

**THE INTERNAL REVENUE SERVICE AND SMALL
BUSINESSES: ENSURING FAIR TREATMENT**

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

HEARING HELD
JULY 17, 2013



Small Business Committee Document Number 113-030
Available via the GPO Website: www.fdsys.gov

U.S. GOVERNMENT PRINTING OFFICE

81-937

WASHINGTON : 2014

For sale by the Superintendent of Documents, U.S. Government Printing Office
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WEDNESDAY, JULY 17, 2013

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 1:00 p.m., in Room 2360, Rayburn House Office Building. Hon. Sam Graves [chairman of the Committee] presiding.

Present: Representatives Graves, Chabot, King, Coffman, Luetkemeyer, Mulvaney, Tipton, Hanna, Huelskamp, Schweikert, Bentivolio, Collins, Rice, Velázquez, Clarke, Hahn, Payne, Meng, Schneider, Chu, and Barber.

Chairman GRAVES. Good afternoon, everyone. I would like to call this hearing to order.

Under the House rules, one of the responsibilities of this Committee is the study and investigation of the problems of all types of businesses, including those concerning tax issues. Today we are carrying out that duty and we are very pleased to have Acting Commissioner of the Internal Revenue Service, Mr. Werfel, here with us.

Small businesses are vital to job creation and innovation in the U.S. economy, accounting for over 60 percent of new net private sector jobs. At the same time, these businesses have fewer resources than large firms to deal with an increasingly complex maze of tax laws and regulations.

Over the past few years, the IRS has increased the number of small businesses that it audits. This has been explained as a way for the IRS to close the “tax gap;” that is, the difference between what the IRS believes is owed and what taxpayers pay voluntarily on time. We certainly support taxpayers paying what is due, and most small business owners do pay their taxes. As the IRS Taxpayer Advocate has recommended, Congress should vastly simplify the tax code to increase tax compliance.

In May, the Inspector General for Tax Administration issued a report that found the IRS had used inappropriate criteria to target certain conservative organizations that sought nonprofit status. Since that time, Congressional investigations have raised additional questions about the IRS’s improper targeting, and whether the IRS may have also improperly targeted the tax returns of small businesses for added scrutiny or audit.

We must ensure that all taxpayers, including small businesses, are treated fairly. In May, I sent a letter to Mr. Werfel requesting information about how the IRS selects and classifies small business taxpayers for closer review and audit, the number of small businesses it audits, and the cost, duration, and yield from all of those audits. Who decides which small businesses are selected? How is the criteria developed? When does it change? And last evening, after a month delay, I did receive a letter providing responses to some of those questions, and we hope to learn more of those answers today.

As elected representatives, we must make sure that our government is accountable, and restore the American people's faith in their leaders.

And with that, I will now yield to Ranking Member Velázquez for her opening statement.

Ms. VELAZQUEZ. Thank you, Chairman Graves.

One of the focuses of this committee is to ensure small businesses are given the tools to comply with regulations without increasing their costs. No place is this more true than when it comes to taxes. In the past, small businesses have told us that complexity and uncertainty create difficulty when filing tax returns. Many business owners worry that one simple mistake can lead to a costly and timely audit, and at a time when many businesses are striving to expand, every hour and dollar counts. Small firms spend up to 66 percent more on tax compliance than their larger competitors and face constant changes to the tax code, creating further confusion and hindering job creation. They should not also have to face intense scrutiny from the IRS through business audits. Nevertheless, audits of small businesses, particularly pass-through companies, continue to rise.

While the vast majority of small business taxpayers comply with tax laws, it seems they may be under increased scrutiny by the IRS, all because a few bad actors misreport their income. Seeing as our nation's fiscal constraint are an ongoing priority, I understand that closing the 450 billion tax gap is critical to our long-term prosperity, but so are small businesses. Any effort to increase tax compliance must be done in a way that is responsible, fair, and not unduly burdensome to small firms.

I am grateful that the IRS commissioner took time out of his schedule to testify before us today, but it is unfortunate we are turning a relevant topic into political theater. It is my hope we can move past the unsubstantiated belief that the IRS politically targeted certain small firms and instead have a productive discussion to ensure small businesses are not unfairly harmed by overzealous auditing.

Today's hearing will give us a better grasp of the amount and scope of small business audits since it is necessary to have an accurate picture of enforcement policies. I am looking forward to learning about the factors considered in deciding on an audit and about the average result. I believe this data is even more important right now as the agency seeks to be more efficient due to financial realities.

We will also discuss whether the private costs and burdens of an audit are contemplated and thereby justified in light of potential

revenue gains of an audit. This hearing will also allow us to examine what is being done to minimize this burden for small entities.

Small firms should be able to look to the IRS for help in answering questions quickly and accurately. For this reason, it is vitally important that we encourage better taxpayer service. The agency's move to increase staff levels in its Taxpayer Assistance Program is an important step in delivering these resources, and I am also pleased to see a greater emphasis on ACA education activities.

With the proper tools, America's small firms can sustain the economic growth currently underway by investing in their operations without fear of an onerous audit.

With that I would like to thank Commissioner Werfel for being here today, and I yield back the balance of my time.

Chairman GRAVES. Thank you.

And our first witness, or obviously our only witness today, is Daniel Werfel, who is the acting commissioner of the Internal Revenue Service. Commissioner Werfel was appointed to lead the IRS in May of 2013 and prior to his appointment he held several positions with the Office of Management and Budget, including controller and the Department of Justice. Thank you for being here again and I look forward to your testimony.

STATEMENT OF DANIEL I. WERFEL, PRINCIPAL DEPUTY COMMISSIONER, UNITED STATES INTERNAL REVENUE SERVICE

Mr. WERFEL. Thank you, Chairman Graves, Ranking Member Velázquez, and members of the Committee. Thank you for the opportunity to appear before you today to discuss tax matters affecting small businesses.

The IRS takes seriously the need to provide excellent service to small business taxpayers. This service includes helping them understand and meet their tax obligations. Our assistance takes many forms. For example, to increase understanding of changes in tax law and in filing requirements, we sponsor meetings, symposiums, and seminars for small business owners and the tax practitioner community each year. We also provide virtual assistance through our website, IRS.gov, which contains a section devoted to small businesses. It has a wealth of videos, audio presentations, and seminars on a wide range of tax topics. Even as we work to ensure that our service to small businesses meet high standards, the IRS must also carry out a rigorous enforcement program.

In fiscal year 2012, the IRS audited approximately 1.65 million returns, of which 21 percent were small business returns. The 2012 small business audit rate equates to only 0.2 percent of all returns filed and 1.3 percent of all small business returns filed. In going about our work in the enforcement area, the IRS strives to ensure the taxpayers receive fair treatment. For instance, we recognize that individual taxpayers and businesses being audited may be dealing with financial hardships, and we have encouraged our employees to be flexible in these situations.

One major example of our efforts in this regard is the Fresh Start Initiative. Under Fresh Start, we have added flexibility to our collection program in 2011 and 2012 to help taxpayers who are struggling financially. We are also focusing on reducing taxpayer burden through such efforts as simplifying forms and publications

and streamlining policies and procedures. For example, in January of this year, we announced a simplified method for claiming the Home Office Deduction. This new option will significantly reduce the paperwork and recordkeeping burden associated with calculating the deduction.

Ensuring fair treatment also involves making sure taxpayers, including small business owners, have recourse in tax disputes with the IRS. We are taking action to raise taxpayers' awareness of the tools at their disposal for resolving issues such as the Taxpayer Advocate Service. We need to be sure taxpayers know how to engage the Taxpayer Advocate Service when they feel they are being treated inappropriately or encounter excessive bureaucratic obstacles. It is important to note that all of our initiatives for assisting taxpayers depend on the IRS receiving adequate funding. It is imperative that we have the ability to continue reaching out to small business owners to provide the help they may need in meeting their tax obligations.

Since fiscal year 2010, the IRS has absorbed cuts and appropriated funding that totaled nearly \$1 billion or nearly 8 percent. This includes a reduction of \$618 million as a result of sequestration this year. At the same time, we have made major strides in reducing costs and finding efficiencies in our operations. We estimate that we will have achieved \$1 billion in budget savings and efficiencies between 2010 and 2013. But additional significant cuts to the IRS budget have the potential to weaken our ability to deliver our service and enforcement programs, including those dedicated to assisting small business owners.

Before I conclude, I want to want to briefly mention the work we have been doing over the past several weeks to chart a new path forward for the IRS as these efforts are important to all taxpayers, including the small business community. We have initiated a robust action plan to address needed improvements that we believe will help restore and sustain the public's trust in the IRS. The report we released last month describes a number of important findings, aggressive actions, and next steps for the IRS. The problems with the 501(c)4 application process that were uncovered by the Treasury Inspector General for Tax Administration have created significant concerns for individuals and taxpayers, and it is incumbent upon us to take swift action to fix the problems that occurred. We are also reviewing the full range of IRS operations, processes, and practices to focus on how we deliver our mission today and how we can make improvements in the future. And that way, we will better understand organizational risks wherever they exist in the IRS. The IRS is committed to correcting the problems that have occurred and to continuing the important work of the agency on behalf of the taxpayers.

Mr. Chairman, Ranking Member Velázquez, that concludes my statement. I will be happy to answer your questions.

Chairman GRAVES. Thank you very much, Commissioner. You obviously do not have an easy job; that is for sure.

The first question, real easy, has anyone in the IRS ever improperly targeted small businesses for additional scrutiny?

Mr. WERFEL. I am not aware of improper targeting of small businesses. Let me explain the context of how I am answering that question because I think it is important.

The TIGTA report that was released in May dealt in the area of 501(c)4 review. That is a particular part of the law where the political activities of the entity under the law are relevant to their application for benefit. In this case, a tax exempt status. So the IRS, it is incumbent because it is in the law. We have to do an evaluation. Now, that evaluation involves assessing the degree to which the entity is involved in political campaign intervention. And in this case, as the IG reported, the way in which that was carried out was done inappropriately.

But shifting over to small businesses, as a general matter, throughout our small business—throughout the tax code and throughout our implementation efforts under the small business, it is rare or virtually nonexistent that the political activity of an entity would be relevant in terms of any increased scrutiny that we would provide. So separating the two in terms of is there a risk that what was found in the IG report transfers over to small businesses, I have two responses to that. One is the risk of inappropriate political labels being used is extremely low because political activities are not relevant to the evaluation that we do. And second, as the report that we issued last month indicates, because of the importance of the findings in the IG report and because of the public concern about those findings which I think are very well justified, we are engaging in a process right now with each of our operating divisions, including our small business and self-employed division, to review the criteria by which small businesses or any taxpayers—but in this case small businesses—are selected for additional scrutiny. To do basically a fairness review, are we doing it exactly right or is there any evidence of any problems, we will surface them. So we are going through that review right now.

Chairman GRAVES. And again, I am glad you are talking obviously to the folks below you. That is what I am worried about, is if you can be sure that they are not, without your knowing it or whatever the case may be, that they are not improperly targeting those small businesses.

Mr. WERFEL. I think one of the things we do is we have procedures in place for how a small business or other taxpayer may be selected for an exam, and we review those procedures on an ongoing basis, and we are going to do a special review as a result of what happened in the IG report of those procedures and those protocols, to make sure they are fair in design. They also have to be fair in implementation and effective in implementation. But that is part of it. It is about training. It is about making sure the architecture of the protocols that we use to essentially select taxpayers for additional scrutiny, is that architecture fair, reasonable, effective? And is it being carried out fair, reasonably, and effective? And we are dedicated to making sure, and I think the IG report is a helpful reminder in some ways to make sure how important it is that we are diligent about that in all areas of the IRS.

Chairman GRAVES. Well, and that is obviously what I am very interested in, too, is the process of how you select, or what goes into that criteria on how you select, small businesses for additional

scrutiny. I know you cannot tell us what those triggers are or what those specific items are on a tax return, but my question is when a small business is identified for further scrutiny or a tax return is kicked out based on whatever trigger that is, well, what happens then? What is the next step in that process?

Mr. WERFEL. Let me start with—make sure that everyone on the Committee understands that so much of the footprint of that work in terms of reviewing returns and selecting is automated and based on a computer application. And that is helpful in a certain regard because to the extent you can take some of the human element out of it, you create a better sense of objectivity about how things may be selected.

And so we have this process. We call it discriminate function or in the halls of the IRS it is called DIF for short. And it basically establishes a set of scores that based on the information that is on a return, just what is on its face, it basically gets us a risk score for potential noncompliance. And the key is how do we structure and program the DIF for what returns may be selected? And that is informed based on ongoing literature and analytics around where we have tended to see noncompliance over time. And critical to that is something called the National Research Program, which is a broader, statistically based study of taxpayer compliance across the broad spectrum of the tax code. And based on those findings, which we get periodically, we learn, okay, this is an area that is growing the tax gap because we are having areas of noncompliance here and then we can translate that into our computer program and say if you see something similar—trend, pattern, behavior—then it should be flagged for a potential audit or exam. That does not mean the taxpayer necessarily did something that was noncompliant but we need some type of mechanism to make sure our resources are most effectively following where the risks may be and that is the process. So once that is flagged then it would go into our exam phase and we would initiate a process and it could be either a field exam or a correspondence exam. We have a great many number of more correspondence exams than field exams because the correspondence exams are less burdensome on the taxpayer, less burdensome on the individual. We found over time that by sending a letter to a taxpayer informing them of certain questions or flags we see in their tax return, that can be a very effective mechanism in terms of reconciling a difference that we want understood rather than going through and sending a team of IRS people out to a particular location.

Chairman GRAVES. Well, sooner or later there is a subjective component to that. I mean, somebody has to make a decision on whether or not that business is going to be audited or given further scrutiny. Who does that? What division?

Mr. WERFEL. So there is a process in place. You are right. It is a combination. We have structures in place that will enable us to target our resources to higher risk areas, and what we try to do is make sure that those structures are as objective as possible based on substantive analytics, based on an automated review of returns which is becoming much and much easier and more effective as e-file numbers increase. And so we are heading into, you know, we are in there but we are really in a modern era now where

we can get tax return information electronically. They come in and we can do automated reviews of them immediately.

And where does the human element come in? It comes in in a couple of places. First of all, it is humans. It is IRS employees that are designing these protocols and programming the computer in terms of how it structures its risk. And then at some point when you determine a problem and you start to see that you have interacted with the taxpayer and you are starting to see how the information is arising between the problem we think may exist and the taxpayer's reaction, then the human intervention comes in to make sure that we are managing this to a successful resolution. And to make sure the process has as much integrity as possible there has to be a series of reviews and checks and balances to make sure that the technology that we are using is fairly structured and architected and that the individuals carrying out on that technology are carrying out in a fair and effective way. And we have existing mechanisms in place to do those reviews. We have an inspector general as an example who, in this one case in 501(c)4, found a major problem and now obviously we have a lot of cleanup to do and fixes to do in that area, but that also, as part of a checks and balances, has led to us now reviewing all the various procedures that I just outlined. We are now doing special additional reviews to make sure that there is fairness in the entire lifecycle.

Chairman GRAVES. Is there any other reason that you know of why a small business would be targeted other than some of the things you just told us?

Mr. WERFEL. I really do not. I think if the program is working as designed and as intended—and I think there is always a risk of variation, there is always a combination of a mistake that could happen, and unfortunately, there have been cases within the IRS where someone acts inappropriately and there is underlying malfeasance or misconduct. Those are rare but they happen, and I am not aware of any of that happening with respect to the selection of a small business. But what I am suggesting is that we do not have any particular evidence at this time that the objective and analytical criteria that we put in place to review small businesses for potential increased scrutiny has any fundamental flaw that would lead one to the conclusion that there was unfair targeting. I do not have any evidence of that but the review that I have asked the new chief risk officer at IRS to carry out—and by the way, that new chief officer I hired away from the Government Accountability Office and he was a leader within GAO and has a lot of knowledge and experience in terms of understanding risk and how to review these types of activities—he is the one that is leading this review. And my commitment has been—it is to this Committee and to other Committees, we want to share the results of that review with Congress because when I go back to that audit report that we have referenced, one of the concerns that I have in looking backwards at this and seeing what happened and dissecting it is that there was not enough sharing of information with appropriate committees as these risks were emerging. And so I want to change that dynamic within the IRS so that not only are we more systematically evaluating our risks on an ongoing basis, but as we are learning information we are bringing it to the attention of the appropriate

committees. Clearly, the review that we do within our small business and self-employment area is highly relevant to this Committee and I look forward to sharing the results of our reviews with you so you can kind of roll up your sleeves and help us make sure that we are doing things appropriately.

Chairman GRAVES. Who is it that is doing that review?

Mr. WERFEL. Well, we have, again, I have a chief risk officer named David Fisher. He was my first hire when I arrived at IRS on May 22nd. Previously, the IRS had not had a chief risk officer position, and based on what I was perceiving coming into the job as this situation, I felt it needed a chief risk officer. That individual is working with our various operating division heads. So in this case, for Small Business, he will work with Faris Fink and Ruth Perez, the commissioner and deputy commissioner for our Small Business operation.

Chairman GRAVES. Well, we would like to continue to work with you on that process as it moves forward.

Mr. WERFEL. Absolutely.

Chairman GRAVES. Ms. Velázquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Commissioner Werfel, the Taxpayer Advocate recently conducted her own study of small business audits and that report identified geographies and industries where business owners are more likely to game the system. For instance, low compliance was correlated to taxpayers who have less trust in the government and belong to associations whose members had similar feelings. With that in mind, was there politically motivated targeting of small businesses through audits?

Mr. WERFEL. Again, I do not believe—I certainly do not have any evidence of it, and I think part of the risk that created the problem with the IG report on 501(c)4 was that there was relevancy to the political activities that were going on and that created additional risk. We have to operate within that risk because that is the law. In this case, we did not manage that risk effectively and that is part of the findings.

But to your point, to the extent—and that is why this is so important. To the extent that an individual or a small business or a large business has a lack of trust in the IRS, that does a lot of damage to our voluntary compliance tax system. So maintaining that trust is our bottom line, and right now we have some work to do but I would point out that one of the jobs I have in building that trust is making sure that the public, this Committee, and other committees understand the nature of the problem that we had in the tax-exempt organizations world and whether it was systemic throughout IRS. And as I have mentioned in my report, we do not have evidence that those types of issues with respect to the use of inappropriate political labels for screening is systemic throughout the IRS. There is no evidence of that but we are doing extra due diligence to look at potential other areas just to make sure that we are answering taxpayer questions.

Ms. VELAZQUEZ. So let me ask you, does the IRS intend to use those findings as a blueprint for auditing specific types of businesses in certain locations around the country?

Mr. WERFEL. I do not think there is any—I would have to go back. I do not believe or have specific knowledge that some of the risk factors that would be placed into our audit selection programming would involve the type of criteria that you mentioned. I will go back, but I do not believe they do. I think it is more about we do research. We randomly select as part of a statistical study tax forms and we look at them and we conduct audits of them and we learn where there is underreporting. We learn where there is underreporting of income. We learn where there may be a lack of filing or something like that. And it could be things like confusion over how to fill out a schedule. There is a whole host of reasons why you might see a material difference between what should have been reported on a tax return and what is not. And we use that study. I do not believe we use kind of the feelings about the IRS in any way, shape, or form as a basis by which to audit.

Ms. VELAZQUEZ. Thank you.

Commissioner, the most recent Enforcement and Service Results report revealed that returns examined by the IRS of large firms has remained pretty steady over the last few years, even as more large corporate returns were filed. Yet, audits of small businesses have increased even though fewer returns were filed. Can you please explain why more attention is given to smaller firms rather than larger companies despite the fact that there was a reduction in the small corporate returns filed?

Mr. WERFEL. So I think it is something that we will have to work with you on to understand those numbers because as I understand those numbers, and Mr. Chairman, we responded to your letter and I apologize for the delay in getting that response, but the statistics that we provided to this Committee in that response show a relatively stable audit coverage rate for small businesses over the last few years. We are holding essentially steady that the audit footprint is roughly 1.4 percent of all small business returns and roughly 0.2 percent. And that is true from fiscal year 2010, 2011, and 2012. There are slight increases or decreases in the numbers, but from a macro standpoint our audit footprint over small businesses has remained relatively constant. And so I want to learn more about the data and statistics that you are referring to that point to an increase. We do not have that same information.

Ms. VELAZQUEZ. I just would like to see some reconciliation between your numbers and this report.

Mr. WERFEL. Yes. I think we need to work through that, the numbers. And maybe the response that I provided to the chairman can be a first step in making sure that there is a consistent understanding of what the trend might be with respect to the audit coverage on small businesses. What I am reporting to you now, based on the best information I have available, is that that audit coverage footprint has remained relatively constant between 10, 11, and 12. When you get—

Ms. VELAZQUEZ. I guess you need to do a better job at putting that out there.

Mr. WERFEL. That could be true. We may need to publicize that. To the extent we can, we can certainly work with—

Ms. VELAZQUEZ. Because otherwise you are going to be hammered constantly, and the constant comment is that the IRS goes

after small businesses because you need to close that gap. And that is what is out there. That is the perception. And time and again that is what people hear.

Mr. WERFEL. I understand.

Ms. VELAZQUEZ. As you may have already guessed, one of the most frequently asked questions from our nation's employers is how the employer mandate will affect their business. Unfortunately, we cannot adequately address their concerns because the final rules have yet to be released. Can you provide any information as to when we can expect the final rule on the employer mandate so that employers can get some certainty?

Mr. WERFEL. So the employer mandate, let me comment on that.

First of all, part of the challenge and approach on the Affordable Care Act implementation from the IRS's perspective, and I think from HHS's perspective, is to have a back and forth with the business community in terms of the impact of this legal impact the ACA is going to have on them. So there are a lot of moving pieces with respect to our readiness for ACA implementation. We have systems that we need to deploy. We need to get our tax filing that are relevant to the ACA ready to go, and we are making good progress and are hitting all our milestones.

But also, employers have to get ready as well. And so we have an ongoing dialogue with them. And based on that ongoing dialogue regarding what the law requires and based on that what we think employers are going to need to do to meet the statutory mandate, they reached back to us and said we have concerns about the start of this occurring in year one. And we made a judgment, or the Treasury Department made a judgment call that there was a need to have a transition period before those employer requirements would trigger.

In terms of the regulations, there are a lot of different regulations so I want to make sure that I am answering which question—which regulation you are asking for, but I can get you—I can do it now or I can do it later—but I can get you information in terms of what the exact schedule is on any given ACA regulation.

Ms. VELAZQUEZ. Thank you.

Chairman GRAVES. Mr. Rice.

Mr. RICE. Thank you, sir.

Thank you, Mr. Werfel, for being here today.

What is your history with the IRS?

Mr. WERFEL. I am a career civil servant. I joined the government in 1997 and I am coming up on my 16 year anniversary in the government. My main interaction with the IRS, prior to joining the IRS in my current capacity, was I spent a large part of my career on financial management, and in particular, efforts to reduce fraud, error, and waste in the federal government. My prior position, which is a Senate-confirmed position of controller of OMB, that is one of the main things you do at OMB as the controller—you work on government-wide efforts to reduce fraud and error. So my main interaction with the IRS was around things like EITC improper payments and things like that.

Mr. RICE. In your last job, you were managing a department or a bunch of people?

Mr. WERFEL. Yes. When I achieved my highest level within the Office of Management and Budget, let us say as of May of this year, I was managing somewhere between 100 and 150 people.

Mr. RICE. And you achieved that in May of this year?

Mr. WERFEL. Well, no, I started January of 2012, I think is when I started managing a larger footprint of people within OMB.

Mr. RICE. How many people work for the IRS?

Mr. WERFEL. Roughly 85,000.

But I would point out, just based on your question, that one of the things about the position that I held within OMB is I had leadership responsibilities over the entire financial management community. I ran the day-to-day operations of the Chief Financial Officer's Council and coordinated the activities of all CFO offices across government. And when you are doing things like implementing the Recovery Act or preparing for a potential government shutdown, the reality is the project management of that and the scope of what I was leading was large. Much larger than just—

Mr. RICE. You know, it seems to me—I do not know you. I have only met you today and I have seen you in testimony and other things, but you seem to be a very forthright and competent guy. But man, you have stepped into a big mess here. And I sure hope that you are a good manager because they need a good manager. This entity is completely out of control as far as I can tell. You have had your past commissioner just resign. You had two directors plead the fifth in the last month. You have had disclosures. You spent \$50 million on conventions at some of the worst economic downturn in United States history in the last 80 years, and disclosures that the IRS cannot even tell us what they spent because their accounting records are not that good. And at a time when we are lambasting corporate executives for money they spend on conventions and denying their deductions and lambasting them for the mode of travel they take, and yet we are spending an average of \$250,000 per convention at the IRS. So this entity is completely out of control as far as I can tell.

