feedback on numerous draft IRS forms, examination reengineering proposals, training materials for the National Research Program (NRP) flow-through entity reporting compliance initiative, Schedule M-3, and other programs.

CONCLUSION

The AICPA greatly appreciates the opportunity to share its views and ideas. We stand ready to provide whatever assistance and support this subcommittee may find helpful in the critical task of increasing compliance for small business.

Mr. Chairman, the steps we are taking to reorganize our outreach and education function will allow us to enhance the quality of our interactions with small business taxpayers, while also ensuring we are being fiscally responsible in dealing with the budget challenges we face in FY 06.

Conclusion

To summarize, on the whole, our system of self-assessment of tax liabilities appears to be working nearly as well as it did in 1988. However, the new compliance data suggest that some types of income may be reported less accurately now than in the past. It is clear that consistent efforts to keep the complexity and unnecessary burden of the tax system to a minimum, to provide the excellent service that the taxpaying public deserves, and to maintain a strong and well-targeted enforcement presence are necessary to improve compliance rates.

While IRS enforcement efforts have lagged in recent years, that is now changing. We will continue to improve service and respect taxpayer rights. But we will also enforce the law. We will not relax until taxpayers who are unwilling to pay their fair share see that is not a worthwhile course to follow.

Thank you very much for the opportunity to discuss the tax gap and our efforts to combat it. I am happy to take your questions.

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