HEARING ON IRS LATEST ENFORCEMENT: IS THE BULLS-EYE ON SMALL BUSINESS?

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

WASHINGTON, DC, APRIL 5, 2006

Serial No. 109–46

Printed for the use of the Committee on Small Business

Available via the World Wide Web: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

28–570 PDF WASHINGTON : 2006

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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WEDNESDAY, APRIL 5, 2006

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Committee met, pursuant to call, at 10:00 a.m., in Room 2360 House Office Building, Hon. Donald Manzullo [Chairman of the Committee] presiding.

Present: Representatives Manzullo, Kelly, Akin, Sodrel, Velazquez, Bordallo, Barrow.

Chairman MANZULLO. Good morning.

Before receiving testimony from the panel, I want to remind everybody that we would like to keep the second panel witnesses to their oral testimony to five minutes. In front of you on the table, you will see a box that will let you know when your time is up. When the light is yellow, you have one minute remaining. When five minutes have expired, a red light will appear. Once the red light goes on please wrap up your testimony as soon as you are comfortable.

This is the second hearing we have been having on the so called tax gap, which the IRS defines as the difference between what is paid and what should be paid. And everybody agrees that people should be paying taxes legally owed.

The purpose of this hearing really is twofold. The first part is whether or not small businesses have been unfairly targeted by the IRS to the exclusion of others that may not be paying their taxes correctly. The second part has to do with what types of remedies are available to the IRS. But I want you to notice that the IRS' efforts are targeted at mom and pop small businesses.

I read over the GAO's report on the IRS last night while watching the tremendous game with the University of Maryland. I do not know if I was more excited over that basketball game or over GAO's report on the IRS. This is a report you have to read yourself. It is dated July 2005. Page 11 makes it explicitly clear because the IRS has no way of knowing whether or not corporations pay their taxes correctly, they do not even discuss going after corporations, instead the IRS goes after the little guys, the most vulnerable, the ones without the big lobbying firms in Washington, the ones represented by trade associations and the little guys who always get the crap kicked out of them on Capitol Hill. This GAO report is nothing less than condemning over what the IRS is doing. It should make the IRS hang its head in shame.

I want to read from it on page 11. Estimates for some components of the tax gap are based on old data. The data is used by the IRS to determine which persons to pursue to reduce the tax gap. The report explains that "The IRS has difficulty estimating the tax gap because of different interpretations that complicate determination as to whether or not taxes are paid fairly by corporations. Further the report states that the IRS also "explained that due to these complexities and the costs and burdens of collecting complete and accurate data for corporation, IRS has not systematically measured large corporate tax compliance through statistically valid studies, even though the officials acknowledged that such studies would be useful in estimating the related tax gap."

If I were a professor and you turned in the report the IRS is using to go after the small people, you would get nothing less than a F or an F minus.

I find it incomprehensible that the IRS is coming out with these new and fiscal schemes going after small businessmen when the data they rely upon is not worthy of a first grader. It's a disgrace that the IRS should rely upon virtually no information. But the word is out. Last year, audits were up 100 percent. If you're a small businessman, they were up 140 percent.

The remedies that the IRS is proposing only attach to the little guys, the moms and pops and not to the C corporations. And the incredibility of these proposals means that if a small businessman is the sole shareholder in a C corporation, he's exempt. But, if he can't afford the attorney to go into a C corporation he's not exempt from the wrath of the IRS. I'm really upset about this. And I'm upset about it because of the poor scholarship that's gone into the study, as much respect as I have for Mark Everson and I know that he inherited this. This study was in place even before he came into office. Mark is still using this information for the purpose of going after the most vulnerable.

Our job here in the Small Business Committee is to look after people that no one else cares about in this place, the forgotten ones, the 7 billion small business people that always get shuffled, the ones that pay health and accident insurance premiums after 15 percent FICA and FUTA taxes. They're the only business people that have to pay for their insurance with after tax money.

And the frustration level of this Chairman is running extremely high at this point because of the number of small business people that are being hit. But in spite of that, we look forward to the testimony of Mark Everson, who I think has done an exemplary job at the IRS. He's got a job that Congress has mandated to go after these people, and he's going after them on the best information that he has and the only methods that he knows. We disagree with the quality of his information and disagree with the remedies he's proposed but agree with the fact that you cannot have a nicer person than somebody like him.

And I yield to the minority, Ms. Velazquez.