Mr. WERFEL. Can I respond to that?

Mr. RICE. Okay, go ahead and respond.

Mr. WERFEL. I think one of the reflections that I have, having arrived at the IRS and coming up on my two month mark, is that it is complex. There is a mixture—

Mr. RICE. Well, yes, it is complex. How many employees?

Mr. WERFEL. There is a mixture—there are very, very effective managers and leaders within the IRS. There are a lot of results that I can point to at the IRS that are extremely commendable and impressive that we need to build on. And I think it is worth noting—

Mr. RICE. My friend, when you have got three of your top people either resigning or pleading the Fifth to avoid criminal prosecution in the last month, this thing is completely out of control. And somebody, some strong manager is going to have to go in there and grab control or I do not know where we are headed with this thing.

Let me ask you this. Do you think they are ready to add to their responsibilities significantly? Do you think they are ready to take on the administration of the Affordable Care Act?

Mr. WERFEL. I think what the IRS does is it carries out the laws that are passed and it more often than not—in fact, a great majority of the time does so effectively. When we make a mistake, it is very public and very significant and we take it seriously. We are going to be ready to implement the ACA. That I am convinced of based on everything I have seen in terms of the project plan, the schedule, the milestones we have hit.

Mr. RICE. Let me reclaim my limited time.

As a taxpayer and a CPA for 25 years, I can point to numerous examples where the IRS is absolutely unresponsive and incapable of handling the job that it already has. And then you add to this all these disclosures and confusions and scandals that have come out in the last three months, and I am really, really concerned about the IRS doing its existing job, much less taking on further responsibilities. Thank you very much.

Mr. WERFEL. Okay.

Chairman GRAVES. Ms. Hahn.

Ms. HAHN. Thank you, Mr. Chairman.

I just was going to follow up on the Affordable Care Act question. Clearly, the IRS has a huge role to play, but I even think before this law is rolled out and implemented, I think you have a role to play in reaching out to Americans, particularly small businesses. I hold small business workshops in my congressional district out of Los Angeles all the time, and I have done several specifically on the Affordable Care Act, what it means to small businesses, and when the tax issue comes up, you know, there is a lot of uncertainty, there is a lot of anxiety. I think there is a lot of misinformation out there, so I am happy to do my part to educate folks on the Affordable Care Act.

But it is not just negative, right? There are some tax credits that are going to be very valuable to small businesses as this is rolled out. What are you all doing to partner with HHS, Small Business Administration, to help educate and possibly diffuse some of these misconceptions and anxiety that is out there, particularly as it relates to small businesses? I do not see you out there yet.

Mr. WERFEL. Well, that is a good question. Certainly, let me distinguish between myself personally and the IRS team. The reason why I say that is because I was in Atlanta last week and I met—not only did I go and visit with the Wage and Investment employees in the Atlantic campus in the Atlantic region, but I also had the opportunity to meet with members of the public, members of the tax professional community, tax preparer community, university community. It was a diverse group. And one of the points that was raised to me, and it was raised in several different ways, was concerns about small business. And the reality is that in order for small businesses to maintain their competitive edge to be sustainable in today's economy, they need an effective IRS that they can work with. And we did not get perfect scores from the small businesses that I met with, but they are extremely appreciative of the important role that we play and they are very concerned about, for example, our resources and the diminution of our resources and how that impacts their ability to do a bunch of things, not only contact someone at the IRS but also the way in which we modernize our forms and our files, et cetera.

So I have started that dialogue and I am finding it useful. And I think it is something useful that I can bring back to Congress, and in particular the Budget Committees, and explain that significant cuts to the IRS budget, certainly they impact the IRS but they also impact small businesses within all of your jurisdictions.

In terms of the Small Business Division, they do a lot of outreach. I was very impressed with the number of symposiums and meetings, and whether they are done electronically or in-person, and obviously, the Affordable Care Act is on everyone's mind right now because it is new and because it creates a different footprint of requirements. Their tax forms are going to start looking different in the coming years and obviously there are implications for them. So we are definitively committed to having an open dialogue with small businesses and large businesses for that matter about their responsibilities under the ACA. And if there are other suggestions you have—but I think if I walked you through the series of symposiums and forms and meetings you would find them overly impressive, but you would also see that we are somewhat constrained by our resources in terms of how much we can do.

Ms. HAHN. I got it. But I do think it is important and I just have not seen any of these out in the Los Angeles area.

Let me just quickly follow up on one more question. More and more businesses are shifting their operations onto computer and Internet platforms, from sales to accounting, invoices, inventory tracking, and other operations. So it is more important for the IRS's e-platforms to work well. I know, again, sequestration, really, you guys have taken a big hit on that. But, and I know you face a lot of obstacles, but within the constraints that you have, what procedures are you considering to operate a more efficient tax administration system as it relates to our new emerging technologies?

Mr. WERFEL. Well, I will tell you, I have a lot of budget meetings as the head of the IRS, and it is often about how are we going to apply a diminishing resource base to a growing set of responsibilities and requirements.

Just to give you an example, there is a lot of concern out there from certain parts of our constituents in terms of the pace by which we are putting forms in an online way because it makes their life much easier if they can do things in a digital environment versus a paper environment. But we have resource constraints in terms of our ability to modernize those forms, and we have to make choices, like am I going to invest in modernizing this particular form or am I going to have more people at the call center so that we can improve our overall service numbers? Or am I going to keep the Taxpayer Assistance Centers open for a longer period of time so members of a local community can come in and get direct feedback on their tax questions? These are the types of issues that behind the scenes at the IRS we are grappling with.

One part of the answer that I wanted to provide you is we try to make really smart decisions about these tradeoffs. So, for example, if we see a form that has usage rate of 12 percent versus a form that has a usage rate of 78 percent we are going to say, okay, well let us not digitize the 12 percent one even though there is a very loud community of concern if we do not, we are going to go with the 78 percent one. Those are the types of tradeoffs we are

making behind the scenes, but ultimately, taxpayers are concerned because they are not getting the full complement of modernization and service that they are hoping for.

Ms. HAHN. Thank you. Thank you. I yield back.

Chairman GRAVES. Mr. Collins.

Mr. COLLINS. Thank you, Commissioner.

I would like to maybe rock-n-roll through a little bit of this. I am chairing the Subcommittee on Health so I get more calls from small business on the Obamacare than anything else.

But I would like to begin by just asking—if you could be quick and direct that would be good—do you do your own tax return?

Mr. WERFEL. I do.

Mr. COLLINS. Good. A lot of people do not.

When we get to the 50 workers, there is a lot of confusion. Is it 30 hours a week or 130 hours a month?

Mr. WERFEL. So orient me back. You are talking about the 50 FTE cutoff?

Mr. COLLINS. We have 12 buckets. Each month we create a new bucket of whether or not, you know, how many FTEs we had in January, February, March, April, May. Then we add them up, divide by 12, and see if that averages 50 or more. And a lot of companies, to set the stage, are very worried about weeks. Monday through Wednesday are in one month; Thursday through Sunday are in another month; their payroll records are by week. So right now there are 12 buckets. Each month you have to do the calculation. And people are doing it right now because I should say the employer mandate has not been eliminated. The employer mandate is the law of this country and it goes into effect January 1. And if people are going to comply, they have to be complying in about five months. You may not enforce the penalty, but that does not mean the law has been delayed. Most of the companies I talked to want to—they do not want to be lawbreakers, so you need to be able to define for them how they are not lawbreakers whether or not you enforce the penalty.

So for each bucket each month, is it 130 hours in the month as opposed—so if you worked 40 hours, 42, then 26, and 12, as long as it added up to less than 130?

Mr. WERFEL. I apologize. I am not going to be able to speak specifically to the tech—I can certainly get you an answer to that question but the underlying technicalities of how you would evaluate your status of having 50 FTE versus 49 FTE in terms of whether your responsibilities trigger for the employer responsibilities, that is something I am going to have to get back to you on with more technicality. I just do not have that at my fingertips.

Mr. COLLINS. So the acting commissioner of the IRS does not know the rules today which we are demanding small businesses adhere to and they are lined up at my office, whether it is a donut shop or a franchise, they are desperately wanting to comply with a law that takes place January 1; the fact that you are not enforcing it until a year from January 1, it is still the law, and I am certainly disappointed that you cannot answer something. That is one of the most fundamental basic questions I had to ask.

But let me keep going here.

Mr. WERFEL. Please.

Mr. COLLINS. If a company had a husband, a wife, and three kids under 26—so that is five full-time workers—is that one health plan they have to offer? Let us say they do not offer a health plan. Husband, wife, and three kids under the age of 26. Do they get penalized five times \$2,000 or one family times \$2,000?

Mr. WERFEL. I mean, again, we are going to start to devolve into a situation where there is going to be a lot more facts that are going to need to be asked, and I am going to have particular subject matter expertise as the head of the IRS, the but the head of the IRS is not going to be the one doing those calculations and providing that legal and technical advice. So it is a question of how we use our resources effectively. You can go through the tax code in great detail and catch me in a lot of things that I am not going to know, especially being two months on the job, but my commitment here, what I am saying here as the acting commissioner and what I am very committed to you is making sure that your constituents or you, yourself, have the answers to those questions because I have professionals at the IRS who are ready, willing, and able to make sure that those answers are as crystal clear as possible. That is the commitment I can make as the head of IRS.

Mr. COLLINS. What I would like to do after this is give you a very detailed list.

Mr. WERFEL. Please.

Mr. COLLINS. These are the exact questions the owners of the donut shops and small businesses, they are the exact questions they are asking because they want to comply with the law. They do not want to be lawbreakers. And it starts right now. I mean, here we are in July. This is the qualifying year, and today the IRS cannot tell them whether these employees qualify or not. How do you calculate a bonus? If I give someone a bonus, do I back that into so many hours because somebody has done well? W-2 wages, 9.5 percent of W-2. What about 401(k) deductions? Where do they enter in? These folk want to comply with the law. We cannot get any answers out of your organization. So the fact that you are not going to enforce the penalty does not mean the law does not go into effect.

And I know most people, if they are driving down the street and the speed limit is 45, they adhere to the speed limit. They do not go 100 miles an hour because somebody said the state police was not going to be there. So I am very concerned because the clock is moving. Come January 1, that starts the next year so I would like to follow up with these questions and hopefully in a very prompt manner you can get them back so I can answer the questions of my desperate small business owners. Thank you.

Chairman GRAVES. Ms. Meng.

Ms. MENG. Thank you, Mr. Chair and Mr. Werfel for being here.

The fiscal year 2014 IRS budget request provides for an increase of over 7 percent for taxpayer services. I understand better taxpayer service and education leads to higher compliance rates. Could you explain if and how this increase in taxpayer service will be used to assist our small business taxpayers?

Mr. WERFEL. Yes, certainly.

The reality is, not to oversimplify but to provide you kind of the basic frame, the way we think about it, two of our core basic mis-

sions are services and enforcement. And on the enforcement side, you know, we have a very robust analytic frame that shows that for every dollar that we spend on enforcement activities there is a very significant return on investment for that dollar. And so when we defund our enforcement activities, ultimately it means less receipts to the federal government and that has real deficit impact.

In terms of our service levels, we invest in a whole variety of different ways to make sure that we are serving our taxpayers—small businesses in particular. Those involved, for example, our phone banks. One of the main ways in which people get answers to the questions and get peace of mind and a sense of what they need to do and cut down on the amount of time that they have to spend trying to figure out what the tax code means is calling up an IRS individual and getting them on the phone and working through the issues. And what our budgets are intended to reflect is we aim to meet certain levels of service metrics. We have metrics for everything, and our levels of service metrics are down. They are down significantly because of the inability of us to fund individuals and hire individuals to train them to be in our call centers to answer these questions. It also limits our ability to invest in web tools and other technologies so that a small business can say, well, I can either call or now the IRS has this new format on the web that makes my life a lot easier. This is great. Let me go on and access it. And when we defund the IRS we miss out on opportunities to help taxpayers navigate what I think we can all agree is a complex set of laws and regulations.

And so when I am sitting here on other committees defending the president's budget, I am not doing so I think without strong analytics that tie these increases to both return on investments for the taxpayers so that more receipts come into the federal government as appropriate and we have a better situation bottom line on our deficit and that we are financing and funding the right activities within the IRS to improve our service to small businesses, to families, to corporations, et cetera. And I think we could spend time, and I am happy to do so, in terms of how the specifics of the president's 2014 budget, what that buys you in terms of improved service levels. But it is really about services and enforcement and there is a modernization element to all of it because as we improve services and enforcement, a lot of that is about investing in new technologies and make sure the IRS is along in the 21st century with other government entities and corporations.

Ms. MENG. Thank you. I yield back.

Chairman GRAVES. Mr. Bentivolio.

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

Mr. Werfel—did I pronounce that correctly?

Mr. WERFEL. You did.

Mr. BENTIVOLIO. Thank you very much for being here today.

You said you had 85,000 employees in the IRS, plus or minus roughly.

Mr. WERFEL. There are part-time employees. There are contractors, but we usually rely on about 85,000 as a rough estimate.

Mr. BENTIVOLIO. One of the prerequisites for becoming an IRS agent, if I am not mistaken, is you have to have a background in accounting. Is that correct?

Mr. WERFEL. I think it depends on what type of work you are going to do.

Mr. BENTIVOLIO. But pretty much accounting.

Mr. WERFEL. Accounting is an important part, yes.

Mr. BENTIVOLIO. Could you tell me again what you said earlier today during the introduction on the sequester?

Mr. WERFEL. Yes.

Mr. BENTIVOLIO. How it affected the IRS?

Mr. WERFEL. Yes. Under the Budget Control Act, between the sequester and something called the 0.2 percent rescission, it is about a little over 600 million. But just the sequester itself, \$594 million reduction in our budget authority for this year as a result of the sequester.

Mr. BENTIVOLIO. And so how much is that in relation to your overall budget?

Mr. WERFEL. It took our budget from 11.9 billion down to 11.2 billion, both the sequester and the rescission.

Mr. BENTIVOLIO. What percentage would that be?

Mr. WERFEL. It is in and around 8 or 9 percent.

Mr. BENTIVOLIO. Eight or 9 percent. People in my district have been taking cuts of 15–20 percent. In some cases, now they have to work part-time. That is the only job they can get because, well, the employer mandate, you can only have so many hours and then they have got to kick in a lot of money. Amazing. And you cannot find a 9 percent cut in the IRS budget when you are doing all these fancy conventions and videos?

Mr. WERFEL. We found the cuts. We are operating on that lower base. It is a question of making sure we are transparent about what we are giving up by operating at that lower base. And ultimately, if the powers that be decide we should operate at that lower base that will happen, but I want to make sure that we are transparent with you and the American people about what trade-offs are involved in operating at that lower budget level.

Mr. BENTIVOLIO. And in regards to picking and choosing winners and losers conservative groups, so on and so forth, you said, if I am not mistaken, you do not believe that small businesses, or any business for that matter, is being singled out because of their political beliefs in any way, shape, or form.

Mr. WERFEL. What I am suggesting is that other than the TIGTA report which shelved the 501(c)4 applications, I have no other evidence at my disposal. And I do not want to speculate, but I have no other evidence of similar type of targeting of other entities. But I have asked my chief risk officer to help coordinate a review across the IRS to look at that question so I can provide a more definitive answer.

Mr. BENTIVOLIO. In that review, would you employ, let us say, cross-referencing somebody who donated to a political campaign from a FEC report to whether or not their small business was audited?

Mr. WERFEL. Again, I would say if there are any types of flagging of a taxpayer for additional scrutiny that was based on political activity, I think that is something that we should be extremely concerned with.

Mr. BENTIVOLIO. What would raise the red flag—10 to 1? For every, you know, maybe 10 businesses because the employer or the owner of the business contributed to a campaign or was involved in some tea party group or something like that?

Mr. WERFEL. A single instance of inappropriate behavior by the IRS should be flagged and addressed. I mean, we have situations in which we have employees that unfortunately at times—you know, it is 85,000 people, so we have TIGTA reports that demonstrate a situation of employee misconduct. TIGTA can write an entire report and spend a lot of resources about one instance of employee misconduct. That is important to us not only to enforce accountability for that individual and to be transparent about it, but also to make sure there is no other systemic behavior going on similar to that particular issue of misconduct. So we care about every incident.

Mr. BENTIVOLIO. Okay. So you are going to check and cross-reference?

Mr. WERFEL. Well, what we are going to do—well, then you are getting into the feasibility about what we can do, and what we are going to do is a variety of different steps, including evaluating the architecture of our screeners, our filters, how things are flagged for additional scrutiny. We can evaluate that architecture. We can make sure that we are documenting it, updating it frequently, benchmarking it against other parts of the IRS and other ways of looking, doing checks and balances to make sure it is appropriate. There is a whole process that we can go through that I think reflects very strong management approaches in terms of how you mitigate risk and error in your operations. It is very difficult to eliminate risk and error, but I think high-functioning organizations work on very robust and sophisticated frameworks to understand their risks and errors and put in place compensating controls to mitigate them to appropriate levels. And that is what we are engaging with in the IRS right now.

Mr. BENTIVOLIO. I see I am out of time. Thank you very much.

Mr. WERFEL. Thank you.

Chairman GRAVES. Mr. Barber.

Mr. BARBER. Well, thank you, Mr. Chairman. And thanks to you and the ranking member for convening this important hearing. And thank you, acting commissioner, for being here. And I have to say thank you for taking on this really sweet opportunity you have been given. It is always good in my mind when someone is willing to step up in the middle of a crisis and say I am going to tackle it and try to get things done. I really have to say from what I have seen and heard today and what I have seen and heard you say in other hearings, I think you are very forthright, and I believe you are doing everything you can to restore public trust in the IRS. The citizens of this country have to trust their government. And what happened at the IRS, I think we would all agree, was egregious. The behavior undermined confidence and trust. It was wrong. It has been acknowledged that it was wrong and I believe you are doing what you can to restore trust and good management. And I appreciate the fact that you have hired someone to take a look at risk who will keep an eye on those things for you.

I have a couple of questions because I think it has been asked and answered, the questions related to targeting, and I am not going to go over that same territory, but I have a couple of questions related to other matters that I think impact adversely or make things difficult for small businesses.

For example, recent IT reports have indicated that there is a very high rate of IRS audits that lead to no significant increase in revenue. In fact, in 2011, 62 percent of S corps cases were closed with no recorded change in revenue, and yet these audits, as you can imagine, cost affected businesses a great deal of money and time. So what steps can you take in your position as acting commissioner to ensure that small businesses are not unnecessarily audited? I mean, there has to be a cost-benefit analysis here of the amount of investment we have in audits and the end result with 62 percent cases closed without a recorded increase or change in revenue seems to me that there might be some overreaching here. So could you respond to how you might take another look at this?

Mr. WERFEL. Yeah, absolutely. I think if you are going to evaluate your mechanisms to enforce compliance, you want to evaluate them across a series of different variables. One of the ones that we are obviously prioritizing right now is fairness and selection and I think that is appropriate given the IG report raised significant questions and it provides us and inspires us to want to look across the IRS and give taxpayers comfort that we are doing that review and sharing our findings and rooting out any potential areas of concern.

But I think you also want to look at the effectiveness of your selection. And I mentioned earlier that we have ways of improving on a continuous basis our models for how we would select a taxpayer for audit. In a limited resource environment—this is very intuitive—in a limited resource environment, when you are trying to do your best and spend the taxpayer dollars as wisely as possible, you are going to try to target those dollars in a way that has the highest impact in terms of driving greater compliance. And if we see issues, whether it is identified by the inspector general, GAO, or internally we discover it, audits that we are doing are not resulting in any change or any additional revenue collected. And that is relevant data in terms of updating how you are going to do your selection going forward. So it is a continuous model of trying to make sure that we are as focused as we can on the areas of non-compliance because one of the goals here is to narrow the tax gap that we have because I think small businesses, they certainly do not want to be audited. They certainly do not want to be audited excessively. I completely understand that and we support that, but I think they also want to make sure that everyone is playing on the same fair ground and that if they are complying with the tax laws, which a vast, vast majority of them are voluntarily without ever having gotten audited, they want to make sure that the IRS is doing our part to make sure the other small businesses are being compliant as well on a voluntary basis.

And so I think there is mutual interest in making sure that our models for how we select taxpayers for audit are effective, sophisticated, fair. And so I think we are on the same page in terms of improving not just the fairness but also the effectiveness of them. And

those TIGTA reports are relevant as we go back and relook at those models.

Mr. BARBER. Just a quick follow-up on that. You talked about closing the tax gap, and I agree we need to do that. So the than auditing small businesses, which may produce limited results, what other measures can the IRS take to close the tax gap?

Mr. WERFEL. Well, I mean, it is in large measure around a combination of enforcement activities. What we try to demonstrate each year as we are planning and showing Congress our budget and the American people our budget, you know, these are the types of enforcement activities that we would engage in. We can do things like increase our efforts on identity theft. We can increase our computer sophistication when a return comes in in terms of identifying a return that might have fraud in it or might have an understatement of their income leading to a higher refund than they were otherwise eligible for.

But remember earlier when I was answering a particular question before I said there are two arms to this. There is enforcement and services. And services are important as well because effectively serving our taxpayers does two key things. It helps them navigate the complex tax code more effectively and allows them to be compliant, but it also builds trust to the sense that they are having a positive experience, they are getting the answers they need from the IRS, we are helping them navigate. It inspires that type of voluntary compliance framework to work more effectively.

So again, when we talk about our budget and the investments that we make, my goal is to just make sure that there is a substantive discussion around the tradeoffs that are involved at our different budget levels. I understand we are in a tight budget environment, and I understand that small businesses around the country are tightening their belts. We have to tighten ours. There are ways in which we are. It is a public dialogue about those tradeoffs involved in our budget.

Mr. BARBER. Thank you. And thank you, Mr. Chairman, for the additional time.

Chairman GRAVES. Mr. Tipton.

Mr. TIPTON. Thank you, Mr. Chairman. Thank you, Mr. Werfel, for taking the time to be here.

You had commented in your oral testimony about being committed to good service, having knowledge of struggling taxpayers, and trying to be able to develop policies to be able to help them. You certainly understand that the IRS is not viewed as warm and cuddly and caring. You know, it gets back to actually paying these taxes.

Mr. WERFEL. I understand that. I definitely understand that.

Mr. TIPTON. You know, but you followed that up with needing adequate resources to be able to help those taxpayers. We actually calculated it out. Even with sequestration, it was 5.8 percent reduction. Can you assure this Committee, can you assure this Congress, and most importantly, can you assure the American people that you are not going to have any more Star War parodies; that you are not going to have any more line dances? And you had noted that you had gone through in part of your previous life in terms of looking out for waste, fraud, and abuse in government, what is

being done to make sure that we really are spending those taxpayer dollars correctly?

Mr. WERFEL. I am glad you asked that question. I have a couple of responses.

First, when I arrived at the IRS, what I found is that while there are incidences out there—things like videos and the expensive conference in Anaheim—and videos are okay but we want to make sure that the videos are for the appropriate purpose and at the appropriate level of funding for those videos because we use videos to train our employees. It helps us cut down on travel. There can be a lot of value to videos. But we have to eliminate our extraneous expenditures. And what I found was a lot of procedures were put in place before I arrived. The IG report that came out on the Anaheim conference, the videos that are garnering some attention were made in some cases 2010, in some cases 2011. I am not excusing them, I am just saying what has the IRS done since then and where are we today? In July of 2013, what does our footprint look like? And we do not do conferences like we did in Anaheim anymore. That is a vestige of a past. We have new controls in place around video costs and content. Again, not excusing the prior activities, and there may be more that come out that occurred in 2010, 2011 before these procedures were put in place. But what I can assure you is that strong, robust procedures have been put in place to constrain both conference spending and any spending of extraneous costs on videos, I cannot say we are at zero risk but we are at a significantly lower risk than we were previously. And that is part of the trust building with the American people, is demonstrating how we are cutting our costs in those areas. There are very impressive results in this area.

Mr. TIPTON. But the bottom line, I guess, and I know you can understand this, what the American people's frustration, my frustration is, when we look at the IRS, just saying, "Hey, we are going to correct the problem. We are sorry. It will not happen again," and they move on down the road, do you apply those same standards to American taxpayers?

Mr. WERFEL. Again, as I said, I am not excusing the behavior. I am just providing an explanation of what steps are taken when a problem occurs. There are varying different types of mistakes and we can talk about mistakes from the IG report that led to a change in leadership at five positions within the IRS from the commissioner down to the lowest senior executive within that managerial chain. They are all—

Mr. TIPTON. Maybe we ought to move maybe to the root of the problem really because when we look at it you noted with Mr. Collins you do your own taxes. Do you do TurboTax or do you do the long form?

Mr. WERFEL. I do not want to give any favorite to anybody. I use a provider. I use a software.

Mr. TIPTON. You use a provider for that.

Do you know how many small businesses fill out their own tax returns and send them in? Is there any kind of data on that?

Mr. WERFEL. I think small businesses are roughly about 80 percent professional preparers.

Mr. TIPTON. Eighty percent. How many pages are there in the tax code?

Mr. WERFEL. Oh, gosh.

Mr. TIPTON. Seventy thousand plus? Seventy thousand plus?

Mr. WERFEL. Something like that. It is a very high number.

Mr. TIPTON. If I call up the IRS today wanting to be able to pay my taxes, to be able to do it lawfully, will whoever answers that phone guarantee me that their answer is correct?

Mr. WERFEL. That is not the way the process works.

Mr. TIPTON. That is not the way the process works when we sign the tax return. So the IRS cannot figure it out. The IRS cannot guarantee us that they understand the policies that are in place, and yet we are trying to tell the American people you must obey the law. Does this not really call for legitimate tax reform to get a flatter, fairer, and simpler tax code and to reduce the number of employees that you would need to manage just by making it sensible for the American people to work with?

Mr. WERFEL. I will answer that question. I have been asked that question numerous times. It is a very important and good question. Two things. One, as a general principle, the IRS administers whatever law Congress passes, and we rely on the Treasury Department to articulate—

Mr. TIPTON. That is not completely true though, is it, simply from the standpoint? Do you not issue rules and regulations that are not approved by Congress? It is your assumption that it meets the legislative directive?

Mr. WERFEL. Right.

Mr. TIPTON. But you do not come back and ask us if it meets the legislative directive.

Mr. WERFEL. We get feedback if there is a concern about it but the reality is—I want to answer your original question.

Mr. TIPTON. I will tell you, as a member of Congress, a lot of the frustration really is we give the feedback and it falls on deaf ears. It is kind of the assumption we are going to be here longer than you are and we are going to do it our own way. And that is the real frustration I think with a lot of the bureaucracies here in D.C.

Mr. WERFEL. If that is the message you are getting that is unfortunate. We want to partner with Congress. These are not easy issues. As you mentioned, the tax code is complex. Our responsibility at the IRS is to do what we can to carry out those complexities in the most efficient and effective mechanism. Very often we are successful. There are situations in which we are not. Those situations are normally publicized and raised as significant concerns and it is all valid.

I think we have the same objective. Our collective objective is to provide a fair and efficient and effective tax system for the American people. From IRS's standpoint, we do deal with a lot of complexities. We want to partner with both the public and Congress and others in terms of how we can continuously improve. We have problems. I understand that. Whether it is the conferences or the IG report, what I am here to say is not to excuse them. I am here to provide transparency on the nature of the problem, what we are doing to try to fix it, how we are holding people accountable—we

can certainly talk about that—how we are fixing it, and what are our future barriers right now. What barriers do we face right now to that goal of more effective tax administration? I just want to have a dialogue about that. And we are working on solutions at the IRS right now and we want to work with you on those solutions.

Mr. TIPTON. Thank you, Mr. Chairman. Far past time.

Chairman GRAVES. Ms. Chu.

Ms. CHU. Thank you, Mr. Chair.

We know that small firms, especially those that are already complying with the tax laws, fear an audit as they are expensive and time-consuming, and I know that the average amount of time an employee spends on a correspondence audit in 2008 was 1.6 hours while for a field exam was 46.4 hours. So that is quite a difference.

Does the IRS estimate the audit costs for taxpayers? And how will you ensure that increased audits do not unnecessarily burden compliance small businesses?

Mr. WERFEL. Well, we certainly look at—we certainly track the duration of an audit. I do not know whether we have an information mechanism that can give us detailed costs on an audit. I mean, we would want to be sensitive to the community in terms of not asking them for information that would increase their burden in terms of having them tracking their costs for complying with a particular audit. But I think the goal here is to achieve the right footprint. What is the optimal? The audit footprint that we maintain should have the right mixture of both correspondence and field. It should have the right mixture because the audits serve multiple purposes; right? They establish a base by which a voluntary compliance system is going to work more effectively because they deter bad behavior and incentivize good behavior. But they also, if they are driven effectively by the right risk algorithms and the right analytics, can really uncover a lot of money. And I think our revenue that we brought in from the IRS based on our enforcement activities exceeded \$50 billion last year. So there are multiple benefits there and I think the goal is to evaluate the various policy tensions that are involved in structuring those and making sure that we are making the appropriate adjustments, whether it is to Congressman Barber's question of making sure that if we are having fruitless audits, I mean, the shame of it would be if we did not learn from those fruitless audits and incorporate into our process going forward. And so that is the goal. These are some of the guiding principles that the IRS has. And again, there are a lot of imperfections but the objectives I think are the right objectives. And in many cases we are successful.

Ms. CHU. Well, one of those big decisions for a small business is the classification of workers and it continues to be a daunting decision for many small employers as to whether to work as an employee or an independent contractor. As part of the Fresh Start Initiative, which helps taxpayers and businesses address their tax responsibilities, the Voluntary Classification Settlement Program was introduced. Can you describe this program and also tell us how successful this settlement program has been and what about the Fresh Start Initiative as a whole?

Mr. WERFEL. That is a good question. One of the messages we have is about the IRS looking to work with taxpayers in a way to

help them navigate our system. But it is not just complying with every letter of the law. It is, are there changes that we can make and adjustments we can make to provide increased flexibility. So if something like they owe a debt to us and they are having trouble making up that debt, we have programs in place, like you mention, like the Fresh Start Initiative that can help kind of relevel—understand the financial hardships that a particular taxpayer might be having right now; adjusting, whether it is the payment schedule or the approach we take with that taxpayer. It is one of those things—and there is also, as you mention, voluntary reports that taxpayers can come in and provide us if they think they have a concern with their taxes. We open up our doors for them to talk about it. We create, to the best of our ability, a nonthreatening environment for them to come in and go over those issues. And we work with them collaboratively on a path forward that makes sense, that gives them peace of mind but also brings them closer into compliance. It is that type of work that I think is very critical. It demonstrates that the IRS is not in a place where if it is not—every I is not dotted and T is crossed exactly the way it is supposed to be that some kind of hammer comes down. It is demonstrating that there are avenues that you can take with the IRS to work through issues. And in particular, if there is an entity or an individual with financial hardship, we have programs in place that have proven successful over the years in providing whether it is a safe harbor or a new approach for taxpayers. They are very successful. They are very popular. I am concerned about their sustainability based on budget. It is another one of those areas where I would like to present a potential tradeoff depending on our budget levels. But I think you are raising an important point about our programs and our ability to work with taxpayers in this way.

Ms. CHU. Thank you. I yield back.

Chairman GRAVES. Mr. Schweikert.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Commissioner, in some of the discussion you have had here today you have talked about noncompliance and triggers, what sets off inquiries. I would like to do something a little bit different in some of the questions. Let us paint a scenario and then see if you can help me work through it.

I am a small business and all of a sudden I have a spike in business or a crash in my business or whatever it may be, so I have more money flowing into my bank accounts. Does the IRS in their data collection see that?

Mr. WERFEL. Likely, no. I mean, we do not access private bank accounts. There could be situations—we have third-party reports, like a 1099. So we might see a change in their interest income.

Mr. SCHWEIKERT. So you might see depending on the model of the business because most of what we would call small businesses are going to be pass-through type entities. So there might be K1s or other types of partnerships or interlocking—

Mr. WERFEL. The nature of the changing circumstance of a particular entity depends on existing mechanisms. So, for example, we get 1099 forms that report to us, you know, things like interest income and other things. So we might have insight, and that is all about trying to use third-party data sources.

Mr. SCHWEIKERT. And you are heading already where I wish to go. I am trying to understand what data accumulation the IRS collects to decide that I have a noncompliance or I have something here I need to investigate or I have someone here I need to send a letter of inquiry or someone here I need to audit. How many layers of information collection are there out there? Are you collecting from private sources? Are you collecting through regulatory sources? How does the triggering mechanisms end up working to now saying this business, something different is happening. Let us go investigate them.

Mr. WERFEL. I want to keep it general because, again, there are certain parts of our business operations that are confidential.

Mr. SCHWEIKERT. And that is a different discussion whether they should be confidential in the government.

Mr. WERFEL. But the answer to your question, again, it is one that might not be able to be effectively answered in two minutes. It varies. We might, you know, someone might come in with information, a tip, or something like that that we would use. That could be. But a large footprint of what happens is that the taxpayer will file their tax returns and then we get information after the filing is done through third-party sources.

Mr. SCHWEIKERT. Walk me through that information because you spoke earlier that much of what happens is automated in the background. That sort of indemnifies bad acts from individuals. I am now trying to understand what—not necessarily bad acts but how much data accumulation is happening.

Mr. WERFEL. I will do my best.

Mr. SCHWEIKERT. And it is a fair question because we all live in the databasing of America, but for you, does that databasing trigger when my constituents get audited?

Mr. WERFEL. Let me answer to the best of my ability and then I might want to bring in reinforcements to help me answer.

Mr. SCHWEIKERT. Okay.

Mr. WERFEL. And I am going to make the assumption that the tax return is filed electronically. But even if it is not it just takes a little bit more time as we process a paper return. But there is an upfront review of the tax return that is done—

Mr. SCHWEIKERT. It is automated?

Mr. WERFEL. Most of it is automated. It picks up on math error. It picks up on different indicators of potential fraud or error. So that happens.

Mr. SCHWEIKERT. And then it is bounced against—

Mr. WERFEL. Well, then what happens is it is flagged for potential—we might not process the return immediately. If we think there is identity theft we might hold it before we just all of a sudden process the refund. Different events would occur. That is based on a data entry. I am just trying to give you the difference because there are two points. There is data entry and then there is later.

Mr. SCHWEIKERT. In my last 60 seconds, and I know this is really complicated, let us go from the other side. You have third-party vendors providing you data that all of a sudden this business has a much greater velocity of deposits, withdrawals, deposits, withdrawals.

Mr. WERFEL. Yes, we can get that. That information does come in.

Mr. SCHWEIKERT. So it is not about what they filed; it is we are picking up something else over here.

Mr. WERFEL. Well, we will run a comparison.

Mr. SCHWEIKERT. But does this set off a trigger to go look at their filing?

Mr. WERFEL. It could. In other words, what happens is once the filing is done and we get all the 1099 or the third-party data in, we will basically run kind of an aggregate comparison. And where we see material anomalies between what was reported on the tax return versus this other information that maybe dictates that it was a materially higher revenue amount for the taxpayer than was put on their tax return, that could trigger, for example, a correspondence. They might get a letter and they might say we want you to look at this.

Mr. SCHWEIKERT. Just because I am thinking about it, as we go through certain business cycles, you know, sometimes a business gets a contract they may not be making a lot of profit on it but that contract may have a lot of in and out, in and out through their bank accounts, through their vendors, through other mechanics.

Mr. WERFEL. Yes.

Mr. SCHWEIKERT. Does that trigger?

Mr. WERFEL. I do not know. It would depend on the circumstances. In a very general matter, we would look for a material difference between what a 1099 is telling us about income going into a particular entity and what they reported on their tax form. If we see a material difference we will flag it and we will ask the taxpayer about it, whether it is through a field exam or a correspondence exam, it will depend on the situation.

Mr. SCHWEIKERT. Thank you, Mr. Commissioner. Thank you for your patience, Mr. Chairman.

Chairman GRAVES. We have a series of three votes. Would you be able to stay?

Mr. WERFEL. Yes. Whatever you need.

Chairman GRAVES. Okay. We will recess briefly and come right back and start with Mr. Payne when we get back. And please get back as quickly as possible. We are recessed.

[Recess]

Chairman GRAVES. We will go ahead and bring the hearing back to order, and we will start off with Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Werfel, on May 22nd we had Secretary Lew in front of us in the Financial Services Committee, and at that time I brought up to him an issue that was of concern to me with regards to the activities of the department within your agency that oversaw the—well, that Ms. Lerner was in charge of and oversaw the applications for tax exempt organizations. And in discussing those with him he said he was going to meet with you that following afternoon with your new job and give you directions on what he wanted to do and the situation you were in. One of the things I brought up to him at that meeting was that not only was it disclosed at that point that the IRS was unfairly targeting conservative groups—tax exempt conservative groups—but I wanted to make the point out

to him that they were not enforcing the law against some liberal organizations. There was an instance that was brought up to me by a group within my state of some activities with regards to a particular group, and I spent three years working with Ms. Lerner to try and get an investigation of that group. Myself and the other group they are working with submitted over 3,000 documents to her and never received a single remark from her with regards to how the investigation was going, whether anything was done. And so Secretary Lew pledged to me that day that he would talk to you about that and have that be investigated and that be in the report, the 30-day report that you submitted. I did not see it in the report. Did he ask you to review that situation?

Mr. WERFEL. I think one of the first things I would respond with is I have some restrictions in terms of what I can and cannot talk about with respect to an individual taxpayer because it seems that your question orients around an individual taxpayer. And delving into the specifics of the situation with that taxpayer would require a 6103 waiver or something like that. So I apologize. I do not know the answer to your question unless I can get more specifics.

Mr. LUETKEMEYER. My question is did he ask you to investigate that situation?

Mr. WERFEL. He asked me—maybe this is a good way of answering it—he asked me to broadly review a variety of different activities within the IRS to ensure fair enforcement. With respect to a particular activity, I do not have a recollection of him raising a particular taxpayer or a particular issue, but I have to go back and consult.

Mr. LUETKEMEYER. Well, one of the concerns I have is that your report, the reports that you did over a 30-day period, does not indicate any sort of investigation or oversight or even a mention of looking at the fact that there may have been a lack of enforcement by the IRS with regards to other organizations. It would lead me to believe that there was not a follow-up or he did not ask the question.

Mr. WERFEL. Let me respond in a couple of different ways. First of all, the 30-day report is a point in time. More work is needed and there is more evaluation that is underway. So to the extent that there is some topic or area that is not as robustly covered in the report that should be based on input from this Committee and others, that is something long overdue. That report was intended to set up a dialogue.

Secondly, I would have to reengage with Mr. Lew to kind of remind ourselves of conversations we had two months ago. But as a general matter, because the issue involves a specific taxpayer, I may not be able to cover it in a public report. It may be something that I need to deal with, and unless you have a waiver from that taxpayer, it may be something that I cannot even articulate in specifics with you just based on what the law is, not because I do not want to help.

Mr. LUETKEMEYER. Okay. Will you pledge to me today to investigate those folks if I send you a request?

Mr. WERFEL. I will pledge to certainly look into it. Look into the matter.

Mr. LUETKEMEYER. And respond in a timely fashion?

Mr. WERFEL. I will respond to the extent I can permitted by law. Yes.

Mr. LUETKEMEYER. But again, what my suggestion may be is that it may be appropriate for the taxpayer to provide a waiver so that I can talk directly about the situation with a particular taxpayer to you, which is done.

Mr. WERFEL. Well, they are not going to do that because they are of a different political ilk and so they are not going to be willing to do that. That is the problem is that they are being very punitive in the way they go about their activities. They are in direct violation of something you said a while ago to a degree in which they are engaged in political activities that are absolutely in violation of their 501(c)3, I believe.

Mr. WERFEL. Let me make one point since you raised the question, if I could, and that is one of the things that was in my 30-day report but as circumstances evolve it merits more discussion and attention. And I think this has been publicly reported but the facts in this case as we review more documents and talk to more people is that there is a diversity across the political spectrum of entities that were, for example, included on these lookout lists that were screened for additional scrutiny. And the reason why I am raising it is just kind of in response to the question of to the extent there was activity by the IRS that leaned in one way, aggressive scrutiny towards one end of the political spectrum and another way less aggressive scrutiny, as the facts and circumstances emerge in this case, I just want to make sure it is clear that there is a diversity across the political spectrum of entities that had issues that are covered by that TIGTA report.

Mr. LUETKEMEYER. Well, the point I am trying to make, Mr. Werfel, is this. Ms. Lerner had a political bent. She obviously was trying to be punitive in the way she looked at the conservative groups. I am saying that there is another side to this that nobody has thought about, nobody has investigated, nobody has said anything about. And that is a fact that she did not enforce the law on the other side of the political spectrum and let them get away with stuff that did not provide fair treatment to all parties who were involved in this 501(c)3 exemption. That is the point I am trying to make is there needs to be a realization and acknowledgment to the fact that she, as a member of this organization, refused to investigate it and that has to be investigated.

Mr. WERFEL. I am not aware of evidence that would support your conclusion.

Mr. LUETKEMEYER. It is in the file. The IRS has got it. Over 3,000 pages of documents. If you want me to send it again, I will be glad to do it.

Mr. WERFEL. I am telling you I am not aware of the evidence that would support it.

Mr. LUETKEMEYER. Okay. Are you willing to look into it then?

Mr. WERFEL. Yes. I mean, one of my main objectives is to look into this entire situation.

Mr. LUETKEMEYER. Okay. I am way over time. I will yield back but I think there is an important question that also needs to

be asked today by somebody. Do you share your databases with anybody?

Mr. WERFEL. We, under the law, we have certain legal responsibilities to share our data, for example, for the administration of tax purposes, yes, we share our data but we do so in a way that has an enormous number of safeguards.

Mr. LUETKEMEYER. Could you share a list with the Committee of all the agencies, all the departments across government that you share your list with? And if anybody on the private sector, any third-parties get access to that information?

Mr. WERFEL. I can. I can give you a head start on your answer, too, which is if you go to section 6103 there is a particular set of exceptions that dictate when the IRS can share information outside the IRS.

Mr. LUETKEMEYER. Will you be willing, Mr. Werfel, to give us a list?

Mr. WERFEL. Yes.

Mr. LUETKEMEYER. Of every agency in state government and all the third-party contractors that collect data that you have access to and that you have sharing agreements with?

Mr. WERFEL. We will do our best to provide you a comprehensive list.

Mr. LUETKEMEYER. Okay. Thank you very much.

Chairman GRAVES. Mr. Huelskamp.

Mr. HUELSKAMP. Thank you, Mr. Chairman. I appreciate, Mr. Commissioner, for you being here today. I would like to cover a couple things that we have briefly discuss previously and want to know under what specific statutory authority was the employer mandate penalty delayed?

Mr. WERFEL. I do not have the details on the legal analysis. The role of the IRS in that decision was to be consulted on the operational implications of this transitional relief period that the Treasury Department announced early in July.

Mr. HUELSKAMP. And did the White House visit with you directly about that period?

Mr. WERFEL. No.

Mr. HUELSKAMP. And so how did you find out about it?

Mr. WERFEL. It was a combination of two factors. One, the first step was that Treasury engaged IRS staff and consulted them on the, again, the administrative implications of a transitional relief period. And then I, in a subsequent meeting with the Treasury Department, learned that they were considering it. And again, the IRS footprint in this is what are the administrative implications?

Mr. HUELSKAMP. In the follow up to that, in the proposal you talk about voluntarily complying. Obviously, the penalty has been suspended. The 4 in 2014 has been changed to 2015 but will there be any implications particularly for small businesses if they do not voluntarily comply?

Mr. WERFEL. No. Again, the definition of small business is one that we have to make sure that we are clear on because if you have more than 50 FTE, then you have these employer reporting requirements and particular responsibilities. If you have less than 50 FTE, the situation for you as an employer is very different. But there will be no penalty. We encourage voluntary reporting but no

penalty for not reporting and no responsibility payment in the first year.

Mr. HUELSKAMP. Will there be any implications in terms of your algorithms in terms of selection for audit if folks do not voluntarily comply? You can guarantee that will not be part of that.

Mr. WERFEL. No, I will talk to the team about it and make sure but there is no intent to do that at all.

Mr. HUELSKAMP. Well, speaking of determining who receives an audit, a few weeks ago it was noted that approximately 24,000 refunds were sent to one address in Atlanta.

Mr. WERFEL. Yes, I am aware of that situation.

Mr. HUELSKAMP. How exactly does your algorithm ignore addresses? That does not show up? You do not compare addresses? That is not in the algorithm to determine whether or not we have some fraud going on?

Mr. WERFEL. That is a very important question. And what happened there, I think there was illegally obtained taxpayer identification numbers and the way in which this individual or entity sought to defraud the government, they were able to orient those in a way that we did not pick up on it as quickly as we should have. We are learning from that experience but I agree.

Mr. HUELSKAMP. Do you know how they missed it? I mean, this is not just—that is the one big instance. There are 154 different addresses that received more than 1,000 refunds to those addresses. So you do not take the address into account at all in the algorithm in determining who to audit?

Mr. WERFEL. I think we do but I have to get back to you to answer the question why this particular fraud scheme alluded us.

Mr. HUELSKAMP. And these folks that put this algorithm together or are investigating that, are they the same folk that will put together the Obamacare reporting system that will be implemented obviously for individuals beginning January 1st?

Mr. WERFEL. Not exactly. But there will be some overlap between the work that is done in terms of our enforcement of ACA and those that would look at individuals. It depends on the nature of the ACA enforcement, but there will be some overlap. Yes. Because the way it works in the IRS is we set up by wage and investment deals with individuals, small businesses deal with small businesses, so I would have to go back and understand exactly how that Atlanta-based scheme played out and who was involved. But there could be some overlap. Yes.

Mr. HUELSKAMP. Well, again, it was not just Atlanta. There were 153 other addresses.

Mr. WERFEL. Yes. No, I understand.

Mr. HUELSKAMP. And I want to make sure that we are clear on the IG report.

I have very specific, a couple regulations that are very detrimental to small businesses. One is regulation by the IRS that will require businesses with non-audited financial statements to evaluate each and every expense over \$100 to determine whether that item must be depreciated; that will kick in on January 1st. And the second one would require that any small business spending more than \$100 to repair any buildings, unit, or property subject, every single expenditure over \$100 up to nine different tests to determine

if the amount spent is an improvement. Now, that is a mouthful. I mean, that is your mouthful, not mine.

But as an absolutely ridiculous example, if a small business owner, for example, would replace a toilet in a building at a cost of \$400 under this guidance, they will be forced to depreciate that toilet over 39 years for a net deduction of \$10 every year. Now, there are a couple of very specific regulations coming on January 1st impacting small businesses. Can you explain the rationale behind these?

Mr. WERFEL. No. What you described sounds nonsensical. I would like to look into it.

Mr. HUELSKAMP. Okay. Can you provide a written response to the Committee?

Mr. WERFEL. Yes.

Mr. HUELSKAMP. Again, I believe one of these, perhaps both of them, were delayed for a year. And again, there is no specific, I do not believe, statutory authority, which is much different than the Obamacare penalty delay. But this is coming January 1st. I am hearing this from small businesses, and it is an absolute paperwork nightmare. I would appreciate very quick response.

Mr. WERFEL. I appreciate you raising the question.

Mr. HUELSKAMP. Because they are preparing for that. We are already, obviously, into the month of July and they have to start gathering this information to prepare for next January 1st.

Mr. WERFEL. I appreciate you raising the concern.

Mr. HUELSKAMP. I yield back, Mr. Chairman. Thank you.

Chairman GRAVES. Mr. Mulvaney.

Mr. MULVANEY. Thank you.

Mr. Werfel, I am going to ask you a couple of questions about the revelations that came out of Senator Grassley's office in the last couple of days.

Mr. WERFEL. Yes.

Mr. MULVANEY. Do you know the donors or candidates whose information was supposedly improperly scrutinized?

Mr. WERFEL. I talked to my staff and I think my staff spoke to the inspector general shop, so we were able to learn that information.

Mr. MULVANEY. Do you intend to tell those folk that their information was inappropriate?

Mr. WERFEL. I think that is consistent with the appropriate process.

Mr. MULVANEY. Have you all figured out yet, I think there is a report today saying that there were several instances where the disclosure may have been inadvertent, one where it was intentional and that that was conducted by a person who was not a member of your agency?

Mr. WERFEL. We have been able to confirm that the one willful, unauthorized disclosure did not occur within the IRS.

Mr. MULVANEY. How is it possible that somebody who is not within the IRS had access to that information to begin with?

Mr. WERFEL. It is a good question. As I mentioned earlier, there are legal frameworks, programs, and policies in place in which the IRS will share taxpayer information with other federal agencies and with state agencies. In particular, for example, for the imple-

mentation of Medicaid. These are the way the programs work. We set up safeguards to ensure that those informations are not breached.

Mr. MULVANEY. But you do not think it was a hacker? You think it was somebody who was—without telling me who it was because I do not want to know who it was because that is an ongoing investigation I take it.

Mr. WERFEL. That is right.

Mr. MULVANEY. It is somebody that was properly given the information; they improperly shared it beyond that?

Mr. WERFEL. It could be one of a number of things but it may be that you have, let us say, hypothetically an individual in a state revenue office who did not have a need to know the information but accessed it anyway. Something like that.