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

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

With April 15 right around the corner, taxes are undoubtedly on everyone's mind. Today's hearing will focus on the tax gap; the dif-

ference between what the IRS is supposed to collect and what is actually collected. According to the IRS, the tax gap is estimated to be $345 billion per year and growing.

As the budget deficit mounts, around $400 billion, the administration is looking for ways to recover lost revenue that was supposed to come flowing in as a result of their fiscal policy. But it has not. Unfortunately, it appears the administration is trying to make up for these shortfalls and balance the budget by unfairly targeting small businesses. Today, we will hear from the IRS about a plan in the President's FY 2007 budget to crack down on small firms by granting the IRS even greater authority for enforcement.

This proposal, while having a significant impact on entrepreneurs will only reduce the tax gap by one tenth of 1 percent. This is a large price to pay for a solution that will not even fix the problem. However, any attempt to solely blame the IRS is wrong. What seems to be lost in this discussion is the impact wrong policy choices, specifically tax policy made by congressional Republicans and the administration, have had on this nation's small businesses.

While providing minimal relief for entrepreneurs, the bulk of the reform passed has only further complicated the process. It has added thousands of pages to the tax code, which will only exasperate the growing tax gap problem.

For proof, one only has to look at the 2004 tax bill. Even the Chairman of the Ways and Means Committee testified that this legislation set back efforts to simplify the tax code. Small businesses are being hit twice; once with the ever-increasing complexities of the tax code and again with the rising possibility of an audit.

Given the growing complexity, tax assistance is needed now more than ever for small businesses. Unfortunately, rather than providing assistance, the Administration is closing taxpayer assistance centers. It simply does not make sense for the IRS to shift these resources when the complexity of the tax code is increasing.

Congress will be voting on the budget this week and we will see just how much commitment there is to fairness for small businesses. The question at hand is: Will Members support the Administration's budget proposal to further reduce tax compliance assistance efforts and impose strict enforcement efforts? Or will they reject these proposals?

While many in the President's party are more than happy to vote for his tax cuts and trump all the supposed good they are doing, when it comes to the consequences, increased compliance costs and a growing tax gap, they are vehemently opposed. Unfortunately, you simply can't have it both ways.

As has been the case with tax, energy and health care policy, the Administration continually favors large corporations. It is no surprise that while the tax gap is not only made up of small business taxpayers, this Administration lets the big corporations off the hook and instead focuses on entrepreneurs. At the same time, many small firms have little or no resources to defend themselves.

Small businesses are the drivers of this nation's economy, and they deserve every effort possible to decrease the burdens they face. If the goal today is to reduce the costs to small business, Congress should first look to reduce the complexity of the tax code.

Most entrepreneurs are doing everything they can to pay the taxes they owe. They should not be blamed for the tax gap. This Administration needs to come to terms with the role their policies have had in furthering the tax gap. They need to admit the problem, then work to reduce the effects rather than point the finger, which is exactly what is happening with this current debate.

Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

The first panel we here from, Mark Everson, who has served as Commissioner of the IRS since 2003.

Next, the Committee will hear from Tom Sullivan who is Chief Counsel of the U.S. Small Business Administration Office of Advocacy.

Both have been before this Committee on several occasions. We look forward their testimony.

I am going to set this clock at about ten minutes for the first panel. And if you do not use it up, that is fine. But because your testimonies are so complex, I want to give you plenty of time to do that.

And Commissioner Everson, thank you for coming and we look forward to your testimony.

And I also want to state to the folks here that you will be leaving after your testimony, but the taxpayer advocate plus somebody else from the IRS will be sitting on the second panel. Kevin Brown will be on the second panel, plus I understand you are going to have people from the agency in the audience that will be monitoring all the testimony. We appreciate that.

STATEMENT OF MARK W. EVERSON, INTERNAL REVENUE SERVICE

Mr. EVERSON. Thank you. I do not think I will use the whole ten minutes. But we already covered a lot in the opening statements, so I think we will get to plenty in the questions.

Good morning Mr. Chairman, Ranking Member Velazquez and the members of the Committee on Small Business.

I am pleased to be here again to update you on our efforts to reduce the tax gap. As you know, the tax gap is the difference between the amount of tax taxpayers should pay for a given year and the amount that is actually paid on a timely basis. The tax gap represents in dollar terms the annual amount of noncompliance with our tax laws.