Mr. MULVANEY. Gotcha.

Mr. WERFEL. Is what we are talking about.

Mr. MULVANEY. In the cases where it was inadvertently scrutinized, do you know which members of your agency participated in that?

Mr. WERFEL. I do not have the full details yet, but in any case in which the IG reports that situation to us, we look into it and we make sure that we are taking the appropriate procedures to make sure that such an inadvertent disclosure does not happen again.

Mr. MULVANEY. Switch with me for a second to your Internet e-mail policy. According to the 2009 IRS employee handbook, your agency says the Fourth Amendment does not protect e-mails because Internet users do not have “a reasonable expectation of privacy in such communications.” Especially in light of the fact that your agency is going to be overseeing or implementing large portions of Obamacare, is it still the position of the IRS that it has the right to search, collect, and review Internet or e-mail data without a search warrant?

Mr. WERFEL. I think there is a Supreme Court decision on this.

Mr. MULVANEY. It is a Sixth Circuit case. It is not a Supreme Court case.

I am not exactly sure.

Mr. MULVANEY. Would you mind letting us know in writing as to what the policy is?

Mr. WERFEL. I will. I will.

Mr. MULVANEY. Thank you very much.

If a small business owner who also happens to be either a participant in a conservative group or a donor to a conservative group or a donor to a conservative candidate has been audited in the last say 48 months and they are naturally suspicious as to whether or not they have been targeted improperly, what is the appropriate steps for them to take to answer that question to their satisfaction?

Mr. WERFEL. I would offer two, and several are taking these steps.

One, if they believe it was inappropriate, they can refer the matter to the Treasury Inspector General for Tax Administration. And I believe TIGTA is receiving those and doing the appropriate investigations. Or they can go to the National Taxpayer Advocate and raise the issue. Now, the National Taxpayer Advocate is more

aligned to—"not that I necessarily feel I was treated inappropriately" but "I am having trouble with the bureaucracy." So it really depends on the circumstance. But if the taxpayer believes that there was really wrongful conduct going on, they should refer the matter to the IG. If I find such an issue, I certainly would refer it to the IG and have them do the appropriate investigation.

Mr. MULVANEY. So if a large donor to Mr. Huelskamp, for example, was audited for the first time in his history and is concerned that he has been targeted, you think the appropriate step is to call the inspector general?

Mr. WERFEL. If the person has a basis to believe that there was something inappropriate going on, but just based on the fact pattern that you provided, it would be very difficult for the IRS to know.

Mr. MULVANEY. How would they know if there is a basis?

Mr. WERFEL. Well, it is a good question. But I would articulate, I mean, I think out of an abundance of caution, if they felt that they were being mistreated by the IRS, they should raise the issue. But I would also articulate that I am not sure the IRS would have that information, nor know how to influence the audit footprint.

Mr. MULVANEY. Are you all worried and have talked about any potential legal liability that you may have to folks that have been targeted?

Mr. WERFEL. We have several lawsuits pending as a result of the IG report that was issued in mid-May.

Mr. MULVANEY. Have you budgeted for any losses related to that lawsuits?

Mr. WERFEL. Well, the budgeting process around litigation loss in the government is somewhat complicated. There are judgment funds that are reserve funds that pay out for those things. So the answer to your question is I have to go back and look at how we are dealing with our litigation exposure. This would not be the first time we are under litigation and we have certain budgetary procedures in place.

Mr. MULVANEY. That makes sense. And finally—and I appreciate the extra time, Mr. Chairman—I was a little bit surprised because, again, I never worked for the government—when Ms. Lerner was asked to resign several weeks ago, she declined and then she was placed on administrative leave, I believe, with pay. Okay, this is something that is completely foreign to those of us who came up in the private sector. Why was she not fired?

Mr. WERFEL. So if I could, can I lift up the discussion?

Mr. MULVANEY. Sure.

Mr. WERFEL. Because the Privacy Act—

Mr. MULVANEY. Better than dragging it down. Yes, go ahead.

Mr. WERFEL. I have to lift it up to more generalities because the Privacy Act would preclude me from commenting on a particular employee's status with respect to a disciplinary action.

Mr. MULVANEY. Understood.

Mr. WERFEL. But let me say this. It is a good question, and I am glad you raised it.

There are very specific laws and regulations in place that govern civil servant employment—how you hire them, how you pay them, how you potentially separate from the government from them,

whether it is retirement, buyout, or a disciplinary action leave. And what we do in the IRS and what I am making sure that we do is to the extent appropriate we will take the most aggressive possible action we can where we believe an individual can no longer hold a position of trust within this agency. And that is generally the steps we take. Now, there is a process, a due process that goes on and it was built to protect federal employees for a whole variety of different reasons, and there is probably a valid public policy debate we could have on those rules where if you have concerns that an individual can no longer hold the position of public trust within the government, the first step in that process is to place them on leave—it is paid leave—while you build the record and give them a chance to respond to that record about what the ultimate disposition of their employment should be.

The rules and regulations are just set up that you default while that discovery is being done and while that due process is being done, the individual is paid. It would be a violation of the law for me in a situation where I felt that an individual could no longer hold the position of public trust to move to immediate termination. There are circumstances where you can do it but it has to do with criminal violations.

Mr. MULVANEY. Just to wrap up and try to bring it back to Ms. Lerner, is that due process still ongoing or have you all made a determination as to whether or not she is able to stay with the organization within a position of trust?

Mr. WERFEL. I cannot comment on that particular situation. I will say that as a general—

Mr. MULVANEY. You can tell me if it is still ongoing or finished, can you not, without telling me any of the details?

Mr. WERFEL. No. I can tell you in a setting that is not public. I can share that information.

Mr. MULVANEY. Is she still employed by the IRS? You can tell me that.

Mr. WERFEL. Yes, she is still employed by the IRS.

Mr. MULVANEY. Thank you, Mr. Chairman. I appreciate the additional time.

Chairman GRAVES. Thank you very much. And with that I want to thank acting commissioner Werfel for being here today. We are going to continue to monitor the IRS and its treatment of small businesses. And I appreciate the fact that you designated Faris Fink as our point person and included us as a part of this review process that you are talking about. He is obviously the commissioner of Small Business and Self-employed Division and we want to interact with him.

In addition, we are also going to have some questions. There will be Committee members on both sides of the aisle that will have questions and I want you to commit to respond to those in a timely manner and as quickly as possible and as fully as possible.

With that, I would ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record.

Without objection, that is so ordered. And with that the hearing is adjourned. Thank you.

[Whereupon, at 3:33 p.m., the Committee was adjourned.]

A P P E N D I X

WRITTEN TESTIMONY OF
DANIEL WERFEL
PRINCIPAL DEPUTY COMMISSIONER
INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE SMALL BUSINESS COMMITTEE
ON THE IRS AND SMALL BUSINESSES: ENSURING FAIR
TREATMENT
JULY 17, 2013

Introduction

Chairman Graves, Ranking Member Velázquez and Members of the Committee, thank you for the opportunity to appear before you today to discuss tax matters affecting small businesses.

The mission of the IRS in regard to small businesses, and indeed to all taxpayers, is to provide quality service by helping them understand and meet their tax responsibilities, and to enforce the law with integrity and fairness to all.

The IRS takes seriously the need to provide excellent service to small business taxpayers. Small businesses and self-employed taxpayers in the U.S. are vital to our country as engines of economic growth, and the IRS needs to do its part to ensure that they can move full speed ahead and flourish. This assistance takes a number of forms to help taxpayers avoid unintentional errors in attempting to comply with the tax laws. Small businesses, from sole proprietors who file Form 1040 with a Schedule C to small corporations and partnerships, continually must face the task of familiarizing themselves with complex aspects of the tax code. Some of these provisions change from year to year, making it important for taxpayers to update their understanding each year. Assisting taxpayers with questions before they file their returns prevents inadvertent errors and reduces burdensome post-filing notices and other correspondence from the IRS.

The IRS believes it is important to conduct outreach to small businesses on changes to the tax law and the latest in filing requirements. The operation of this outreach reflects the widespread use of tax professionals by small business owners. Because the vast majority of small businesses and self-employed individuals use professional return preparers, the IRS partners with thousands of industry and small business organizations, including minority-owned business associations, tax professional and payroll associations and

other government agencies to extend and amplify our outreach and education efforts.

A major component of our outreach efforts involves the meetings, symposiums and seminars we sponsor for small business owners and the tax practitioner community each year. In FY 2012, the IRS held more than 2,000 of these events, which were attended by more than 163,000 business owners and tax professionals.

Increasingly, the IRS is employing technology to reach small business owners and help them fulfill their tax obligations. Our website, IRS.gov, includes a section that is devoted to small businesses and contains a wealth of videos, audio presentations and webinars on a wide range of tax topics, such as employment taxes, electronic filing and retirement plans geared toward small business.

We also assist business taxpayers by operating a special toll-free telephone line dedicated to small businesses, corporations, partnerships and trusts. Callers can get help with, for example, business returns or business accounts, employer identification numbers and federal tax deposit issues. A separate toll-free line for practitioners is staffed by IRS representatives specially trained to handle their questions and resolve their clients' account-related issues.

IRS-published products are also important resources for small business taxpayers. These include the Tax Calendars which provide highlights on tax topics, resources, instructions and important dates. Our electronic publication, *e-News for Small Businesses*, includes the latest IRS news releases and announcements. The quarterly *SSA/IRS Reporter* is a collaborative effort with the Social Security Administration that provides information on payroll taxes and other employee issues.

IRS Enforcement Programs

Even as we seek to ensure that our service to small businesses meets high standards, the IRS also must carry out a rigorous enforcement program. This includes administering a balanced examination program that helps ensure that taxpayers accurately report their income, deductions and credits. This also includes administering our collection program, which seeks to collect assessed tax liabilities.

The IRS collected more than \$50 billion in total enforcement revenue in Fiscal Year (FY) 2012, the third year in a row the enforcement revenue exceeded that level. The amount collected in 2012 was actually lower than in 2011 and 2010, for a number of reasons. For example, the economic slowdown contributed to lower enforcement figures, as most enforcement dollars collected resulted from audits of returns for years during the slowdown. Another factor behind the FY 2012 numbers reflected changes in agency staffing and budget resources. After a nearly flat budget in FY 2011, the IRS' FY 2012 budget was reduced by \$305 million. This reduction affected the level of staffing available to deliver service and enforcement programs. Overall full-time staffing has declined by more than 8 percent over the last two years, and staffing for key enforce-

ment occupations fell nearly 6 percent in the past year. In 2013, the IRS absorbed an additional \$618-million reduction in its budget due to sequestration, which will have further negative impacts on IRS performance, including performance in enforcement programs.

In FY 2012, the IRS audited approximately 1.65 million returns, of which 21 percent were small business returns. For FY 2011 the percentage was 22 percent, and for FY 2010, 21 percent. This group includes filers of Schedule C and Schedule F, along with small corporations, S corporations and partnerships. The 2012 small business audit rate equates to only 0.2 percent of all returns filed, and 1.3 percent of small business returns filed.

In conducting its examination program, the IRS uses a variety of techniques to focus exam resources on the areas of greatest compliance risk. As returns are processed, a majority of them are scored by a computer program for compliance risk, with a higher score indicating a higher probability that a change will be recommended during an examination. While the computer score is the most frequent reason for selecting a return for examination, there are other reasons a return may be selected. These include the need to reconcile what is reported on a taxpayer's return with third-party information provided on forms such as W-2s or 1099s.

In addition, a small business may be randomly selected for audit under our National Research Program. The results from examinations conducted under this program are used for research purposes. The information gained from these audits helps us improve our audit selection criteria and update our estimates of the tax gap, which is the amount of taxes owed but not paid on time.

The type of audit a taxpayer may undergo depends on the number and complexity of issues involved. A single issue questioned on a return will generally give rise to a correspondence audit, while multiple issues will likely result in a face-to-face exam.

For all exams, the average additional tax recommended in FY 2012 was \$23,345. Within that total, the average additional tax recommended for self-employed individuals was \$11,880 and for small corporations, \$28,988. For all taxpayers, the average cost to the IRS of a correspondence exam in FY 2012 was \$400, compared with \$324 in FY 2010. The average cost of a field exam to the IRS in FY 2012 was \$6,232, down from \$7,248 in FY 2010.

Ensuring Fair Treatment for Small Business Taxpayers

In going about our work in the enforcement area, the IRS realizes that many small businesses face substantial economic challenges, even as the economy recovers. We have worked diligently to communicate to our employees the importance of recognizing that individual taxpayers and businesses being audited may be dealing with financial hardships, and we have encouraged our employees to be flexible in these situations.

Increasing our employees' flexibility allows them to respond appropriately to taxpayers with financial troubles. Even as our economy recovers, too many small business owners continue to struggle to make their payrolls, secure lines of credit, contribute to their

employees' retirement plans and stay current with their taxes. For that reason, we will continue to make sure that our employees have the guidance and the discretion they need to assist small businesses with the service they need and deserve.

One major example of our efforts to help individuals and small business owners in this regard is the Fresh Start initiative, which began in 2011. Under this initiative, we have increased flexibility in our collection program to help taxpayers who are struggling financially. For example, we made it easier for taxpayers to obtain lien withdrawals after paying back taxes owed, and allowed liens to be withdrawn when a taxpayer signs a Direct Debit Installment Agreement (DDIA). Another provision helps more small businesses get access to Installment Agreements if they sign up for a DDIA and have less than \$25,000 in unpaid taxes. We also changed our rules for Offers in Compromise (OIC) so that more taxpayers could qualify for a streamlined OIC.

We have continued to refine the Fresh Start initiative, and further increased flexibility in our collection program in 2012. This includes easing failure-to-pay penalties for unemployed taxpayers, and expanding our Allowable Living Expenses (ALE) standard. The standard is used to provide taxpayers a fair and consistent amount to live on while they repay tax debts.

As part of our work to ensure fair treatment for small business taxpayers, we continue our focus on taxpayer burden reduction, through such efforts as simplifying forms and publications and streamlining policies and procedures. For example, as part of our effort to implement Executive Order 13610, "Identifying and Reducing Regulatory Burdens," in January 2013 we announced a simplified method for claiming the home office deduction. This new option is expected to help owners of home-based businesses by significantly reducing the paperwork and recordkeeping burden associated with calculating the deduction for business use of a home.

Another aspect of ensuring that small business owners receive fair treatment involves ensuring that they have recourse in tax disputes with the IRS. It is important to note that my plan of action for improving IRS operations, which I will describe in more detail later in my testimony, includes enhancing mechanisms for taxpayer recourse. The IRS does have the Taxpayer Advocate Service (TAS) to assist taxpayers having difficulty resolving issues with the IRS, but we concluded in our recent report that these mechanisms are not well understood by taxpayers and therefore are not being sufficiently leveraged.

Therefore, we are taking action to raise taxpayers' awareness of their rights and of the tools at their disposal for resolving issues, such as TAS. We need to be sure that all IRS employees are aware of their responsibilities with respect to ensuring taxpayers know their rights, and in particular, ensuring that taxpayers know how to engage TAS when they feel they are being treated inappropriately or are encountering excessive bureaucratic obstacles. The IRS leadership is committed to working with the National Taxpayer Advocate to evaluate the training provided to all IRS employees in this regard and modify it, as appropriate, to make necessary im-

provements to fill whatever gaps may exist in the current process or actual behavior.

It is important to note that all of the outreach, education and burden-reduction initiatives I have described in my testimony depend on the IRS receiving adequate resources to fund them. It is imperative that we be able to continue to reach out to small business owners to help them file income and payroll taxes, understand tax law changes and seek help from us in cases of financial hardship. The IRS has absorbed significant cuts in our budget in the last few years, and we have made major strides in reducing costs and finding efficiencies in our operations. Additional significant cuts to the IRS budget have the potential to weaken our ability to deliver our service and enforcement programs, including those dedicated to assisting small business owners.

Charting a Future Path for the IRS

Before concluding my testimony, I want to give the Committee a brief overview of the work we have been doing over the past several weeks to chart a new path forward for the IRS, as these efforts are important to all taxpayers, including the small business community. We have initiated a robust action plan to address needed improvements that we believe will help restore and sustain the public's trust in the IRS.

The report we released last month describes a number of important findings, aggressive actions and next steps for the IRS. The problems with the 501(c)(4) application process that were uncovered by the Treasury Inspector General for Tax Administration (TIGTA) have created significant concerns for individual and business taxpayers, and it is incumbent upon us to take swift action to ensure accountability, fix the problems that occurred and thoroughly examine other aspects of IRS operations.

Over the past month, an ongoing review of the events described in the TIGTA report has shed further light on the management failures that occurred within the IRS and the causes of those failures. There was insufficient action by IRS leaders to identify, prevent, address and disclose the problems that emerged with reviews of applications for tax-exempt status. Our report outlines management deficiencies and the steps that must be taken to correct them.

Of note, there is no current evidence of the use of inappropriate screeners or other types of criteria in other IRA operations beyond those discussed in the TIGTA report. We recognize, however, that there is public concern over the criteria the IRS adopted to review applications for tax-exempt status, a concern shared by the Committee as expressed in its recent letter to the IRS. Because we realize that more needs to be done to evaluate our screening criteria and procedures, we are establishing a review process by which screening criteria and procedures across the IRS will be periodically assessed to safeguard against any risks of inappropriate criteria.

We are also continuing to review the full range of IRS operations, processes and practices to focus on how we deliver our mission

today and how we can make improvements in the future. In that way, we will develop a better understanding of organizational risks wherever they exist in the IRS. We have a great deal of work ahead of us, and the IRS is committed not only to correcting the problems that have occurred, but also to continuing other important work of the agency.

Conclusion

Mr. Chairman, Ranking Member Velázquez, thank you again for the opportunity to testify today on the IRS service and enforcement efforts in relation to small businesses. As we continue to chart a path forward for our agency and determine what improvements are needed in IRS operations, we will do everything possible to ensure that small businesses are treated fairly and given the assistance they need to comply with our nation's tax laws. This concludes my statement, and I would be happy to answer your questions.

Questions for the Hearing Record
Submitted to Acting IRS Commissioner Daniel Werfel
Committee on Small Business Chairman Sam Graves
Following the Hearing:
"The Internal Revenue Service and Small Businesses: Ensuring Fairness"
July 17, 2013

Chairman Sam Graves

1. In my letter of May 31, 2013, I asked you for the average cost of an audit of a small business or small business owner, and the average cost of all audits (questions 5 and 6). In your response, you said the Internal Revenue Service (IRS) does not track cost of small business audits by audit type.

a. How does the return per dollar spent on small business audits compare to the amount of revenue collected from other audits?

Response

The outcome of an examination could be a no change, overassessment or additional dollars recommended. In FY 2012, the average additional tax recommended for audits of Form 1040 returns with Schedule C or F was \$11,880 and the average additional tax recommended for audits of Form 1120 returns with total assets under \$10 million was \$28,988.

In FY 2012, the average additional tax recommended for all examinations or audits was \$23,345.

Although the IRS currently does not track cost by audit type, we are evaluating potential methods of allocating costs by audit type which will enable us to compare revenue collected from other audits.

Average Additional Tax Recommended for Small Business Audits*			
	FY 2010	FY 2011	FY 2012
1040 Returns with Schedule C or F	\$10,919	\$9,865	\$11,880
1120 Returns with Total Assets under \$10 Million	\$33,199	\$26,945	\$28,988
1065 Returns	0**	0**	0**
1120S Returns with Total Assets under \$10 Million	0**	0**	0**

*Derived from 2010, 2011, and 2012 IRS Data Book, Table 9a. Examination Coverage: Recommended and Average Recommended Additional Tax after Examination by Type and Size of Return.

** These are non-taxable entities. The additional tax liability would be at the partner or investor level.

Average Additional Tax Recommended for All Audits			
	FY 2010	FY 2011	FY 2012
Total Audits	\$25,826	\$25,305	\$23,345

Derived from 2010, 2011, and 2012 IRS Data Book, Table 9a. Examination Coverage: Recommended and Average Recommended Additional Tax after Examination by Type and Size of Return.

b. If the IRS doesn't track this data, shouldn't it?

Response

The IRS is evaluating potential methods of stratifying cost data by type of return (e.g. Form 1040, Form 1040 Schedule C, Employment Tax, Form 1065). To date, we track the average cost of all correspondence examinations and the average cost of all field examinations. In FY 2012, the average cost was \$400.39 and \$6,231.64 respectively.

Examination Cost per Case		
Fiscal Year	All Correspondence Exams	All Field Exams
2010	\$324.24	\$7,248.07
2011	\$349.16	\$6,208.92
2012	\$ 400.39	\$6,231.64

- All Field Exams - includes both direct and indirect costs for SB/SE Field, LB&I and TE/GE. These include the largest, most complex cases worked by higher graded employees.
- All Correspondence Exams – includes W&I and SB/SE Campus.
- Field: The cost per case closed is calculated by dividing the total cost of field exams by the number of field exam cases closed.
- Correspondence: The cost per case closed is calculated by dividing the total cost of correspondence exams by the number of correspondence exam cases closed.

2. How much IRS staff time is spent carrying out audits on small businesses?

Response

IRS tracks the direct time spent on closed audits. The first column in the chart below shows the direct hours spent on small business cases closed in each of the fiscal years shown.

Year	Total Direct Hours
Fiscal Year 2010	5,122,296
Fiscal Year 2011	5,507,741
Fiscal Year 2012	5,476,842

- The totals above do not include Non-Direct Exam time of examiners carrying out the audits
- The totals do not include time of support staff

3. In your written testimony, you said because the IRS recognizes there is public concern over the criteria IRS adopted to review applications for tax-exempt status, a concern which I shared in my letter, IRS is establishing a review process by which screening criteria and procedures across the IRS will be periodically assessed to safeguard against any risks of inappropriate criteria.

a. What is the timetable for the review?

b. At the hearing, you mentioned you initiated a chief risk officer position at IRS, and hired David Fisher for it. Will he be heading up the review of selection and audit protocols across the IRS?

Response

The nature of the problems identified in the tax-exempt application process, coupled with the concerns raised by taxpayers, warrants a review of certain process controls within the IRS. To this end, the new Chief Risk Officer at the IRS established a plan that will initiate a comprehensive, agency-wide review of our compliance selection criteria, encompassing all business units across the IRS. To prepare for this review and assessment, we are working with the leadership of the major business units to conduct a thorough evaluation of all relevant documentation, and to prepare updates as warranted. This step will be followed by a review of these documented criteria and the process by which such criteria are developed. We will then share the assessment with the leadership of the Department of the Treasury, the IRS Oversight Board, and the Chairpersons of the House Ways and Means Committee and the Senate Finance Committee.¹

After the initial agency-wide assessment is complete, we will pursue similar reviews of these processes and selection criteria for at least one of our major business units on an annual basis, and share those results in a similar fashion. Our expectation in carrying out these new procedures is that, with respect to the effectiveness of our compliance or enforcement selection criteria, we maintain consistent and robust standards across the IRS for:

- Documentation;
- Frequency of updates;
- Benchmarking across IRS business units;

¹ Daniel Werfel, IRS. *Charting a Path Forward at the IRS: Initial Assessment and Plan of Action*. pp. 31-32. (www.IRS.gov web address: <http://www.irs.gov/pub/newsroom/Initial%20Assessment%20and%20Plan%20of%20Action.pdf>)

- Objective testing and assessments; and
- Routine collaboration with appropriate external stakeholders on the results of all the aforementioned activities.

4. At various times in the past, the IRS has established advisory committees to ensure that its programs and policies are fair and relevant. A board of outside experts, such as practitioners, small business taxpayers and others, would provide the IRS with critical input during the review process to determine whether processes will function as they should. You mentioned during the hearing that the IRS budget can impact decisions. Stakeholder assistance can be particularly helpful to the IRS in these times of tight budgets. Will the IRS commit to establishing a committee of stakeholders, including small business owners and practitioners who assist small business owners, to offer input as the audit selection process is in progress and to review the audit results?

Response

The Internal Revenue Service has several advisory groups established under the Federal Advisory Committee Act (FACA). However, the Internal Revenue Service Advisory Council (IRSAC) is the overarching committee that focuses on specific issues. The IRSAC has a subgroup that is dedicated to address small business issues. The Internal Revenue Service Advisory Council (IRSAC) formerly known as the first Advisory Group to the Commissioner of Internal Revenue – or the Commissioner's Advisory Group ("CAG") – was established in 1953 as a "national policy and/or issue advisory committee." Renamed in 1998 to reflect the agency-wide scope of its focus as an advisory body, the IRSAC's primary purpose is to provide an organized public forum for senior IRS executives and representatives of the public to discuss relevant tax administration issues. As an advisory body designed to focus on broad policy matters, the IRSAC reviews existing tax policy and/or recommends policies with respect to emerging tax administration issues. The IRSAC suggests operational improvements, offers constructive observations regarding current or proposed IRS policies, programs, and procedures, and advises the Commissioner with respect to issues having a substantive effect on federal tax administration.

The IRSAC is structured into four groups, each dedicated to the specific needs of similarly situated taxpayer segments. This centralized focus was intended to facilitate uniform and consistent practices across geographic areas. To develop a diverse advisory council, the selections are based on several factors including: geographic location, major stakeholder representation and customer segments, such as large and mid-size businesses, international, small business, practitioners, and wage and investment stakeholders. Members may also bring forth issues, but to do so, the issue must be presented to the full IRSAC, noting the number of taxpayers affected by the issue and establishing the priority and relevance of the issue. At the request of any IRS operating division or external stakeholder, the advisory IRSAC group may/will work on or offer assistance and recommendations on emerging issues, such as the audit review and

selection process while in progress and provide feedback during the review of the audit results.

5. In these times of smaller budgets, what changes does the IRS foresee to audit programs?

Response

A smaller budget will require some adjustments by the IRS that will impact taxpayers. Continued smaller budgets will force us to choose between maintaining reasonable levels of enforcement activity or significantly weakening other programs. Recently, the National Taxpayer Advocate wrote in her 2012 Report to Congress: "The significant, chronic underfunding of the IRS poses one of the most significant long-term risks to tax administration today, including reduced revenue collection, impaired taxpayer rights, and greater taxpayer burden." In FY 2013, the IRS operated at a budget almost \$1 billion below FY 2010 levels. Full-time permanent staff at IRS have declined by more than 9,000 positions since implementing a hiring freeze in December 2010. While IRS made efforts to mitigate the impact of these cuts on enforcement functions, there could be a decline in enforcement revenue of up to \$3 billion and other core enforcement actions will be adversely impacted, resulting in a significant reduction in: the number of individual and business audits completed, Automated Underreporter contact closures, collection actions, and appeals and litigation case closures. Moreover, a decrease in enforcement action may also lead to a decrease in voluntary compliance.

a. Could changes add costs to the taxpayer due to longer processing times?

Response

In Field Exam, we expect to conduct fewer audits but do not anticipate longer processing times in audit programs. In Correspondence Exam, we have already seen a major impact to the age of taxpayer correspondence because of the reduced budget. Correspondence Exam started audits based on initial approved funding. Significant reductions in funding during the fiscal year (sequestration, overtime cuts, furloughs, and hiring freezes) caused a backlog of correspondence from inventory already in the pipeline, resulting in longer processing times causing increased burden to taxpayers.

b. Does the IRS believe additional third party reporting is a solution to fewer IRS resources?

Response

Voluntary compliance is higher when income and/or deductions are subject to information reporting by third parties. So, additional third party reporting could be beneficial in reducing the tax gap. Third-party reporting allows the IRS to address underreporting of specific income/over-reporting of specific deductions through a most cost-effective notice process; however, resources are still required to answer taxpayer responses to the notices. Recent budget cuts that the IRS has absorbed have affected

the upcoming filing season. Elimination of practitioner electronic services, longer waits for help at taxpayer assistance centers and for phone assistance have a very real impact on our ability to deliver taxpayer services. IRS's increased efforts in critical areas such as stolen identity refund fraud have been possible only by reallocating resources from other enforcement activities and service programs. The IRS will need more resources in order to continue to address critical areas of identity theft and refund fraud and to deliver taxpayer services.

c. If expanded third party reporting is envisioned, how will the IRS measure the burden that the additional reporting could place on a small business?

Response

The IRS has been developing an updated set of burden estimation models based on recent taxpayer burden survey responses. These models help the IRS better understand the current baseline and how changes in the law and regulations can be expected to affect those costs. The IRS has recently initiated a study designed to update our understanding of the costs associated with issuing information returns. Through this effort the IRS seeks to better support both burden reduction and consideration of respondent burden in legislative implementation efforts. The President's Fiscal Year 2014 Budget contains a legislative proposal to expand third party reporting to private separate accounts of life insurance companies. This is one example of how IRS believes third-party reporting could be helpful. We will continue to address burden as these types of improvements are proposed.

d. What taxpayer services or compliance programs, if any, will be reduced or ended to provide needed resources to enforce the health care law?

Response

In general, for any given fiscal year, the IRS faces challenges when it does not receive the requested funding. With our responsibilities to administer all of the tax laws, including to implement the tax provisions of the Affordable Care Act, the IRS must balance our responsibilities to provide services to taxpayers, follow up on potential non-compliance, and invest for the future in information technology and workforce development. The IRS expects to answer approximately 3 million ACA-related telephone calls, in addition to the projected 33 million non-ACA related calls. Without the requested funding in FY 2014, this 10% increase in call volume would have a significant impact on IRS' ability to ensure there is no degradation or disruption in the telephone service and other services currently available to taxpayers.

6. You acknowledged in your testimony that "there was insufficient action by IRS leaders to identify, prevent, address and disclose the problems that emerged with reviews of applications for tax-exempt status."

- a. How will the IRS be changing the architecture of the protocol for small business audits utilized by IRS leaders in the future?
- b. How often will the protocol be reviewed for fairness, reasonableness and effectiveness?
- c. How often will the implementation of the protocol be reviewed?

Response

As stated in the testimony, we have initiated a robust action plan to address needed improvements in the Exempt Organizations operating division to restore and sustain the public's trust in the IRS. Of note, there is no current evidence of the use of inappropriate screeners or other types of criteria in other IRS operations beyond those discussed in the TIGTA report.

We understand the public concern over the criteria the IRS adopted to review applications for tax-exempt status, a concern shared by IRS management and the Committee. Because we realize that more needs to be done to evaluate our screening criteria and procedures, as noted in the document "*Charting A Path Forward at the IRS: Initial Assessment and Plan of Action*," we are establishing a comprehensive, agency-wide review of our compliance selection criteria, encompassing all business units across the IRS. Under this review process, screening criteria and procedures across the IRS will be periodically assessed to safeguard against any risks that inappropriate criteria could be used. Because that review process is just beginning, we have not yet established how often the protocols and implementation will be reviewed.

- 7. You referred in your testimony to a special toll-free telephone line dedicated to small businesses, corporations, partnerships, and trusts. However, on the IRS's website, there appears to be only a telephone number listed for businesses, not small businesses: <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/IRS-Hotlines-and-Toll-FreeNumbers>. That does not appear to be dedicated to small businesses; what is the small business telephone number?**

Response

Although the IRS does not have a telephone line dedicated solely to small businesses, all small businesses can get help by calling the Business and Specialty Tax Line. Assistance is available on many tax matters, including employment and payroll taxes, Employee Identification Numbers, information and/or help with business returns or business accounts, and ordering free publications and forms.

The IRS has also expanded its use of technology to provide assistance. Our website at irs.gov includes a comprehensive section geared toward small business taxpayers. It contains a wealth of videos, audio presentations and webinars on a wide range of tax topics.

A series of videos provides assistance on both audit and collection matters. The examination series, *Your Guide to an IRS Audit*, follows three hypothetical small businesses through the audit steps, from notification to closing. The collection series, *Owe Taxes? Understanding IRS Collection Efforts*, covers topics that are helpful when working with the IRS to resolve unpaid taxes and unfiled returns.

The *Virtual Small Business Tax Workshop* is a free interactive Web application that provides training to small business owners on navigating federal taxes, offers the convenience of 24/7 availability, and is updated as tax law changes take effect. *Filing Season Central* is a one-stop resource for filing and paying business taxes.

IRS-published products are also important resources for small business taxpayers. These include the Tax Calendars, which provide highlights on tax topics, resources, instructions and important dates. Our electronic publication, *e-News for Small Businesses*, includes the latest IRS news releases and announcements. The quarterly SSA/IRS Reporter is a collaborative effort with the Social Security Administration that provides information on payroll taxes and other employee issues.

8. Does the IRS ever match information from one IRS database to another to help it determine the size or type of a small business?

Response

No, the size and type of a small business are determined based upon information included in the tax return.

9. On average, how long does it take from the time a small business is notified it will be audited until the audit closes? Is it possible to actually commence the audit soon after the taxpayer is notified, both to reduce the burden on small businesses and increase the chance that the funds are collectible?

Response

The IRS makes every effort to commence audits including audits of small businesses as soon as possible after a taxpayer has been notified. There are no special audit processes specific to small businesses. The processes described here apply to all types of taxpayers. For audits conducted primarily through correspondence, the notification and commencement of the audit are simultaneous. The issuance of the Initial Contact Letter (ICL) begins the audit process and serves as the first notification to the taxpayer. For audits conducted in person, notification and commencement of the audit are not simultaneous. The revenue agent works with the taxpayer (or taxpayer representative) to schedule the initial appointment at a mutually agreeable time. General IRS audit procedures, which are available to taxpayers and practitioners, provide that every effort should be made to schedule the initial appointment within 14 days of the first action on the case. The IRS and taxpayer may agree to a later start date to accommodate the

taxpayer's schedule or permit the taxpayer additional time to prepare for the start of the audit.

10. On average, over the course of an audit, how many contacts (such as notices, phone calls, information sent in writing, meetings, etc.) are made between the small business and the IRS?

a. In FY 2012, how many instances occurred with more than ten contacts, and over what period of time? This matters because a situation where there are five contacts in one day is quite different from five over a period of two years. In that case, the small business owner must find the files, be re-educated about the facts, and operate the business with the continuing uncertainty of tax liability.

Response

The IRS does not systemically track the total number of contacts between the IRS and taxpayers, or taxpayer representatives, during the course of an audit. Examiners record contacts in the audit case file, but there is no systemic report to calculate the average number of contacts across all audits or to identify audits with a specific number of contacts.

The number of contacts made during an audit varies based on the type of audit being conducted and the facts and circumstances of each case. Contacts between the taxpayer (and/or the taxpayer representative) and the IRS occur at different times throughout the course of an audit based on the need to exchange information, verify records, and discuss potential findings. The audit process is designed to balance the interest of timely audit completion with the objective of minimizing the burden taxpayers experience during the audit.

b. What are the IRS's goals for the number of contacts over the duration of a small business audit?

Response

The IRS has no specific goals for the number of contacts over the course of a small business audit. The number and type of contacts made during an audit vary from case to case based on the facts and circumstances of each case and by the type of audit being conducted.

11. Some small business owners have told the Committee that during an audit, they have contact with multiple IRS employees, never know who will respond, don't have a direct contact number to reach one point person, and generally find it difficult to contact or provide information to the IRS. What is the IRS doing about these customer service issues and to help small businesses who are undergoing an audit?

Response

During audits conducted in person, generally the originating examiner will work with the taxpayer throughout the examination and provide the taxpayer with contact information for his/her group manager (name and phone number). If there is a need to assign the examination to another examiner during the course of the examination, the taxpayer will be notified of the reassignment. After the examination is completed, taxpayers are provided with new contact information in all subsequent correspondence.

During a correspondence audit, a taxpayer may speak to several people about their case. A toll free contact number is provided at the top of each notice to the taxpayer. Each notice also includes an address, a return envelope and a fax number for the taxpayer to submit documentation. While the audit is generally assigned to one examiner, once a response is received, our toll-free line is designed so that calls are answered by the next available assistor nationwide. The assistor answering the call has access to the case notes and should be able to answer questions about the audit and the documentation needed. If a discussion with the assigned examiner is necessary, the assistor is to leave a note on the case file for a call back by the assigned examiner.

As a result of feedback from practitioners, taxpayers and employees, we looked into concerns regarding call-backs and found that established procedures weren't always followed. As a result, we reinforced our procedures in a briefing delivered to all correspondence examination employees in June. Future reviews are planned to ensure that these procedures are being followed.

12. Has the IRS ever done a study to examine the cost to the taxpayer to be represented during an audit?

Response

The IRS is currently conducting a post-filing burden study to collect information on both time burden and representation costs of individual taxpayers in response to IRS examinations. The study population includes sole-proprietors. The only business form included is sole proprietors. This is the first study of its kind in which the IRS is looking at burden in this depth. The study includes individual taxpayers and sole proprietors. Burden studies on other business forms are planned for the future.

13. The Office of the National Ombudsman, an office within the Small Business Administration, evaluates each federal agency's assistance to small businesses in resolving regulatory enforcement issues. In the Ombudsman's most recent report to Congress, the IRS took an average of 181 days to respond to the Ombudsman's office regarding small business concerns longer than any other federal agency except one. What specific steps will you take to resolve the concerns of small entities more efficiently and effectively?

Response

The National Ombudsman rates federal agencies based on timeliness, quality, non-retaliation policy, compliance assistance, providing information about Small Business Regulatory Enforcement Act (SBREFA), and overall. In its most recent Report to Congress, the National Ombudsman gave the IRS a "B" for timeliness, an "A" for quality, an "A" for non-retaliation policy, an "A" for compliance assistance, an "A" for providing information about SBREFA, and an "A" overall.

Cases referred to the IRS pursuant to the SBREFA are generally assigned to the IRS's Taxpayer Advocate Service (TAS). The TAS organization receives relatively few SBREFA cases. For context, TAS has recently been receiving an average of around 270,000 taxpayer cases in each fiscal year. By contrast, during the 21 months from the start of FY 2012 (Oct. 1, 2011) through June 30, 2013, TAS closed nine SBREFA cases. In the Ombudsman's most recent report, it was noted that eight cases were open as of Feb. 1, 2012. (SBREFA cases constitute a tiny fraction of the small business cases in TAS's inventory. Each year, TAS assists thousands of small business taxpayers whose cases come from non-SBREFA channels, including from congressional referrals.)

TAS follows special procedures to ensure that SBREFA cases are fully reviewed and that the small businesses involved in these cases are assisted to the maximum extent possible. TAS's goal is to handle SBREFA cases in a timely manner and to help the taxpayer achieve the correct result. The National Taxpayer Advocate (NTA), who leads TAS, has had numerous conversations with the SBA Ombudsman's Office over the past decade about its timeliness criteria. Those discussions have led to changes in procedures by both organizations:

- On the IRS side, SBREFA cases prior to FY 2006 were not centralized and took almost twice as long to complete as they take today. In FY 2005, the average SBREFA case required 336 days to close. To help TAS work SBREFA cases more effectively, the National Taxpayer Advocate at that time directed that the Local Taxpayer Advocate office in Washington, D.C would handle all SBREFA cases. This policy has substantially reduced cycle time.
- On the Ombudsman's side, there is greater awareness that tax cases are unusually complex and time-consuming. That is why, although the SBA Ombudsman generally gives an "F" to agencies that average more than 120 days in resolving cases, we have worked out procedures whereby TAS provides interim responses to the Ombudsman. Under these procedures, the Ombudsman gave the IRS a "B" on timeliness in its last report despite the longer case-resolution time.

While timeliness and quality are both important goals, they sometimes conflict. When a case is worked quickly, details can be overlooked. The NTA believes strongly that helping the taxpayer achieve the best result possible is a more important goal than getting a quick answer.

Although the number of SBREFA cases that come to the IRS is small, they usually present complicated issues and generally are referred only after the IRS has made an adverse decision that the small business is seeking to challenge. To help a small business obtain relief, TAS must carefully analyze the facts the taxpayer presents, determine whether there are related issues or arguments that the taxpayer did not present or the IRS did not consider, request documentation to support each of the taxpayer's arguments, help the taxpayer develop the arguments, and ultimately, where appropriate, persuade the IRS that it erred and should change its position. These steps typically require significant back-and-forth interactions with both the taxpayer and the IRS.

The NTA personally reviews every SBREFA case to ensure TAS is doing everything it can to advocate for the taxpayer. Then, after the case is resolved, TAS prepares a letter to the Ombudsman that the NTA reviews and signs, describing the case in detail and identifying any systemic problems that surfaced along with recommendations to address them. Depending on the complexity of the issues, the letter may be completed several weeks after the case has been resolved and the taxpayer has received relief, yet this additional time is included as part of the cycle time of the case from the Ombudsman's perspective.

Overall, TAS is effective in obtaining relief for taxpayers and receives high customer satisfaction scores. In FY 2013 to date, TAS has obtained relief for taxpayers in 79 percent of the cases it has closed (nearly 200,000), and 90 percent of taxpayers who have used TAS report in customer satisfaction surveys conducted by an outside firm that they are satisfied or very satisfied with the services they received. Among the nine cases TAS closed over the recent 21-month period delineated above, the TAS obtained relief for the taxpayer in seven cases and provided assistance (but not relief) in two cases. In most cases where a taxpayer does not receive relief, TAS ultimately agrees with the IRS that the taxpayer is not legally entitled to relief under law. Where TAS disagrees with an IRS determination to deny relief, the NTA may issue a Taxpayer Assistance Order pursuant to Internal Revenue Code section 7811 directing the IRS to provide relief, and the IRS must comply with the order unless it is modified or rescinded by the Commissioner or Deputy Commissioner.

During the pendency of SBREFA cases, TAS keeps in regular contact with the small businesses it is attempting to assist. TAS will continue to give priority to SBREFA cases and provide the best possible combination of quality and timeliness to these small business taxpayers.

It should be emphasized that the overwhelming majority of small business taxpayers that TAS assists come to TAS directly rather than through the SBA's Office of the National Ombudsman. As compared with less than a dozen pending SBREFA cases, TAS handled about 18,000 cases involving small business taxpayers during FY 2013. The median cycle time for those cases was 70 days and the mean cycle time was about 100 days. (The mean is typically longer than the median for TAS cases because a relatively small number of complex cases are kept open while other IRS functions do additional

work.) Thus, the cycle time of non-SBREFA small business cases is nearly half the cycle time for SBREFA cases.

Rep. Blaine Luetkemeyer

1. On May 22, 2013, the House Financial Services Committee held a hearing in which Treasury Secretary Lew informed me that he would discuss with you an ongoing inquiry I have had with the IRS in respect to an organization's tax-exempt status. I understand that you may not be able to fully disclose the information on an investigation, but in the House Small Business Hearing on July 17, 2013, you commented that you did not know about the evidence I had submitted to the IRS on a number of occasions but pledged to look into it. The latest letter I sent was on May 17, 2013 to the Inspector General for Tax Administration as well as to the Attorney General and the Secretary of the Treasury Department. Prior to those letters, I corresponded with the IRS on a number of occasions from March 23, 2010 to October 9, 2012. If you need me to re-send any of this documentation or provide you with a copy of any of my letters, please contact my office at 202-225-2956. I hope to hear from the IRS regarding this investigation at your earliest convenience.

Response

I am aware of your previous inquiries. As we have indicated to you in the past, we are unable to comment on this type of situation.

2. Also, at the end of my questioning on July 17, 2013 in the House Small Business Committee, I inquired about the IRS's sharing of databases and you agreed to provide the committee with a complete list. Therefore, I would once again ask, With what agencies, federal departments, state governments, government contractors, and any other third parties does the IRS share its database-both in full or in part?

Response

As of July 17, 2013, the IRS shares its master file data base, in full or in part, with the agencies, federal departments, state governments, government contractors and other third parties listed on the attached spreadsheet. Please note that all contractors or private contractors listed are under contract with the IRS to perform specific services and, like all IRS data sharing partners, they maintain regulated safeguards related to the data being shared. **(NOTE: Insert 'DataSharingPartners - FINAL.xls' Excel spreadsheet attachment here)**

Rep. Mick Mulvaney

22nd Century Technologies, Inc.
Alabama Child Support Enforcement
Alabama Department of Human Resources
Alabama Department of Labor
Alabama Department of Revenue
Alabama Medicaid Agency
Alabama Securities Commission
Alaska Department of Health & Social Services
Alaska Department of Revenue, Child Support Services Division
Alaska Division of Banking and Securities
American Samoa Department of the Treasury
American Society of Association Executives (ASAE), The Center for Association Leadership
Amy Dunbar (Contractor)
Andrew Duxbury (Contractor)
Arizona Department of Economic Security
Arizona Department of Economic Security, Division of Child Support Enforcement
Arizona Department of Economic Security, Unemployment Insurance Administration
Arizona Department of Financial Institutions
Arizona Department of Revenue
Arizona Department of Transportation
Arizona State University, Research Consultant
Arkansas Department of Finance and Administration
Arkansas Department of Finance and Administration, Child Support Enforcement
Arkansas Department of Human Services
Arkansas Department of Workforce Services
Arkansas Securities Department
ASR Analytics LLC
B. Erard & Associates
Bank of America, Merrill Lynch
Booz Allen Hamilton
Brilliant
California Department of Child Support Services
California Department of Financial Institutions
California Department of Justice
California Department of Social Services
California Employment Development Department
California Franchise Tax Board
California Office of State Controller
California Office of the Attorney General
California State Board of Equalization
Centers for Medicare & Medicaid Services (CMS)
CEO Update Newsletter
CGI
Charity Navigator

Colorado Department of Corrections
Colorado Department of Human Services
Colorado Department of Human Services, Division of Child Support Enforcement
Colorado Department of Labor & Employment
Colorado Department of Revenue
Colorado State Bank Commissioner
Congressional Budget Office
Congressional Joint Committee on Taxation
Connecticut Department of Banking
Connecticut Department of Labor
Connecticut Department of Revenue Services
Connecticut Department of Social Services
Connecticut Department of Social Services, Bureau of Child Support Enforcement
Delaware Department of Finance
Delaware Department of Transportation
Delaware Health and Social Services
Delaware Health and Social Services, Child Support Enforcement
Delaware Office of the State Bank Commissioner
Deloitte
Department of Agriculture
Department of Commerce, Bureau of Economic Analysis
Department of Defense, Defense Manpower Data Center
Department of Defense, Defense Logistics Agency
Department of Education
Department of Health & Human Services, Administration for Children and Families, Office of
Department of Health & Human Services, Departmental Appeals Board
Department of Health & Human Services, Office of Medicare Hearings & Appeals
Department of Homeland Security, Federal Emergency Management Agency (FEMA)
Department of Homeland Security, Immigration & Customs Enforcement (ICE)
Department of Homeland Security, Secret Service
Department of Homeland Security, US, Customs and Border Patrol (CBP)
Department of Justice
Department of Justice, Federal Bureau of Investigation (FBI)
Department of Labor
Department of Transportation
Department of Treasury
Department of Treasury, Financial Crimes Enforcement Network (FinCEN)
Department of Treasury, Financial Management Service (FMS)
Department of Treasury, Office of Tax Analysis (OTA)
Department of Treasury, Treasury Inspector General for Tax Administration (TIGTA)
Department of Veterans Affairs
Department of Veterans Affairs, Veterans Benefits Administration
Department of Veterans Affairs, Veterans Health Administration
District of Columbia, Department of Human Services

District of Columbia, Office of the Attorney General, Child Support Services Division
District of Columbia, Office of the Chief Financial Officer, Office of Tax and Revenue
DRC
Dun & Bradstreet
Eastport Analytics
Economic Research Institute
Emmanuel Saez Research Associates
Equilar
Erin Henry (Contractor)
Federal Reserve Board of Governors
Florida Department of Children & Families
Florida Department of Revenue
Florida Department of Revenue, Child Support Enforcement
Florida Office of Financial Regulation
FORS Marsh Group (FMG)
Foundation Center
Futurenet Group, Inc.
George Plesko (Contractor)
Georgia Department of Banking and Finance
Georgia Department of Human Services
Georgia Department of Labor
Georgia Department of Revenue
Georgia Division of Child Support Services
Government Accountability Office (GAO)
Government Services Administration (GSA)
Guam Child Support Enforcement Division
Guam Department of Revenue & Taxation
Guidestar
Hawaii Child Support Enforcement Agency
Hawaii Department of Attorney General
Hawaii Department of Human Services
Hawaii Department of Labor and Industrial Relations, Unemployment Insurance
Hawaii Department of Taxation
ICF MACRO International
Idaho Department of Finance
Idaho Department of Health & Welfare
Idaho Department of Health & Welfare, Child Support Enforcement Agency
Idaho Department of Labor
Idaho State Tax Commission
Illinois Attorney General
Illinois Department of Financial and Professional Regulation
Illinois Department of Healthcare and Family Services, Division of Child Support Services
Illinois Department of Human Services
Illinois Department of Labor