We now estimate that for the year 2001, the overall gross tax gap for all types of tax was approximately $345 billion, or a noncompliance rate of 16.3 percent. Our estimate of the net tax gap or what remains after enforcement and other late payments is $290 billion.

To reduce the tax gap we seek to improve service to taxpayers, we also enforce the law against those who do not comply. Our working equation at the IRS is service plus enforcement equals compliance. We strive to pursue to a balanced approach for all taxpayers, not just small businesses.

For service, our outreach and education programs help small businesses deal with the complexities of the tax code. And we are reducing wherever possible the paperwork and reporting burden

small businesses face. Electronic filing, which is growing rapidly across the nation, sharply reduces taxpayer errors on their returns. Our award winning website, IRS.gov, is one of the most widely used websites in the world during tax seasons.

On the next panel, you will hear from Kevin Brown, the head of our Small Business/Self Employed Division. Kevin will talk more about our efforts to decrease the amount of time and money taxpayers must spend to meet IRS requirements.

We will continue to work to improve services. But as you know, we are also boosting enforcement. The typical small business already has enough challenges without having to deal with a competitor who does not pay his or her fair share in taxes. We need to make sure that all are playing by the same rules. We want a level playing field.

No businessman or businesswoman should gain an unfair competitive advantage because he or she decides to underreport income, overstate deductions or fail to properly remit payroll taxes.

In recent years we have restored the credibility of our overall enforcement programs. In fiscal year 2005 individual audits were up 20 percent from 2004 to 1.2 million. They're up 97 percent since 2000.

High income audits were also up and have increased a 120 percent since 2000.

Corporate audits bottomed out in 2003, but by 2005 had recovered by over 50 percent.

Collections are more robust. Last year we had 2.7 million levies versus 200,000 in the year 2000.

All told, enforcement revenues have increased from $43.1 billion in 2004 to $47.3 billion last year.

In the President's fiscal year 2007 request we seek to build on this progress. We are asking for an additional $137 million in enforcement. This increase will allow us to maximize the return on the investment made in enforcement last year when Congress provided $42 million in additional enforcement funding.

Our research on the tax gap clearly indicates that where there is third party reporting, there is better compliance. In this regard I would draw to your attention a number of proposals in the President's 2007 budget aimed to address administrative and reporting issues. The most important of these is the proposal to mandate reporting to the IRS of gross receipts by credit card issuers for their business customers.

I believe the five legislative proposals that accompanied the Administration's funding request can make a significant contribution to reducing the tax gap. I hope they will enjoy your support.

In addition to these specific legislative proposals, I would also note that we plan to study the distinction between independent contractors and employees under current law.

Let me make one final point. The extraordinary complexity of our tax system contributes to the tax gap. I continue to be a strong advocate of tax reform and simplification.

Thank you.

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

Chairman MANZULLO. Thank you.

Mr. Sullivan?

STATEMENT OF THOMAS M. SULLIVAN, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SULLIVAN. Good morning Chairman Manzullo, Congresswoman Velazquez, Congressman Kelly. I am Tom Sullivan, the Chief Counsel for Advocacy at SBA. Congress established my office to independently represent the views of small business before Congress and federal agencies. So the comments expressed here don't necessarily reflect the Administration or the SBA.

My written statement was not circulated to OMB for comment. I'd like to submit my written statement for the record and briefly summarize.

Chairman MANZULLO. All the written statements of the witnesses will be inserted into the record without objection.

Mr. SULLIVAN. Thank you, Mr. Chair.

The small business industry groups who come to my office to try to appeal to us to bring their views into other government agencies have expressed concern that IRS is focused on small entities as a primary means of improving tax compliance. News articles illustrate the reasons why these trade groups view IRS' focus to be trained on their members. A March 20th "Tax Notes Today" article reported that IRS increased its number of audits primarily through a spike in small business audits.

In recent testimony the Commissioner highlighted the return on investment for resources spent on enforcement each dollar, the Commissioner said, spent generated $4 in additional taxes collected.

Small business groups who have appealed to my office are insistent that a similar analysis of how the service function of IRS realizes a return on investment would go far to demonstrate the balance of service plus enforcement.

Nina Olson, the National Taxpayer Advocate who is on the second panel this morning, has on numerous occasions and recently at a hearing over in the Senate encouraged the IRS to "recognize the central role taxpayer service plays in achieving compliance and do more to study the optimal ways to deliver taxpayer service and the magnitude of the impact."