Illinois Department of Revenue
Indiana Department of Child Services, Child Support Bureau
Indiana Department of Financial Institutions
Indiana Department of Revenue
Indiana Family & Social Services Administration
Infanata, Inc.
Inforeliance Corporation
InSysCo
Iowa Department of Human Services
Iowa Department of Human Services, Child Support Recovery
Iowa Department of Revenue
Iowa Workforce Development
Kansas Department for Children and Families, Child Support Services
Kansas Department of Children and Families
Kansas Department of Labor, Unemployment Insurance Tax Division
Kansas Department of Revenue
Kansas Office of the State Bank Commissioner
Kentucky Cabinet for Health and Family Services
Kentucky Cabinet for Health and Family Services, Department for Income Support, Child
Kentucky Department of Revenue
Kentucky Education and Workforce Development Cabinet, Department of Workforce
Investment, Office of Employment and Training, Division of Unemployment Insurance, Tax
Kentucky Lexington/Fayette Urban County Government
Kentucky Louisville Metro Revenue Commission
Kentucky Office of Financial Institutions
Laducer & Associates Inc
Louisiana Child Support Enforcement
Louisiana Department of Children & Family Services
Louisiana Department of Health & Hospitals
Louisiana Department of Revenue
Louisiana Office of Financial Institutions
Louisiana Workforce Commission
Maine Department of Health and Human Services
Maine Department of Health and Human Services, Division of Support Enforcement and
Maine Department of Labor, Bureau of Unemployment Compensation
Maine Office of Consumer Credit Regulation
Maine Revenue Services
Maryland Commissioner of Financial Regulation
Maryland Comptroller of Maryland
Maryland Department of Assessments and Taxation
Maryland Department of Human Resources
Maryland Department of Human Resources, Child Support Enforcement Administration
Maryland Department of Labor, Licensing, and Regulation
Massachusetts Department of Revenue

Massachusetts Department of Revenue, Child Support Enforcement Division
Massachusetts Division of Banks
Massachusetts Executive Office of Health and Human Services
Massachusetts Executive Office of Labor and Workforce Development, Department of
Mathematica Policy Research
Metasoft Systems, Inc.
Michigan City of Detroit Finance Department
Michigan Department of Human Services
Michigan Department of Human Services, Office of Child Support
Michigan Department of Treasury
Michigan Keweenaw Bay Indian Community Tribal Child Support Enforcement Agency
Michigan Office of Financial and Insurance Regulation
Michigan Office of the Auditor General
Michigan Unemployment Insurance Agency
Minnesota Department of Commerce
Minnesota Department of Employment and Economic Development
Minnesota Department of Human Services
Minnesota Department of Human Services, Office of Child Support Enforcement
Minnesota Department of Revenue
Minnesota Red Lake Band of Chippewa Indians Tribal Child Support Enforcement Agency
Minnesota White Earth Nation Tribal Child Support Enforcement Agency
Mississippi Child Support Enforcement
Mississippi Department of Banking & Consumer Finance
Mississippi Department of Employment Security
Mississippi Department of Human Services
Mississippi Department of Revenue
Missouri City of Kansas City Finance Department
Missouri City of St. Louis Collector of Revenue
Missouri Department of Labor & Industrial Relations, Division of Employment Security
Missouri Department of Revenue
Missouri Department of Social Services
Missouri Department of Social Services, Family Support Division, Child Support
Missouri Division of Finance
MITRE Corporation
Montana Department of Public Health & Human Services
Montana Department of Public Health & Human Services, Child Support Enforcement
Montana Department of Revenue
Montana Department of Transportation
National Archives & Records Administration
National Science Foundation
Nebraska Department of Health and Human Services, Division of Children and Family
Nebraska Department of Health and Human Services, Economic Assistance Unit
Nebraska Department of Labor
Nebraska Department of Revenue

Nebraska Dept. of Banking and Finance
Nevada Department of Employment, Training & Rehabilitation, Employment Security Division
Nevada Department of Employment, Training and Rehabilitation
Nevada Department of Health and Human Services
Nevada Department of Health and Human Services, Division of Welfare & Supportive
Nevada Department of Taxation
New Hampshire Banking Department
New Hampshire Department of Health & Human Services, Division of Child Support Services
New Hampshire Department of Health and Human Services
New Hampshire Department of Revenue Administration
New Hampshire Department of Safety
New Hampshire Employment Security
New Jersey Department of Banking and Insurance
New Jersey Department of Human Services
New Jersey Department of Human Services, Division of Family Development, Child Support
New Jersey Department of Labor & Workforce Development
New Jersey Department of Treasury, Division of Taxation
New Mexico Employment Security Commission
New Mexico Human Services Department
New Mexico Human Services Department, Child Support Enforcement Division
New Mexico Taxation and Revenue Department
New York City Department of Finance
New York Division of Child Support Enforcement
New York Office of Temporary and Disability Assistance
New York State Attorney General, Charities Bureau
New York State Banking Department
New York State Department of Labor
New York State Department of Taxation & Finance
New York State Government
North Carolina Department of Commerce, Division of Employment Security
North Carolina Department of Health & Human Services
North Carolina Department of Health and Human Services, Division of Social Services Child
North Carolina Department of Revenue
North Carolina Office of the Commissioner of Banks
North Dakota Department of Human Services
North Dakota Department of Human Services, Child Support Enforcement
North Dakota Dept. of Financial Institutions
North Dakota Job Service
North Dakota Office of State Tax Commissioner
North Dakota Three Affiliated Tribes, Tribal Child Support Enforcement Agency
Office of Personnel Management
Office of Personnel Management Combined Federal Campaign (CFC)
Office of the NYC Deputy Mayor for Health and Human Services
Ohio Central Collection Agency

Ohio City of Cincinnati Finance, Income Tax Division
Ohio City of Columbus Income Tax Division
Ohio City of Toledo, Taxation and Treasury
Ohio Department of Commerce
Ohio Department of Job and Family Services
Ohio Department of Job and Family Services, Office of Child Support
Ohio Department of Job and Family Services, Office of Unemployment Compensation
Ohio Department of Taxation
Ohio Regional Income Tax Agency
Oklahoma Cherokee Nation, Human Services, Child Support Services
Oklahoma Chickasaw Nation, Child Support Services
Oklahoma Department of Human Services
Oklahoma Department of Human Services, Child Support Services
Oklahoma Employment Security Commission
Oklahoma Kaw Nation, Child Support Services
Oklahoma Modoc Tribe of Oklahoma, Tribal Child Support Enforcement
Oklahoma Muscogee Creek Nation, Child Support
Oklahoma Osage Tribe of Oklahoma
Oklahoma Ponca Tribe of Oklahoma, Child Support Enforcement
Oklahoma Tax Commission
Oregon Department of Human Services
Oregon Department of Justice, Division of Child Support
Oregon Department of Revenue
Oregon Division of Finance & Corporate Securities
Oregon Employment Department
Pacific Consulting Group (PCG)
Pacific Northwest National Laboratory
Pennsylvania City of Philadelphia Department of Revenue
Pennsylvania Department of Banking
Pennsylvania Department of Labor & Industry, Office of Unemployment Compensation Tax
Pennsylvania Department of Public Welfare
Pennsylvania Department of Public Welfare, Bureau of Child Support Enforcement
Pennsylvania Department of Revenue
Pension Benefit Guaranty Corporation
Peter Sailer (Contractor)
Public Resource Org., Inc.
Puerto Rico Department of Family Administration, Child Support Enforcement
Puerto Rico Department of Treasury
Puerto Rico Financial Institutions
Purisolve, Inc.
QinetiQ North America
Questnet Corporation
Railroad Retirement Board
Rhode Island Department of Human Services

Rhode Island Department of Human Services, Office of Child Support Services
 Rhode Island Division of Taxation
 SAP
 Social Security Administration
 South Carolina Department of Employment and Workforce
 South Carolina Department of Revenue
 South Carolina Department of Social Services
 South Carolina Department of Social Services, Child Support Enforcement Division
 South Dakota Department of Labor
 South Dakota Department of Revenue and Regulation
 South Dakota Department of Social Services
 South Dakota Department of Social Services, Division of Child Support
 South Dakota Division of Banking
 South Dakota Sisseton-Wahpeton Oyate Sioux, Child Support Enforcement
 TechBlue
 Technology Blue
 Tennessee Department of Financial Institutions
 Tennessee Department of Human Services
 Tennessee Department of Human Services, Child Support Enforcement Agency
 Tennessee Department of Labor and Workforce Development
 Tennessee Department of Revenue
 Texas Comptroller of Public Accounts
 Texas Department of Banking
 Texas Health & Human Services Commission
 Texas Office of the Attorney General, Child Support Division
 Texas Workforce Commission
 The Grants Connection
 The Modeling Agency
 Thomas Schultz (Contractor)
 Tim Wheeler (Contractor)
 Training Technologies Inc
 Treasury Inspector General for Tax Administration (TIGTA)
 True Information Assurance
 United States Army & Air Force Exchange Services (AAFES)
 United States Census Bureau
 United States Postal Service
 University of Illinois, Research Consultant
 University of Texas, Research Consultant
 Urban Institute
 Utah Department of Financial Institutions
 Utah Department of Human Services, Office of Recovery Services, Child Support Services
 Utah Department of Workforce Services
 Utah Department of Workforce Services, Unemployment Insurance Division
 Utah State Tax Commission

Vermont Agency of Human Services, Department for Children and Families, Office of Child
 Vermont Department for Children and Families, Economic Services Division
 Vermont Department of Banking, Insurance, Securities & Health Care Administration
 Vermont Department of Labor, Unemployment Insurance and Wages Division
 Vermont Department of Motor Vehicles
 Vermont Department of Taxes
 Virgin Islands Bureau of Internal Revenue
 Virgin Islands Department of Justice, Paternity and Child Support Division
 Virgin Islands Department of Labor, Employment Security Agency
 Virginia Bureau of Financial Institutions
 Virginia Department of Motor Vehicles
 Virginia Department of Social Services
 Virginia Department of Social Services, Division of Child Support Enforcement
 Virginia Department of Taxation
 Virginia Employment Commission
 VIVA USA, Inc.
 Washington Confederated Tribes of Coleville Reservation
 Washington Department of Labor and Industries
 Washington Department of Revenue
 Washington Department of Social and Health Services
 Washington Department of Social and Health Services, Division of Child Support
 Washington Dept. of Financial Institutions
 Washington Employment Security Department
 Washington Puyallup Tribe of Indians Tribal child Support Enforcement Agency
 West Virginia Department of Commerce, Workforce West Virginia
 West Virginia Department of Health & Human Resources
 West Virginia Department of Health & Human Resources, Bureau for Child Support
 West Virginia Department of Revenue
 West Virginia Division of Banking
 Westat
 Wisconsin Department of Children & Families, Division of Family and Economic Security,
 Wisconsin Department of Financial Institutions
 Wisconsin Department of Health Services
 Wisconsin Department of Revenue
 Wisconsin Department of Workforce Development, Division of Unemployment Insurance
 Wisconsin Forest County Potawatomi Community, Tribal Child Support Agency
 Wisconsin Lac du Flambeau Chippewa Tribe, Health and Human Services, Child Support
 Wisconsin Menominee Indian Tribe of Wisconsin, Child Support
 Wisconsin Oneida Tribe of Indians of Wisconsin, Social Services, Child Support Agency
 Wyoming Department of Family Services
 Wyoming Department of Family Services, Child Support Enforcement Division
 Wyoming Division of Banking

We are not aware of IRS sharing any IRS database, in whole or in part, as of July 17, 2013 with any Tax Treaty or Tax Information Exchange Agreement partner as the result of an information exchange permitted by Internal Revenue Code Section 6103(k)(4). We do, however, regularly exchange information with our extensive network of Tax Treaty and Tax Information Exchange Agreement partners. IRS' JCX 8-13 report to the Joint Committee on Taxation for 2012 reflects 710,574 disclosures in response to specific requests; bulk sharing of information regarding payments reported on Form 1042-S to residents of partner jurisdictions; and spontaneous exchanges of information foreseeably relevant to partner tax

Australia
Austria
Belarus
Belgium
Bulgaria
Canada
People's Republic of China
Cyprus
Czech Republic
Denmark
Finland
France
Georgia
Germany
Greece
Hungary
India
Indonesia
Ireland
Israel
Italy
Jamaica
Japan
Kazakhstan
Latvia
Lithuania
Mexico
Netherlands
New Zealand
Norway
Peru
Philippines
Poland
Portugal
Romania
Russia

South Africa
South Korea
Spain
Sweden
Turkey
Ukraine
United Kingdom

1. According to a 2009 IRS employee handbook, the tax agency said the Fourth Amendment does not protect emails from warrantless surveillance because Internet users don't "have a reasonable expectation of privacy in such communications." A lawyer for the IRS reiterated the policy in 2010. And the current online version of the IRS manual says that no warrant is required for emails that are stored by an Internet storage provider for more than 180 days. In *United States v. Warshak*, however, the Sixth Circuit Court of Appeals found that the government needs probable cause before asking email providers to release messages. A leaked memo and an ACLU review found that it was the IRS's policy to read emails without a warrant before that ruling and that the IRS contends the Fourth Amendment doesn't apply to email. But it's still not clear to many if the IRS changed its policy after the ruling - something many are calling on the IRS to clarify. Will you please clarify the IRS's current policy regarding this issue?

Response

In the criminal context, the ability of IRS Special Agents and other criminal investigators to obtain disclosure of emails and other electronic communications from third parties is governed by the Fourth Amendment and Title II of the Electronic Communications Privacy Act (ECPA), 18 U.S.C., §§ 2701 through 2712, which sets forth the legal parameters for seeking disclosure of stored customer communications from electronic communications service providers and remote computing service providers. IRS internal procedures limit the way IRS employees may access taxpayer email communications. Policy Statement 4-120 was signed in May 2013 making it clear that the IRS will follow the holding in *United States v. Warshak*, 631 F.3d 266 (6th Cir 2010) in all judicial circuits. This means that the IRS will obtain a search warrant in all criminal cases when seeking from an internet service provider (ISP) the content of email communications stored by the ISP. In such instances, search warrants will be obtained with the assistance of the U.S. Department of Justice, consistent with all applicable federal laws and regulations. Furthermore, as with all criminal investigative methods used by IRS Special Agents, careful consideration is given to protecting the rights and privacy of individuals when determining whether to seek a search warrant.

By contrast, the IRS will not seek the content of email communications from an ISP in any IRS civil administrative proceeding. There are, however, specific situations in ongoing civil examinations or investigations in which the IRS can and does request the content of emails directly from the author or recipient of the email communication. For example, in individual examinations, the IRS may request that taxpayers under examination provide their own supporting information, which may include electronic records, such as emails. In addition, IRS examinations sometimes lead to civil litigation. In those circumstances, the federal court discovery rules specifically provide that parties may seek electronic records. In both situations, the taxpayer is aware of the information request, has all the rights and protections afforded under the law, and may challenge any such request in court.

Rep. Chris Collins

1. To determine the number of FTE employees, an employer has to keep track of his employee's hours each month to determine if they are full time or part time and to calculate the FTE if they are part time.

In general, section 4980H of the Internal Revenue Code imposes an assessable payment on applicable large employers that fail to offer health care coverage, or offer coverage that is not affordable or does not provide minimum value, to their full-time employees (and their dependents) if at least one full-time employee receives a premium tax credit under section 36B. Section 4980H applies only to applicable large employers, generally meaning an employer that employed, on average, at least 50 full-time employees (or the equivalent combination of full-time and part-time employees) during the previous year.

On December 27, 2012, the IRS issued proposed regulations that provide guidance on the requirements under section 4980H. The proposed regulations provide equivalency rules so that employers do not always need to track actual hours of service. On July 2, 2013, it was announced that no employer shared responsibility payments will be assessed for 2014; any employer shared responsibility payments will be assessed only for 2015 and subsequent years. (Also see Notice 2013-45, released on July 9, 2013.)

a. Is the 130 hour FTE denominator that is used to divide into the total part time hours each month to calculate the FTE a constant? In other words, does an employer use 130 hours every month regardless of the number of work days, effectively treating February the same as March?

Response

Because the abbreviation "FTE" could refer to "full-time employee" or "full-time equivalent employee," each of which has a different meaning under section 4980H, we address both terms in answering this question.

For purposes of determining whether it is an applicable large employer, an employer must, in addition to counting the number of full-time employees for a month, include the number of full-time equivalent employees by dividing the aggregate number of hours of service of employees who are not full-time employees for the month (but not more than 120 hours of service for any employee) by 120. So, for a month, the total number of hours of service for employees that are not full-time employees is divided by 120, not 130.

Under section 4980H(c)(4), a full-time employee means, for any month, an employee who is employed on average at least 30 hours of service per week. The proposed regulations permit employers to treat 130 hours of service in any calendar month as the monthly equivalent of at least 30 hours of service per week. We have received

comments on this provision of the proposed regulations, and are giving these comments full consideration as we formulate the final regulations.

b. When a work week is divided by two different months, does the employer have to break down the hours in that week to put some of the hours into one month and the rest of the hours into the subsequent month?

Response

Under section 4980H and the proposed regulations, whether an employee is a full-time employee is determined with respect to any month. So if a week spans two months, the hours of service for which an employee is employed on a particular day will count toward full-time employee status for the month in which the day occurs. This is consistent with the application of the individual responsibility provisions under section 5000A and the premium tax credit under section 36B which also apply based on a calendar month. We have received comments on this provision of the proposed regulations, and are giving these comments full consideration as we formulate the final regulations.

The proposed regulations also provide an alternative method to determine whether an employee is a full-time employee (other than in determining whether the employer is an applicable large employer), called the look-back measurement method. In general, under the look-back measurement method, an employer measures an employee's hours of service over several months (the measurement period) to determine if the employee is a full-time employee for an equally long, or longer, subsequent period of time (the stability period). So, under the look-back measurement method, instead of looking at each month to determine full-time employee status, the applicable large employer will average hours of service over the entire measurement period.

c. It would appear that the determinant of full time or part time is 130 hours worked in any given month, rather than hours worked in any given week. Is that correct?

Response

See the answers to Questions 1.a and 1.b, above.

2. If an employee receives a bonus or vacation pay in lieu of vacation, does that pay have any effect on hours worked?

Response

Under the proposed regulations, an hour of paid leave counts as an hour of service. Bonuses or payments in lieu of vacation are not treated as hours of service.

3. The health care law states that a plan is affordable only when the employee premium is equal to or less than 9.5% of income.

Response

Section 4980H(b) imposes an assessable payment on an applicable large employer for certain full-time employees who are offered coverage but receive a premium tax credit. One case in which the employee offered coverage may still be able to obtain a premium tax credit is if the coverage offered is not affordable within the meaning of section 36B.

Under section 36B, coverage offered under an eligible employer-sponsored plan is affordable for an employee if the employee's required contribution to the plan does not exceed 9.5% of a taxpayer's household income for the taxable year.

Because employers generally will not know their employees' household incomes, the proposed regulations under section 4980H provide employers with three safe harbors under which an offer of coverage will be treated as affordable for purposes of section 4980H (regardless of whether the offer of coverage was affordable under section 36B). Under these safe harbors, coverage is treated as affordable if the employee's required contribution does not exceed 9.5% of the wages the employer pays the employee, as reported in Box 1 of Form W-2, or if the coverage satisfies either of two other design-based affordability safe harbors based on the employee's rate of pay or the federal poverty line. The affordability safe harbors apply only with respect to the employer's responsibilities under section 4980H, and do not determine an employee's eligibility for the premium tax credit under section 36B.

a. When the IRS decides whether or not a plan is "affordable" using the 9.5% of income calculation, is the income that is used the W2 taxable income from the prior year?

Response

We assume your question relates to the Form W-2 safe harbor that applies for purposes of section 4980H. Under the Form W-2 safe harbor, coverage that an employer offers will be considered affordable under section 4980H(b) with respect to a full-time employee if that employee's required contribution for the calendar year does not exceed 9.5% of that employee's Form W-2 wages from the employer for that year. The safe harbor looks to the Form W-2 wages for the current year, not for the prior year. So, for example, to determine affordability under this safe harbor for 2015, an employer would look at the Form W-2 wages for 2015, reported and furnished to the employee on a Form W-2 in early 2016.

b. What if an employee only worked part of the previous year - how is the 9.5% calculated for his insurance premium?

Response

For an employee not offered coverage for an entire calendar year (because, for example, the employee did not work the entire year), the Form W-2 safe harbor is applied by adjusting the Form W-2 wages to reflect the period for which coverage was offered and then comparing that adjusted wage amount to the employee's required contribution for the period. The Form W-2 wages are adjusted by multiplying the wages by a fraction equal to the number of calendar months for which coverage was offered over the number of calendar months during the year that the employee was employed. Note that the section 4980H provisions apply only to periods during which an employee is employed, so the employer obligations with respect to a full-time employee apply only during that employee's period of employment.

c. Is vacation pay in lieu of vacation and bonus pay that are part of W2 wages included as part of the 9.5% calculation?

Response

The Form W-2 safe harbor, which applies for purposes of section 4980H(b), is based on the wages required to be reported in Box 1 of Form W-2 (meaning the amount of wages subject to federal income tax withholding). These wages include bonuses and pay in lieu of vacation.

d. Are 401(k) deductions, deductions for the employee portion of health insurance and HSA accounts that are not included in taxable income included, or not included, in the 9.5% calculation?

Response

The Form W-2 safe harbor, which applies for purposes of section 4980H, is based on wages reported in Box 1 of the Form W-2. Wages reported in Box 1 of the Form W-2 exclude elective deferrals that an employee makes into a section 401(k) plan and exclude amounts that an employee elects to contribute to a section 125 cafeteria plan through salary reduction (for example, to contribute towards health insurance premiums, health flexible spending arrangements, dependent care assistance, or health savings accounts). This treatment is consistent with the application of the premium tax credit under section 36B, the eligibility for which is determined based on an individual's household income which also excludes these amounts.

e. If an employee works another job, can the employer include those outside wages in the 9.5% calculation?

Response

If an employer elects to use the Form W-2 safe harbor for purposes of section 4980H, the safe harbor affordability calculation is based only on wages from that employer. The other section 4980H affordability safe harbors (the rate of pay safe harbor and the

federal poverty line safe harbor) also do not take into account wages from another employer. However, whether an employee remains eligible for a premium tax credit because an employer's offer of coverage is not affordable is determined based on the employee's household income, which would include wages from every job.

4. If a company employs a husband, wife and two children under age 26 from the same family, and does not offer qualified health insurance, is the employer taxed \$2,000 for all four employees even though they represent one family?

Response

In general, if this company is an applicable large employer that does not offer coverage to its full-time employees and at least one full-time employee gets a premium assistance tax credit, the section 4980H(a) assessable payment is determined based on the number of full-time employees (minus 30). The statute does not provide for a reduction in the number of full-time employees on the basis of a family relationship between full-time employees.

5. Many companies use outside, independent commissioned sales representatives to sell their products. These sales reps often times represent a multitude of companies and products and are truly independent. They receive a 1099 from the company for commissions paid. Do these independent, 1099 sales reps count as employees for the 50 FTE determination of the ACA?

Response

Under the proposed regulations, whether an individual is an employee for purposes of section 4980H is determined under the common law standard. If an individual is not an employee under that standard (for example, the individual is an independent contractor), then that individual is not counted for purposes of section 4980H.

6. If a company does not offer health insurance and is subject to the ACA tax because they have over 50 FTEs, do they have to pay the \$2,000 tax for employees who are covered under another policy by virtue of their status as a spouse or child under age 26?

Response

An assessable payment under section 4980H(a) applies if an applicable large employer does not offer coverage to its full-time employees (and their dependents) (which the proposed regulations interpret as requiring an offer of coverage to 95% of the employer's full-time employees (and their children)) and at least one of those full-time employees receives a premium tax credit. As provided in the statute, the assessable payment for any month is equal to: (1) 1/12 of \$2,000 multiplied by (2) the number of full-time employees (reduced by 30). The statute contains no reduction of the section

4980H(a) assessable payment for not offering coverage based on whether the full-time employee is covered under another policy.

7. If a regular full-time employee takes time off without pay such that they do not work 130 hours in a given month, do they count as a full-time employee or part-time employee during the month they are not paid?

Response

Full-time employee status generally is determined based on the hours of service credited during a month. Under the proposed regulations, an hour of service means each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer; and each hour for which an employee is paid, or entitled to payment, by the employer for a period of time during which no duties are performed due to vacation, holiday, illness, incapacity, layoff, jury duty, military duty or leave of absence. Under this definition, a period of time during which no duties are performed and for which an employee is not entitled to pay would not count as hours of service in determining whether the employee had 130 hours of service for a particular month.

However, the proposed rules provide an alternative method to determine whether an employee is a full-time employee (other than for purposes of the applicable large employer determination), called the look-back measurement method. In general, under the look-back measurement method, an employer measures an employee's hours of service over several months (the measurement period) and then uses those hours of services to determine the employee's full-time employee status during a subsequent period of time (the stability period). If an employee takes unpaid leave that does not count as hours of service during a month of the measurement period, the employer would include zero hours of service for that period in determining the average hours of service for the entire measurement period. That average for the measurement period would then be used to determine the employee's full-time employee status during the subsequent stability period.

In addition, under the look-back measurement method, average hours of service over a measurement period are computed by excluding periods of unpaid leave subject to the Family Medical Leave Act of 1993, unpaid leave that is subject to the Uniformed Services Employment and Reemployment Rights Act of 1994, or unpaid leave on account of jury duty. So, although unpaid leave generally is not counted as an hour of service, these special types of unpaid leave are excluded from the calculation of average hours of service over a measurement period.

8. If a regular full-time employee takes time off for sick time, vacation, or maternity leave such that they do not work 130 hours in a given month, but are fully paid for the time off, do they count as a full-time employee or part-time employee during the month they take time off?

Response

Under the proposed regulations, hours of service include each hour for which an employee is paid, or entitled to payment, by the employer for a period of time during which no duties are performed due to vacation, holiday, illness, incapacity, layoff, jury duty, military duty or leave of absence.

9. If an employer has over 50 FTEs and offers health insurance where the employee premium is considered affordable for 80% of the employees using the 9.5% calculation, but is not affordable for 20% of the employees using the 9.5% calculation, is the employer subject to the \$2,000 tax for the 20% of the employees? If so, can they apply the 30 employee credit towards those employees?

Response

Under the proposed regulations, if an applicable large employer offers coverage to at least 95% of its full-time employees (and their dependents) it will not be subject to an assessable payment under section 4980H(a). However, if the coverage offered is not affordable to one or more employees and one of those employees obtains a premium tax credit, the employer will owe an assessable payment under section 4980H(b). The amount of the section 4980H(b) assessable payment for any month equals the number of full-time employees who receive a premium tax credit for that month multiplied by 1/12th of \$3,000. However, the amount of the section 4980H(b) assessable payment cannot exceed the total number of full-time employees for the year (minus up to 30 employees) multiplied by \$2,000 (so that it can't be more than the maximum assessable payment that could have applied under section 4980H(a)).

Rep. Tim Huelskamp

1. I have been made aware of several regulations that could have a detrimental impact on small businesses. One will require businesses with non-audited financial statements to evaluate each and every expense over \$100 to determine whether that item must be depreciated rather than written them off as a business expense. This seems like an extremely low threshold and burdensome regulation that will affect about 95% of all small businesses on January 1, 2014. The second would require that any small business spending more than \$100 to repair any building's "Unit of Property" to subject every single expenditure over \$100 to up to 9 different tests to determine if the amount spent is an improvement. As an absolutely ridiculous example, if a small business owner replaces the toilet in a building at the cost of \$400 under this guidance, they will be forced to depreciate that toilet over 39 years for a net deduction of \$10 every year.

For your reference, the specific regulations as provided to me were promulgated at REG168745-03, 76 Fed. Reg. 81128-01 [2012-14I.R.B. 718]; De Minimis Rule: § 1.263(a)-2T(g) and Safe Harbor for Routine Maintenance: § 1.263(a)-3T(g).

a. Please provide the rationale for these rules.

b. Is there any guidance that provides relief to small businesses under these regulations?

Response

Section 162 of the Internal Revenue Code (Code) generally allows a deduction for all the ordinary and necessary expenses incurred during the taxable year in carrying on a trade or business, including the costs of certain supplies, repairs, and maintenance. However, section 263(a) provides that no deduction is allowed for (1) any amount paid for new buildings or permanent improvements or betterments made to increase the value of any property or estate, or (2) any amount expended in restoring property or in making good the exhaustion for which an allowance has been made.

The standards for applying sections 162 and 263(a), as set forth in previous regulations, case law, and administrative guidance, generally require an examination of all the taxpayer's particular facts and circumstances to determine whether an expense related to property is currently deductible as a repair or maintenance expense or is an improvement that must be capitalized. In an effort to reduce controversy in this area, the IRS and the Treasury Department issued final regulations under sections 162 and 263(a) on September 19, 2013 (T.D. 9636) addressing the tax treatment of amounts paid to acquire, produce, or improve tangible property under sections 162 and 263(a). The regulations establish a consistent framework for distinguishing capitalizable improvements from deductible expenditures for supplies, repairs, and maintenance.

The final regulations include several safe harbors and bright-line rules intended to ease the application of these regulations for all taxpayers. In response to specific concerns raised by small taxpayers, the final regulations also include several provisions specific to small taxpayers to facilitate compliance and eliminate burdens associated with applying facts and circumstances tests. Some of the simplifying provisions are discussed below.

The final regulations provide that amounts paid to acquire or produce materials or supplies (which are defined, in part, to include property with an economic useful life of less than 12 months or property with an acquisition or production cost not exceeding \$200 (increased from \$100 in the temporary regulations)) are deductible in the year acquired (if incidental) or the year first used or first consumed in the taxpayer's operations (if non-incidental). See §1.162-3.

The final regulations include a de minimis safe harbor election that allows a taxpayer to deduct the cost of certain de minimis items, consistent with the treatment of those items on the taxpayers' audited financial statements or (or in some cases, books and

records) up to certain limits (\$5,000 per item for taxpayers with audited financial statements and \$500 per item for taxpayers without audited financial statements). This safe harbor election allows taxpayers to follow established accounting procedures and simplifies the determination of whether a particular expenditure is deductible or is subject to capitalization. See § 1.263(a)-1(f).

The final regulations also provide a safe harbor for routine maintenance on property based, in part, on whether the activity is expected to be performed more than once during the class life of the unit of property (or, for buildings, during a 10-year period). To the extent that an expenditure meets the routine maintenance safe harbor, the expenditure is not considered a capitalizable improvement to the property, and may be deducted. See § 1.263(a)-3(i). Moreover, if at the time a specific property is placed in service, the taxpayer has reasonably determined that a particular activity performed on that property qualifies for the routine maintenance safe harbor, that determination will be respected for those expenditures in future tax years, even if the taxpayer does not actually perform activity on that property for more than once during the relevant period.

The final regulations contain a specific safe harbor for small taxpayers (average annual gross receipts of \$10,000,000 or less) that allows a qualifying taxpayer to elect not to apply the detailed improvement rules when the taxpayer's expenditures related to a building (with an unadjusted basis of \$1,000,000 or less) do not exceed (i) \$10,000 or (ii) 2% of the unadjusted basis of the building, whichever is lower. This provision allows qualifying small taxpayers with limited total building expenditures to elect a simplified alternative to the detailed general analysis required under the regulations. See § 1.263(a)-3(h).

Finally, the regulations also allow taxpayers in a trade or business to elect to capitalize otherwise deductible repair and maintenance expenditures if the taxpayer's books and records treat such expenditures as capitalizable amounts (Many taxpayers prefer to follow book capitalization rules, which generally result in more capitalization for federal income tax purposes than the applicable tax law may otherwise require). This provision simplifies taxpayers' compliance burden by providing legal authority to follow book accounting rules for federal tax purposes, while allowing taxpayers who prefer to maximize tax deductions to apply the detailed general rules. See § 1.263(a)-3(n).

In addition to the specific items above, the final regulations clarify and refine several of the criteria for distinguishing materials and supplies, repairs, maintenance, and improvements. We believe that the final regulations address many of your concerns and will reduce controversy and ease the perceived administrative burdens of complying with sections 162 and 263(a) for all taxpayers.

2. Will failure to comply voluntarily with the employer mandate provisions of the Affordable Care Act be a factor as part of the Discriminant Index Function, "Be on the Lookout" list or any other factor in determining whether a business will be flagged for an audit?

Response

No. Under the employer shared responsibility provisions of section 4980H, an applicable large employer generally must offer affordable, minimum value health coverage to its full-time employees (and their dependents) or a shared responsibility payment may apply if one or more of its full-time employees receive a premium tax credit under § 36B. Because the § 6056 information reporting is integral to the administration of the employer shared responsibility provisions, the transition relief from § 6056 information reporting for 2014 is expected to make it impractical to determine which employers owe shared responsibility payments for 2014 under the employer shared responsibility provisions. Accordingly, no employer shared responsibility payments will be assessed for 2014, even if employers and other affected entities voluntarily comply for 2014 with the information reporting provisions. Real-world testing of reporting systems and plan designs through voluntary compliance for 2014 will contribute to a smoother transition to full implementation for 2015, but are not mandatory.

3. Who specifically made the final decision not to enforce the employer mandate of the Affordable Care Act?

a. Was it the President of the United States, Secretary of the Treasury, Director of the Office of Management and Budget or someone else?

Response

Although IRS personnel were consulted on providing transition relief with respect to the reporting requirements by employers under Internal Revenue Code (Code) section 6056 and reporting requirements by health insurance providers under Code section 6055, the decision to provide that transition relief was ultimately made by the Treasury Department. The decision to provide transition relief with respect to the employer shared responsibility provisions was a practical result of the transition relief on the employer reporting requirements, because the lack of employer reporting would make it impractical to determine which employers owed shared responsibility payments for 2014. This decision was also made by the Treasury Department.

b. Were you consulted before the decision was made and on what date(s) did such a meeting(s) occur?

Response

IRS personnel were consulted by Treasury as to the administrative aspects of transition relief. Discussions between IRS and Treasury staff on the issue of reporting transition relief began around April 15, 2013.

c. Did the IRS provide any written guidance in the form of emails or memorandums to Treasury, OMB or Executive Office of the President regarding the implementation of the employer mandate enforcement prior to the decision? If so, please provide them.

Response

IRS personnel were consulted by Treasury as to the administrative aspects of transition relief. Treasury and IRS personnel need to be able to engage in free, full, and unfettered discussions about policy and legal matters. Public disclosure of pre-decisional discussions and documents could have a significant chilling effect on our deliberations and could inhibit the ability of agency staff to fulfill their statutory responsibilities.

d. When were you informed of the final decision and was that in a meeting, conference call or in writing?

Response

I was first informed of the decision in a meeting on June 21, 2013.

e. Are there any memorandums or emails informing the IRS of the decision and explaining the statutory authority to make the decision? If so, please provide them.

Response

The IRS has not identified any such records in its possession. However, an explanation of the statutory authority for the decision can be found in the Treasury Department's written testimony before the House Committee on Ways and Means Subcommittee on Health on July 17, 2013. That testimony states, "Notice 2013-45 is an exercise of the Treasury Department's longstanding administrative authority under section 7805(a) of the Internal Revenue Code. This administrative authority has been used to provide transitional relief to taxpayers seeking to comply with new legislation, and to provide a wide range of other guidance. In particular, on a number of prior occasions across Administrations, this authority has been used to postpone the application of new legislation when immediate application would have subjected taxpayers to unreasonable administrative burdens or costs. For example, the Small Business and Work Opportunity Act of 2007 made changes to the standards return preparers must follow to avoid penalties. The amendments were effective May 25, 2007. On June 11, 2007, the Treasury Department released Notice 2007-54 providing that the IRS would follow the standards in prior law in determining whether to assert penalties for returns due on or before December 31, 2007. Similarly, the Airport and Airway Extension Act, Part IV (signed August 5, 2011) reinstated the air transportation and aviation fuels excise

taxes retroactively to July 23, 2011, when they had expired. On September 9, 2011, the Treasury Department released Notice 2011-69 providing that the excise taxes would not be imposed on purchases of air transportation services made after July 22, 2011 and before August 8, 2011." (See "Written Testimony of J. Mark Iwry, Senior Advisor to the Secretary and Deputy Assistant Secretary for Retirement and Health Policy, U.S. Department of the Treasury, Before the House Committee on Ways and Means Subcommittee on Health, July 17, 2013," available at: http://waysandmeans.house.gov/uploadedfiles/hl8_071713_iwry_testimony_final_.pdf)

Rep. David Schweikert

1. What types of private data does the IRS collect that subsequently informs its auditing and/or compliance decisions?

Response

The majority of the private data that the IRS collects for use in auditing and compliance decisions comes from filed tax returns or from third-party information, such as 1099's and W-2's. In addition, we receive information from other sources (internal and external) on potential noncompliance with the tax laws or inaccurate filing, including information received through agreements with state and local governments and treaties with foreign governments. We evaluate this information for reliability and accuracy before we use it as the basis of an examination or investigation.

2. What private databases does the IRS access and/or monitor for those purposes?

Response

IRS uses Accurint, a Lexis/Nexis web-based research tool to assist with audit work. Accurint provides information such as asset ownership and locator services, which is used in research, auditing and compliance decisions. Other third-party databases are used for other purposes, such as authenticating a taxpayer's identity.

3. Does the IRS rely solely on tax filings to inform its auditing and compliance decisions, or do personal and/or business activities inform them as well? If so, what types of activities are on IRS's radar? And how?

Response

While IRS relies primarily on tax filings to inform its auditing and compliance decisions, it also uses information from federal agencies and state and local governments to inform decision making. In addition, outside data can be used in research of compliance trends

to evaluate and update risk assessment rules. The resulting rules are applied to tax filing data to select cases for audit or compliance action.

a. Is the IRS, for example, able to track when I convert my paycheck into a transferable form of payment like cash or prepaid cards?

Response

No, IRS is not able to track when you convert your paycheck into a transferable form of payment.

b. Are changes in my spending patterns outside my normal spending habits somehow tracked?

Response

No, IRS does not have information that tracks a taxpayer's spending habits. .

4. What of that accumulated data is maintained? How and for how long?

Response

Information used to inform auditing and compliance decisions is maintained in accordance with Internal Revenue Manual 1.15.23, Records Control Schedule for Tax Administration - Examination. The length of time data is maintained is dependent upon the nature of the material and how it used.

5. What additional outside data is maintained?

Response

Information obtained from Accurant used to inform auditing and compliance decisions is maintained in a similar manner.

Rep. Tom Rice

1. Acting Commissioner Werfel, I am deeply interested in a report from the Treasury Inspector General for Tax Administration regarding the Additional Child Tax Credit. You may recall this report. It was issued on July 7,2011. Specifically, the report highlights the gross misuse of claiming the Additional Child Tax Credit by people using individual taxpayer identification numbers. In other words, a person who does not have a Social Security Number and is not authorized to work in the United States may claim the Additional Child Tax Credit. As you may know, Individual Tax Identification Number (ITIN) filers' claims for the Additional Child Tax Credit have increased from \$924 million in 2005 to \$4.2 billion for 2010. This

information is detailed in the report. We are giving billions in tax credits to individuals who are not authorized to work in our country. There is also evidence of ITIN filers claiming multiple children who do not even reside in our country! The Treasury Inspector General for Tax Administration's report directed both the IRS and the Department of the Treasury to look into this staggering issue. Since the report was issued almost two years ago, I am very interested in the IRS and Department of Treasury's progress.

a. What efforts has your agency taken to end this blatantly fraudulent activity?

Response

The IRS has taken a number of steps to address issues identified in the 2011 Treasury Inspector General for Tax Administration (TIGTA) report regarding the Additional Child Tax Credit (ACTC) [Audit 200940031; Report 2011-41-061] and to strengthen the ITIN program. Notably, in a follow-up report issued in May, 2013, the Treasury Inspector General for Tax Administration concluded, "The IRS initiated corrective actions to address the majority of recommendations included in our prior audit report. These actions are significantly improving the identification of questionable ITIN applications." (Source: <http://www.treasury.gov/tigta/auditreports/2013reports/201340052fr.html>)

ITINs play a critical role in the tax administration process, as they are essential to the processing of tax returns that report tens of billions of dollars in taxable income and billions in tax revenue for individuals who have a U.S. tax filing obligation and otherwise would not have a U.S. taxpayer identification number. The IRS has made clear progress in ensuring ITINs are issued appropriately, as well as in addressing fraudulent ACTC claims. Specifically:

In June 2012, the IRS initiated a comprehensive review of the ITIN program and put in place interim changes to tighten the procedures for issuing ITINs. On November 29, 2012, after completing our review, we announced updated procedures to strengthen the ITIN program. To protect the integrity of the ITIN application and refund processes, IRS has enhanced procedures for issuing ITINs. With few exceptions, IRS will only issue ITINs to taxpayers and dependents when applications include original documentation, such as passports and birth certificates, or certified copies of these documents from the issuing agency. Certified Acceptance Agents (CAAs) and their authorized representatives can provide assistance to resident and non-resident applicants. These CAAs are required to complete forensic training, to aid in identifying fraudulent identification documents.

We changed Form 8812 to Schedule 8812, Child Tax Credit, for tax year 2012 to make it part of the return signed under penalties of perjury. A new section was added for taxpayers that have dependents with ITINs to verify that the child met the substantial presence test for residency in the U.S. This change was made to emphasize and verify the requirement that, for purposes of the CTC and ACTC, a qualifying child must be a

citizen, national, or resident of the United States. Schedule 8812 will also allow the IRS to better determine eligibility for CTC and ACTC during processing of the tax return.

The IRS reviews questionable CTC and ACTC claims on ITIN returns prior to issuance of refunds. Several fraud detection filters are in place to help detect issues with the credit. The IRS also reviews ACTC claims as part of other audit programs with child-related issues such as the Earned Income Tax Credit (EITC) audit program. For the 2013 filing season, we started freezing the portion of the refund attributable to ACTC on all pre-refund EITC exam cases. Because sixty-six percent of EITC audits also contain CTC, generally related to the same child claimed, we review the CTC issue during the EITC audit. We adjust the CTC ninety-six percent of the time.

IRS and Treasury worked together to include an ACTC provision in Treasury's General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals, released with the President's Budget in April 2013. The proposal provides for the extension of the EITC paid preparer due diligence requirement to the CTC. Extending the due diligence requirement to the CTC, which shares many eligibility criteria with the EITC, could improve compliance, while ensuring that the additional burden to preparers and eligible filers is minimized.

The IRS is committed to administering the law as written by Congress in a fair and consistent manner and to using all appropriate means to combat erroneous or fraudulent refunds for ACTC. Note that current law does not require the taxpayer or the eligible child to have a social security number (SSN) in order to receive either the Child Tax Credit (CTC) or Additional Child Tax Credit (ACTC). Additionally, the law does not prohibit a resident alien who does not have a SSN from being eligible to claim the ACTC.

b. Why does your agency refuse to go after those known to be committing fraud, and instead put so much effort into auditing our job creators, most of whom have given your agency no reason to believe they deserve such treatment?

Response

The IRS aggressively addresses the most egregious tax noncompliance found in those committing fraud and focuses its efforts on other areas of noncompliance, including small business taxpayers, based on risk and resources available.

In Fiscal Year (FY) 2012, the IRS audited approximately 1.65 million returns. Of these, 21 percent were small business returns that include filers of Schedule C and Schedule F, small corporations, S corporations and partnerships. The percentage was similar for the prior two years. This audit rate equates to only 0.2 percent of all returns filed, and 1.3 percent of small business returns filed.

The IRS focuses its limited examination resources on the areas of greatest compliance risk in developing its annual examination program. IRS is committed to combating fraud,

intentional noncompliant behavior, whether it's individual taxpayer, business, or preparer-related fraud, through targeted and expanding fraud and identity theft efforts.

In addition, we have addressed international tax compliance through our Offshore Voluntary Disclosure Program (OVDP). In January 2012, the IRS reopened the OVDP with tightened eligibility requirements in response to strong interest from taxpayers and tax practitioners. Through the end of FY 2012, the OVDP has resulted in a total of more than 38,000 disclosures of unpaid taxes and collected more than \$5.5 billion in back taxes, interest and penalties.

The agency's work on identity theft and refund fraud continues to grow, touching nearly every part of the organization. The IRS expanded these efforts for the 2013 filing season to better protect taxpayers and help victims. More than 3,000 IRS employees are currently working on identity theft – more than double the number at the start of the previous filing season. We have also trained 35,000 employees who work with taxpayers to recognize identity theft and help victims. So far this calendar year (based on our August 2, 2013 written testimony to the House Oversight and Government Reform Subcommittee on Government Operations), the IRS has worked with victims to resolve more than 565,000 cases. This is more than three times the number of identity theft victim cases that we had resolved at the same time last year.

Our fraud detection efforts have increased as well. We expanded the number and quality of our identity theft screening filters, and we have suspended or rejected more than 4.6 million suspicious returns so far this calendar year. The number of identity theft investigations by our Criminal Investigation (CI) division continues to rise, with more than 1,100 investigations opened so far in FY 2013.

During 2012, the IRS protected \$20 billion of fraudulent refunds, compared with \$14 billion in 2011. Within that \$20 billion, \$12 billion represents fraud related to identity theft. The IRS stopped 5 million suspicious returns in 2012 – up from 3 million suspicious returns stopped in 2011. As noted above, we have already suspended or rejected 4.6 million suspicious returns so far this year worth more than \$7.4 billion.

A significant portion of the 4.6-million returns suspended or rejected this year – 725,000 – were rejected at the point of filing, even before they entered IRS processing systems. The remaining returns generally require further review to determine whether the filer is legitimate, so the total returns and refunds rejected for 2013 will be significantly higher once these cases are worked. The IRS is committed to improving its multi-faceted approach to blocking these fraudulent refund claims, and we strive to operate in such a way that false returns are screened out at the earliest possible stage.

The IRS will continue to strengthen its efforts to catch identity theft and other fraud before erroneous refunds are issued. We will continue refining our filters aimed at detecting and preventing the processing of fraudulent returns, and develop new methodologies as needed. Additionally, we are considering new technologies for

authenticating the identities of taxpayers at the time of filing as a future means of precluding tax-related identity theft.

2. Recently, I received a letter from the Department of the Treasury in response to a letter I sent regarding the undue scrutiny of conservative groups' requests for 501(c) (4) status. One such organization is the Myrtle Beach Tea Party, located in my district. The intimidating letter they (the MB Tea Party) received from the IRS in response to their request (similar to letters received by at least 75 organizations throughout the country) caused many individuals to drop their membership, and the group continues to wait for approval. I understand my letter requesting an explanation has since been referred to your office.

a. When do you think their application will be processed?

b. How many other groups continue to wait for approval?

c. Do you understand the effects this scrutiny and unduly long process has had on these organizations?

Response

Congress enacted section 6103 of the Internal Revenue Code (Code) to preserve the privacy of American taxpayers, including tax-exempt organizations, unless the disclosure is authorized by some provision of the Code. Due to the Code's restrictions, we cannot provide information on the progress or even the existence of a pending application for recognition of exemption of a particular organization, including the organization you describe, without a privacy waiver from that organization. General information that does not identify specific taxpayers may, however, be disclosed and such information is provided below.

We are aware of the impact that the delay and extra scrutiny has had on these organizations. The IRS has realigned technical staff to assist with reviewing section 501(c)(4) applications. In addition, the IRS has several process improvements underway to ensure that taxpayers are treated appropriately and effectively in the review of applications for tax-exempt status.

The IRS identified 132 applications for recognition of section 501(c)(4) status that involved advocacy issues and had been pending for more than 120 days as of May 28, 2013. One hundred twenty of the 132 applications had been open more than 200 days. This included 28 cases open more than 200 days but less than 1 year, 73 cases open more than 1 year but less than 2 years, and 19 cases open more than 2 years. The IRS developed a new voluntary process to help these applicants gain fast-track approval to operate as a 501(c)(4) tax-exempt organization. This process allows them a streamlined path to tax-exempt status if they certify that their political and social welfare activities will meet specified limits and thresholds.

The IRS mailed about 90 letters the week of June 24th offering this expedited option. The remainder of the cases in the original backlog of 132 were either processed through normal procedures or required further development. Determinations were originally made on 34 of the cases including 17 approvals, 4 applications withdrawn by the applicants, and 13 cases closed for "failure to establish" (i.e., failure to provide necessary information). Seven cases were identified as having inurement issues which required further development. As of October 18, 2013, IRS had closed 99 cases in the original backlog of 132 (75%). This includes 77 cases that received favorable determination letters including 38 applicants participating in the optional expedited process. Remaining cases continue to be processed. The IRS is providing monthly updates regarding the processing of these applications on its website at <http://www.irs.gov/uac/Newsroom/IRS-Charts-a-Path-Forward-with-Immediate-Actions>.

Rep. Donald Payne, Jr.

In your testimony, you mentioned several IRS efforts to help small businesses navigate the tax world. How many of these outreach efforts were located in areas home to small disadvantaged businesses and minority owned businesses? And how often were these services utilized by these small business owners?

Response

Although we don't separately track information on outreach efforts in areas home to small disadvantaged businesses and minority owned businesses, we do have some interaction with agencies working with small business owners in empowerment zones. For example, we have partnered with the City of San Diego and California Franchise Tax Board to present information about available Federal tax incentives to attendees of events highlighting Enterprise Zone and Historically Underutilized Business (HUB) zone programs. These programs, run by the Small Business Administration, encourages small businesses to locate in and hire employees from economically disadvantaged areas of the United States.

In Detroit, we partner with the Southwest Detroit Hispanic Business Association, which services Hispanic business owners in a designated empowerment zone. We provide information to the organization for dissemination to their members and we also partner with them each year in delivering a Hispanic Small Business event that includes a Leveraged Small Business Tax Workshop and Small Business Roundtable. Also in Detroit, we provide materials for events for the Vanguard Community Development Corporation which also services small business owners in designated empowerment zones.