Also you mentioned, Mr. Chairman, in your opening statement the GAO. GAO has encouraged the IRS to conduct research on the reasons for taxpayer noncompliance. And in 1996 GAO made similar recommendations.

Small business groups feel that this type of research on the service components of IRS can guide the IRS' education in taxpayer compliance programs.

Now let me turn my attention to some of the specific proposals that were mentioned by the Commissioners and will be mentioned in the second panel by the National Taxpayer Advocate.

The Treasury proposals and the Taxpayer Advocate's proposals that I will address require third party reporting and withholding. The Administration has proposed information reporting and backup withholding on credit card payments, payment card issuers, which are credit and debit cards. They would report reimbursements made to merchants and withhold taxes in certain circumstances.

Second, the Administration has proposed to require information reporting and backup withholding on all non-wage payments made to government contracts.

Small business groups who have come to my office have expressed that an unintended consequence of the increased withholding will be its harm to the cash flow of small businesses. In general, cash flow or liquidity is one of the most significant constraints small entities face in managing their business. According to a recent NFIB survey cash flow issues ranked in the top ten of important problems faced by small businesses. Small entities have a more difficult time paying their bills when their cash flow is interrupted. And small businesses must either borrow additional capital or forego early payment discounts to manage cash flow shortfalls.

Another unintended consequence of increased withholding is that tax deductible expenses of small entities may unnecessarily be taxed. Payments received by small entities for the services and products they provide include both their expenses and profits. Small business groups are concerned that another unintended consequence does not enter into the equations of withholding because expenses are generally tax deductible while profits are subject to tax.

Before Treasury and IRS impose new reporting and withholding requirements, small business believe it is important to determine the impact that small card issuers and small local governments will need to absorb as a consequence of these reporting and withholding strategies.

The National Taxpayer Advocate has proposed other reporting and withholding regimes. The third party proposals detailed in my written statement, while presented as voluntary really impose additional administrative burdens on small businesses that contract with self-employed taxpayers. Small businesses currently shoulder exceedingly high tax compliance costs. A study that was recently updated by my office shows that the cost of compliance costs employers with less than 20 employees a total of $1304 per employee. Additionally, requiring the payors of self-employed taxpayers to withhold may distort the line between being an employee and being an independent contractor.

Payors of self-employed taxpayers may become vulnerable to employer liability issues in that blurry line of independent contractor versus employee. Those issues include workman's compensation and unemployment tax issues.

Research sponsored by my office continues to show that the cost of tax compliance is 67 percent higher in small firms than in large firms. What can the IRS do to limit this disproportionate burden or unlevel playing field? Small businesses believe that IRS can evaluate the service they provide taxpayers so the importance of taxpayer service is not lost as they attempt to improve tax compliance.

And certainly this hearing is an opportunity for IRS to consider some alternatives that may minimize the unintended impact of some proposals on small business.

Thank you for allowing me to appear this morning.

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

Chairman MANZULLO. Thank you.

Ms. Kelly, why don't you go first?

Ms. KELLY. Thank you. I appreciate it. I have a markup in another Committee I have to get to.

I am very pleased to have the two of you here. There is no one that knows who really likes to dip in their pocket on April 15th and pay taxes. They would rather keep the money. Quite frankly, as a Republican in this Congress, I would like to have them keep the money. But that being said, when you talk about small business as a small business owner, former small business owner I know that the tax system is very complicated, but I also know that there is an attitudinal problem. Many times when someone comes into your office and says "I am here from the IRS for an audit," the attitude is ah-ha got you.

At point in the past in my husband's office there was an auditor who came and said "I have not found anything, but I have to find something because I have to cover the cost of my salary for being here." I know that that is not the first time that I have heard that. I have heard that in testimony in this Committee from other people, other small business owners.

Our problem as small business owners is several. The basic problem is clarity. We do not get enough education at the small business level to truly understand the tax codes. So you wind up holding on to every tiny little slip of paper because you do not know what the tax man is going to want when he comes in. It is everything from whether or not your business has donated to charity, paid for an ad in a high school book, all kinds of things that effect us as small business owners.

And I would encourage you, Mr. Everson and your group, your staff; Mr. Sullivan, I know you are out trying to help with clarity, but I know that both of you know that we have got to work through chambers of commerce, the NFIB, the groups that are out there to get more education on this tax code to the small business owners. It makes it easier for them. And without their full knowledge of all the little tiny tangential laws that may effect their particular business, then they do not save or have necessarily what is there.