In Cleveland, we partner with the Council of Smaller Enterprises (COSE) that assists small business owners in the Cleveland Metropolitan Area including those in designated empowerment zones.

We do track events with industry partners whose membership includes limited English proficient (LEP) and/or minority members. In FY 2013, as of June 30, 2013, there were 163 events identified as minority LEP or minority. Examples of minority LEP events include events held for Hispanic or Chinese organizations where the event is conducted in their primary languages. Examples of events for minority only organizations include African American or women's organizations where the events are conducted in English.

I am aware of the IRS's "Solution Saturday" program. How popular is this program, specifically among disadvantaged businesses, and what are some of the challenges that are identified during this event?

Response

Solution Saturday was a one-time event held on November 7, 2009. The event was offered at five IRS Taxpayer Assistance Centers in strategic large cities. The IRS provided personalized help to individual taxpayers, small business owners and those that are self-employed.

Many IRS organizations participated in the event including Wage & Investment Division (organizer), Small Business Self Employed Division, Taxpayer Advocate Services, Appeals, Counsel and Tax Exempt and Government Entities Division. During the event, IRS employees provided taxpayers face-to-face assistance. For Examination and Appeals questions, taxpayers received virtual assistance. Statistics were not kept on the types of taxpayers served. Over 500 employees worked to plan, set-up and execute this one day event that served 915 taxpayers.

Challenges identified during the event included:

- Taxpayers needed to complete further action/more documentation
- Taxpayers did not have the necessary materials for resolution such as identification or financial information

For small businesses, the IRS believes it is important to conduct outreach on changes to the tax law and the latest in filing requirements. Because the vast majority of small businesses and self-employed individuals use professional return preparers, the IRS partners with thousands of industry and small business organizations, including minority-owned business associations, tax professional and payroll associations and other government agencies to extend and amplify our outreach and education efforts.

A major component of our outreach efforts involves the meetings, symposiums and seminars we sponsor for small business owners and the tax practitioner community

each year. In FY 2012, the IRS held more than 2,000 of these events, which were attended by more than 163,000 business owners and tax professionals.

Increasingly, the IRS is employing technology to reach small business owners and help them fulfill their tax obligations. Our website, IRS.gov, includes a section that is devoted to businesses and contains a wealth of videos, audio presentations and webinars on a wide range of tax topics, such as employment taxes, electronic filing and retirement plans geared toward small business.

We also assist business taxpayers by operating a special toll-free telephone line dedicated to small businesses, corporations, partnerships and trusts. Callers can get help with, for example, business returns or business accounts, employer identification numbers and federal tax deposit issues. A separate toll-free line for practitioners is staffed by IRS representatives specially trained to handle their questions and resolve their clients' account-related issues.

IRS-published products are also important resources for small business taxpayers. These include the Tax Calendars which provide highlights on tax topics, resources, instructions and important dates. Our electronic publication, *e-News for Small Businesses*, includes the latest IRS news releases and announcements. The quarterly *SSA/IRS Reporter* is a collaborative effort with the Social Security Administration that provides information on payroll taxes and other employee issues.

What could we do in Congress to alleviate the tax challenges of small businesses that you have observed, including the tax gap?

Response

In its FY 2014 Budget, the Administration submitted to Congress a number of proposals intended to assist small business while combating the tax gap. Below are listed proposals that would encourage growth and investment in small businesses. This list is not, however, intended to be exhaustive; the Budget contains a number of other proposals, such as the New Manufacturing Communities Tax Credit or improvement in the Research and Experimentation Tax Credit, that could benefit small businesses though not specifically targeted at them. Below are also listed proposals to improve compliance by businesses, strengthen tax administration, or simplify tax filing. The Budget contains other business-related compliance and administrative proposals, but those are generally more targeted.

PROPOSALS TO ENCOURAGE GROWTH AND INVESTMENT IN SMALL BUSINESS

- Extend Increased Expensing for Small Business
- Eliminate Capital Gains Taxation on Investments in Small Business Stock
- Double the Amount of Expensed Start-Up Expenditures

- Expand and Simplify the Tax Credit Provided to Qualified Small Employers for Non-Elective Contributions to Employee Health Insurance
- Exclude Self-Constructed Assets of Small Taxpayers from the Uniform Capitalization (UNICAP) Rules
- Provide Small Businesses a Temporary 10-Percent Tax Credit for New Jobs and Wage Increases

PROPOSALS THAT COULD IMPROVE COMPLIANCE BY BUSINESSES, STRENGTHEN TAX ADMINISTRATION, AND SIMPLIFY TAX FILING

- Require a Certified Taxpayer Identification Number from Contractors and Allow Certain Withholding
- Require Greater Electronic Filing of Returns
- Implement Standards of Clarifying When Employee Leasing Companies Can Be Held Liable for Their Clients' Federal Employment Taxes
- Increase Certainty with Respect to Worker Classification
- Require Taxpayers Who Prepare Their Returns Electronically but File Their Returns on Paper to Print Their Returns with a 2-D Bar Code
- Expand Internal Revenue Service (IRS) Access to Information in the National Directory of New Hires (NDNH) for Tax Administration Purposes
- Repeal Technical Terminations of Partnerships
- Impose a Penalty on Failure to Comply with Electronic Filing Requirements

Rep. Yvette Clarke

Acting Commissioner Werfel, can you give us a macro view on the effects of sequestration on your ability to run an effective IRS?

Response

Through reductions of \$594.4 million due to sequestration and \$23.6M due to a rescission, the IRS FY 2013 enacted budget was \$618.0 million (5.23%) below the FY 2012 enacted level. Combined with a \$300 million decrease taken in FY 2012; the IRS operating levels were reduced by almost \$1 billion over the past two years and were only \$324 million above FY 2008 levels. As a result of these cuts, IRS has not been able to fill behind attrition, resulting in a decrease of over 9,000 employees through attrition and buyouts since FY 2010. Reduced staffing and lower resources for core information technology (IT) non-labor costs have had a significant impact on IRS operations.

While IRS made efforts to mitigate the impact of these cuts on customer experience and enforcement functions, there has been a decline in the anticipated Level of Service and IRS's ability to respond to taxpayer's written and/or phone inquiries and to assist taxpayers at the assistance centers. Enforcement revenue could decline by up to \$3

billion and other core enforcement actions will be adversely impacted, resulting in a significant reduction in: the number of individual and business audits completed, Automated Underreporter contact closures, collection actions, and appeals and litigation case closures. Also impacted is IT infrastructure support critical to delivering high-priority programs, including: tax processing and customer support systems, including electronic filing systems; enforcement systems support, including electronic and refund fraud systems; and "break-fix" programs and infrastructure support that ensure system operability during critical filing season timeframes.

Considering you have to not only lead a reform of the agency while concurrently implementing ACA, at what point do you run into a situation where you simply don't have the resources to do either effectively?

Response

Recent budget cuts and sequestration have been a challenge in funding all IRS functions. Prior to FY2013, the HHS Health Insurance Reform Implementation Fund (HIRIF) account funded IRS staffing and information technology development costs necessary to implement ACA. Without additional appropriations or HIRIF resources to continue the implementation of ACA in FY 2013, the IRS has absorbed the costs of the staff, previously funded by HIRIF, into base resources and reprioritized current technology requirements to ensure IT resources are available to cover the costs for ACA IT needs. Although the IRS has absorbed the staff in the base for FY 2013, this comes at the expense of not being able to fill behind attrition in critical IRS service, enforcement, and operations support programs. Additional user fees and other funds appropriated in FY 2012 and available for two-years (through FY 2013) are also being used to continue this work. As a result of these actions all critical activities needed for the successful implementation and administration of the ACA have been funded to date, but at the expense of other programs.

While the IRS has continued ACA implementation for FY 2013 through a combination of absorbing Full Time Equivalent (FTE) in the base and use of user fees and other funds that expire in FY 2013, this is not a long term funding solution. The FY 2014 budget request will ensure that the IRS has the resources to continue implementing ACA – not only for the critical IT development but to address the anticipated increase for customer service through the call centers. Should IRS not receive the requested funding, it will be difficult to sustain the ongoing requirements for FY 2014 and beyond without degrading our IT infrastructure and eroding performance in service and enforcement programs.

Small Business Tax-Related Questions
Small Business Committee
Chairman Sam Graves
July 23, 2013

1. During your review of IRS's efforts, have you had the opportunity to consider the IRS's "Real Time Tax System" initiative?

a. During the IRS's efforts to explore the expansive "Real Time Tax System" initiative, has there been any analysis of the impact on small businesses? Any review of the paperwork changes and burdens which would be placed on small businesses? And if not, I ask that you consider these issues and provide an impact analysis on small businesses to this Committee within 30 days.

Response

The IRS is not pursuing and has no plans to implement a "Real Time Tax System" to create a pre-filled or simple tax return program. The IRS is exploring ways to improve the tax filing process through earlier and more intelligent matching of available data, such as third-party information returns, to income tax returns filed by taxpayers. We refer to this exploratory effort as real time tax.

The IRS has developed a vision for a real time tax data matching process and we are exploring how best to move toward that vision. The vision includes reducing taxpayer burden, improving voluntary compliance, and increasing tax administration efficiency through up-front identification and resolution of compliance issues.

This exploratory effort is aimed at identifying and evaluating the best options for resolving mismatched data earlier in the process. With our current budgetary constraints and need to prioritize critical work, we have not as yet devoted resources to fully analyze stakeholder burden. Any exploration of potential solutions, if or when identified, will include an analysis of the potential benefits and burdens on businesses both large and small. In addition, the IRS does not currently have a real time data tax matching process implementation plan or schedule.

The Government Accountability Office (GAO) recently reviewed the IRS's real time tax matching exploratory effort (GAO-13-515, June 4, 2013 <http://www.gao.gov/products/GAO-13-515>). GAO determined:

- IRS matches information returns to individual tax returns well after issuing refunds, resulting in delays notifying taxpayers of discrepancies, and
- IRS is generally following leading practices in its real time tax exploratory efforts, but has not documented a timeline or risk management framework.

Based on the single GAO recommendation, the IRS is developing a high-level timeline for different phases of the exploratory effort that will help guide activities and mitigate risk.

The IRS believes the exploration of possible improvements to the tax filing process is necessary and appropriate. We will continue to engage with our stakeholders during this exploratory effort to determine what is needed to move in the direction of the real time tax data matching vision.

b. How much money has been spent on the "Real Time Tax System" effort? From what source or budgetary line did the funds originate?

Response

The IRS is not pursuing and has no plans to implement a "Real Time Tax System" to create a pre-filled or simple tax return program. Since former Commissioner Shulman first spoke publically about his vision for real time tax in April 2011, we have explored the concept of earlier and more intelligent matching of available data to income tax returns filed by taxpayers to improve our current filing process for the benefit of taxpayers and compliance efficiency.

The Deputy Chief Information Officer, Strategy and Modernization, the Deputy Commissioner of the Wage and Investment Division, and the Director of Wage and Investment Business Modernization Office have led the ad hoc, real time tax core team. The team consisted of approximately ten employees at any one time that developed and refined a working vision statement and identified a preliminary set of business focus areas. Contractor support was provided by Booz Allen Hamilton (and their subcontractor Oliver Wyman), and Accenture. The contract costs to date have been approximately \$3.54 million and came from the Operations Support and Enforcement budgets.

There is no current plan to implement a Real Time Tax matching process. A small IRS ad hoc team continues to explore the real time tax data matching vision. However, contractors are no longer working on the effort.

2. A May 2012 Government Accountability Act report that I requested found few small businesses have claimed even a partial small employer health insurance tax credit, partly due to its complexity and restrictive eligibility requirements. Has the IRS made any suggestions to the Treasury Department to simplify or otherwise alter the credit?

Response

The IRS worked with the Treasury Department (which has jurisdiction over issues of tax policy) in developing a proposal in the Administration's FY 2014 budget to simplify the small business health tax credit. That proposal would greatly

simplify the phase-out of the credit, eliminate the requirement that an employer make a uniform contribution on behalf of each employee, and eliminate the limit imposed by the state average premium.

3. You have said that the Internal Revenue Service will be ready to implement its provisions of the health care law. However, at a House committee hearing on July 17, 2013, Alan Duncan, a Treasury Department Assistant Inspector General for Tax Administration, raised many questions about the "protection of confidential taxpayer information that will be provided to the state and federal exchanges." In addition, Mr. Duncan said he is concerned that the IRS may not be able to detect or prevent fraud by some consumers obtaining tax credits and tax refunds under the health care law.

a. What protections does the IRS have in place now that will prevent compromises of confidential taxpayer data under the health care law, including that of small businesses?

Response

The IRS has protections in place to mitigate the risk of the loss, breach or misuse of Federal tax information (FTI) available under provisions of the Affordable Care Act (ACA). All taxpayer data, including that of small businesses, is protected under the provisions of Internal Revenue Code section 6103. Section 6103 imposes safeguarding requirements on the disclosure of FTI, and the Code imposes penalties on the unauthorized use or disclosure of FTI. Moreover, no return information related to small businesses will be disclosed under the ACA - only return information from individual tax returns is authorized for disclosure under the ACA. Confidential business tax information is not needed to purchase health plans through an Exchange, or Marketplace.

Each Marketplace must comply with the safeguarding requirements outlined in IRS Publication 1075, *Tax Information Security Guidelines for Federal, State, and Local Agencies*, throughout the operation of the Marketplace. These requirements were incorporated into the *Minimum Acceptable Risk Standards for Exchanges (MARS-E)* - the security and privacy requirements published by Health and Human Services (HHS). Certified compliance with all security requirements and standards, evidenced by an IRS approved Safeguards Procedures Report (SPR), must be received prior to the release of any tax records through the Centers for Medicaid and Medicare Services (CMS) Federal Data Hub to state Health Insurance Marketplaces and agencies.

IRS FTI security guidance and expectations are enforced through a robust, dedicated ACA review process. A specialized review team was established comprised of six members (3 Disclosure Enforcement Specialists and 3 Computer Security Specialists) with expertise in the unique aspects of ACA safeguarding. The team supports the preparation and review of ACA SPRs by state agencies,

conducts on-site visits, and will conduct subsequent reviews once data is exchanged. Through a multi-agency coordination team, the IRS developed a strategy for unified oversight and procedures for reporting data loss incidents of personally identifiable information. In the event a critical security concern is identified or reported, the IRS has the ability to quickly stop the flow of data.

b. How does the IRS intend to prevent fraud in tax refunds or tax credits under the health care law?

Response

Beginning with 2014 tax returns filed in 2015, individuals will be eligible to claim the premium tax credit and will be required to reconcile any advance premium tax credits already paid to their insurance company on their behalf. The IRS will be required to promptly process accurate returns while also efficiently identifying and stopping any erroneous claims for the credit.

To facilitate this process, the Marketplaces will be transmitting over secure, encrypted channels to the IRS enrollment information for individuals purchasing coverage through those Marketplaces. This transactional information will include the fact and cost of coverage, and information on any advance payments of the premium tax credit made during the coverage year to the taxpayer's insurance company on their behalf. While certain identifying information, such as name and SSN, is required to support the tax return processing, no personal health information is ever provided. The IRS will reconcile the information with what the individuals report on their tax returns so that the IRS can verify whether they received the proper amount of credit, are owed more, or must repay any excess advance payments.

It is important to note that the IRS already routinely receives third-party information that helps it verify the accuracy of tax returns, and we have longstanding policies in place related to the safety and privacy of this information. We will use this experience to guide us in making sure that any taxpayer information we receive is properly safeguarded.

In addition to the data, tools and systems that the IRS uses to combat tax fraud of all kinds, we have some specific tools for enforcing proper payments of the premium tax credit. As mentioned above, the Marketplaces will be providing the IRS with key 2014 transactional data prior to the beginning of the 2015 tax filing season. Having this pre-positioned transactional data will allow the IRS to efficiently sort for many of the basic qualification and computational elements of the premium tax credit. While the IRS does not share publicly all of the tools and techniques used for detecting non-compliance, it is important to note that as the tax returns are processed, for example, the IRS will be able to determine whether:

- There is a record of anyone on the return having enrolled at a Marketplace (a basic requirement to claim the credit);
- The return indicates that advance payments have already been paid directly to the insurance company and need to be netted against the credit calculation before a refund can be due; and
- The return reports inaccurately high premium costs or inaccurately low advance payments as compared to the Marketplace data.

Additional eligibility and accuracy issues will also be checked using other ACA-specific information and by applying the same new and enhanced techniques we apply to all returns to detect non-compliance.

4. According to the National Federation of Independent Business, one in four small business owners also own at least 10% of one or more separate and distinct employing businesses. About 13% of all small employers have a 10% or greater interest in at least three employing businesses. Some of these business ownership arrangements can be complicated. Small business owners have expressed concern about whether the employees in a business they own a part of will be considered to be their employees for purposes of the employer mandate. The IRS's Questions and Answers on the Employer Shared Responsibility Provisions; Section 414(b) and (c) and Section 1563(a) of the Internal Revenue Code, which govern controlled groups of companies and other business entities; as well as the attribution rules, are not clear on the many situations that can arise. Please provide an answer for the following questions:

Response

Whether a small business arrangement would result in the application of the employer responsibility provisions of the Affordable Care Act depends on the particular facts and circumstances. We welcome your questions and intend to use them to update available Q&As on our website. More specifically, we have attempted to address the specific scenarios below and to explain what else would be needed if a definitive answer is not provided.

The employer responsibility provisions apply only to "applicable large employers," generally meaning an employer that employed, on average, at least 50 full-time employees (or the equivalent combination of full-time and part-time employees) during the previous year. For purposes of determining whether an employer is an applicable large employer, all entities treated as a single employer for other purposes under the Internal Revenue Code (that is, the rules for qualified retirement plans under sections 414(b) (c), (m) and (o)) are treated as a single employer.

Although many of the subparts of question 4 do not state whether the entities you are asking about are incorporated or unincorporated, the answers assume that they are unincorporated. We note that the rules that apply to incorporated and unincorporated entities are very similar.

For unincorporated entities, two or more trades or businesses are under common control if they are a "parent-subsidiary controlled group," a "brother-sister controlled group," or a "combined group."

A parent-subsidiary controlled group is one or more chains of organizations connected through ownership with a common parent organization if (1) a "controlling interest" (at least 80%) in each of the organizations, except the common parent, is owned by one or more of the other organizations, and (2) the common parent owns a controlling interest in at least one of the other organizations. This type of controlled group can be described by the following example: parent company A owns 80% of company B, which owns 80% of company C. In this example, companies A, B, and C are all members of the same parent-subsidiary controlled group.

A brother-sister controlled group exists if the same five or fewer persons own (1) at least 80% of each organization (a "controlling interest"), and (2) more than 50% of each organization, taking into account each person's ownership to only to the extent that it is identical within each organization ("effective control"). For example, if Steve owns 90% and Jane owns 10% of company Y and Steve and Jane each own 50% of company Z, then companies Y and Z are in the same brother-sister controlled group. This is because Steve and Jane together own at least 80% of both companies and, looking at Steve and Jane's ownership only to the extent that it is identical in each company, Steve and Jane together own 60% of both companies. (Steve's identical ownership of Y and Z is 50% because Steve has at least a 50% ownership interest in each company. Jane's identical ownership of Y and Z is 10% because Jane has at least a 10% ownership interest in each company.)

A combined group means any group of three or more organizations if each organization is a member of either a parent-subsidiary controlled group or a brother-sister controlled group, and at least one of the organizations is the common parent of a parent-subsidiary controlled group and is also a member of a brother-sister controlled group.

In determining whether persons have a controlling interest or are in effective control of an organization, the ownership attribution rules apply. These rules generally provide that an interest owned by one person or entity may be considered as owned by or for other persons or entities that have relationships specified by the Income Tax Regulations.

a. An individual owns 90% of a business with 45 employees and his brother and sister own the remaining 10%. The business does not provide health insurance. If the individual's brother asks the individual to invest in a new business that employs 6 people, including the brother, and the individual invests, will both his business and his brother's new business be viewed as having 51 employees?

Response

We would need more information to determine whether these two businesses are under common control. If the entities are in the same controlled group, then both entities will be treated as a single employer for purposes of section 4980H.

The facts do not describe each person's ownership interest in the new business so it cannot be determined whether the ownership of the individual (X) (or the individual together with his brother (B) and sister (S)) are sufficient to cause the new business to be in the same brother-sister controlled group as the individual's original business. If, for example, B owns 5% of the original business and X and B each owns half of the new business, the two businesses would be in the same controlled group. This is because together, both X and B own at least 80% of each business, and, looking only at the identical ownership in each company, X and B own 55% of the combination of companies (X's identical ownership of the businesses is 50% because X has at least a 50% ownership interest in each company; B's identical ownership of the businesses is 5% because B has at least a 5% ownership interest in each company). If, however, B owns 5% of the original business and 90% of the new business (with X owning the other 10%), the two companies would not be in the same controlled group. This is because, although together both X and B own at least 80% of each business, X and B own only 15% of the combination of companies looking only at the identical ownership in each company (X's identical ownership of the businesses is 10% because X has at least a 10% ownership interest in each company; B's identical ownership of the businesses is 5% because B has at least a 5% ownership interest in each company).

Even if the two companies are in the same controlled group, however, they might not be subject to the employer shared responsibility provisions of the ACA if they do not together have at least 50 full-time employees (or the equivalent combination of full-time and part-time employees) during the previous year. The term "employee" does not include a partner in a partnership or a 2-percent shareholder in an S corporation. Thus, if X and B are partners or 2-percent S corporation shareholders, they would not count and the two companies combined would not have 50 employees.

b. Will a crowd funding investor who also owns a business have his employees counted toward the crowd-funded business's employees (or vice versa)?

Response

The controlled group rules apply only to the aggregation of “trades or businesses.” Although the question refers to a “crowd-funded business,” we need more information to determine whether the entity is actually a “trade or business” for purposes of these rules. We would also need more information (such as ownership interests) to determine whether the entities are part of a controlled group.

c. If an individual owns 100% of one company and 50% of another, which employees are attributed to the individual?

Response

If these companies comprise a brother-sister controlled group (as discussed above), then their employees will be treated as employed by a single employer (consisting of the two companies). Based on these facts alone, these companies are not a brother-sister controlled group.

The individual (X) has a controlling interest in and effective control of the company in which he is 100% owner. However, X does not appear to have either a controlling interest in or effective control of the company in which he is 50% owner. This analysis may change based on currently unknown facts. For example, if the other 50% of the company is owned by X’s spouse, X would be considered to own that interest under the attribution rules.

Finally, these facts do not suggest the presence of either a parent-subsidary controlled group or a combined group.

d. If you are in a partnership or LLC owning separate businesses, are the businesses separate or combined?

Response

We do not have enough information to answer this question. As discussed above, whether these businesses are part of a controlled group generally will depend on whether they are part of a parent-subsidary controlled group, a brother-sister controlled group, or a combined group. The controlled group analysis with respect to partnerships or LLCs is very similar to the analysis involving corporations. The answer to this question will depend on a variety of factors, such as the ownership interests of the individuals and entities involved.

e. If separate health care businesses are owned by an individual, his wife, his mother and brother, are they assumed to be combined or separate?

Response

We would need more information to answer this question, including the extent of each person's ownership interest in each business. We would also need more information to determine whether any of the attribution rules under which an individual may be considered to own interests owned by his or her spouse, parent, or child (but not a sibling) apply.

The controlled group rules generally attribute to an individual an interest owned by his or her spouse, provided they are not legally separated, unless each of the following conditions are satisfied: (A) the individual does not directly own any interest in the organization at any time during the taxable year, (B) the individual is not a director, fiduciary, or employee and does not participate in the management of the organization at any time during the taxable year, (C) not more than 50% of the organization's gross income for the taxable year was derived from royalties, rents, dividends, interest, and annuities, and (D) the spouse's interest in the organization is not subject to conditions that substantially restrict or limit the spouse's right to dispose of the interest and that run in favor of the individual or his or her children who are under 21. Without more information, we cannot determine whether these attribution rules apply.

An individual who is under 21 is deemed to own an interest owned by his or her parents, and an individual is deemed to own an interest owned by his or children who are under 21. If an individual is in effective control of an organization, then he or she will be considered to own any interest in that organization that is owned by his or her parents and children who are 21 or older. Without more information, such as the age and ownership interests of the individual, we cannot determine how these attribution rules apply.

f. If three different companies are owned that are different types of operations, with 20 employees in each company, but the employees are all the same people, is the owner a small or large employer?

Response

Assuming that the three companies are in the same controlled group, the employees of all three companies are treated as employed by a single employer. However, each employee should not be counted more than once so that the employer would not be an applicable large employer.