Because my husband and I own several different small business we at one point in our lives for a period of about 15 years were audited on every single year by the IRS because the IRS did not know enough about the businesses that we were running to understand what we were filing as our tax code. And I see heads in the audience shaking. Sure, other people have been through that. I am not the only person.

Well, what concerns me is that we have some evidence here in this study that Chairman Manzullo was talking about that nothing really has changed over the course of the last ten years. We need to have a change.

So I would like an open commitment from you to try to help us teach small businesses better than you have been to approach a clarity with the type of business that people are in. Someone who shoes horses for a living has a totally different business than someone who is making small pieces of equipment for the Intel industry.

All these different businesses have different approaches to their business.

You have got a one size fits all approach to the filing of things, and that is very difficult and it makes it very complicated. I would like to see you work toward clarity. Can you give me some assurance that you are going to do that?

Mr. EVERSON. Well, you have covered a lot of ground there, and I agree with a great deal of it. We are committed to outreach and education and I think Kevin will get into some more of the details on that. But we have active programs working with the NFIB, which you mentioned, and all the different groups and get involved in their newspapers. And I think that is an area where I would suggest to you that that has been a success story of recent years.

Can we do more? Absolutely, we need to do more.

Two other points on this. Again, simplification of the Code. As you keep handing us the Jobs Act. The Jobs Act was this thick.

We've talked about the proposals. The Chairman and I talked yesterday about one of the things we want to look at is the definition of employee versus independent contractor. This is our training manual to apply the 20 part test on whether somebody is an employee or an independent contractor. We can only educate our people so well with the law that you have given us, if you will. So this is a joint discussion.

But, yes, we will continue to focus on the education and the outreach.

The last point I would say is I do not agree with the idea that somebody has to find something. Our no change rate on audits that you are talking about runs something like 16 or 17 percent. This research that we have undertaken the Chairman does not have much faith in it but we think it is pretty good, we believe will help us better figure out where we want to look so that we are not in that situation that you are discussing; that somebody is in there saying "gee, there is nothing here." This is something where we believe if we use the research properly, we will be able to risk adjust where we look.

Ms. KELLY. Well, just a follow-up on that, Mr. Everson. Are you in fact investigating more small businesses in this nation, is that a fact?

Mr. EVERSON. Yes, that is fact. If the Chair will indulge me for just a minute I would like to show several charts that will sort of frame this issue.

Selected coverage rates 2005. Companies with assets of $250 million, 44 percent. That is why we did not bother to do the research. We did the 46,000 audits on individuals, the coverage is so much lower. I would not use any more money on the corporations based on even if I knew that the tax gap was understated by half, because it is a relatively small piece. We are in there all the time auditing the biggest companies.

Estate tax, gross estates with over $5 million, 28 percent audit rate.

Corporations $10 to $50 million assets, 14 percent audit rate.

Individuals with income over a million dollars, that's 5 percent. This is still too low. We are bring this up.

What we are talking about here is individual businesses, individuals with the Schedule C, that is at 3 percent audit rate. That is in contrast to the fact that if we go to the tax gap map you will see that the problem.

Time filing that's most the individuals, that's about 8 or 9 percent, underpayment. You say you what you owe us but then you just do not pay us, that is another 8 or 9 percent. Eighty percent of it is under reporting. Most of that is in the individual income tax.

The biggest piece is in the under reported business income and that has an effect on the self-employment taxes. So it is really a bigger number than the $109 billion that effects the $39 billion?

The areas where we don't get much reporting, third party reporting come up to $110 billion of the tax gap. The biggest piece there is Schedule C income, that is $68 billion. That $68 billion has different components. The biggest single piece of that is gross income, that is $39 billion. There are other pieces in here.

And I agree. Look, education of what depreciation could be or car and truck expenses, we can do better there. But I don't think that gross income is—that most of this education will do it on this $39 billion. The question here is whether the income is being reported.

Why is this important? Because if you look at individual returns, this shows the change in individual returns since 1978. It has gone up 50 percent for all individual returns. We are up at over 135 million now. But Schedule C filers have gone up by 175 percent. This is no surprise to you. You know what has happened; there is a small growth in small businesses. But that issue that I just showed there, that is going to get bigger as time goes on.

So the basic rule here, we want to increase the audits, and we are increasing them everywhere, it is not just small businesses. But when we get the legislative proposals this is what you—this breaks out the compliance relatively speaking.

Wages, we have 150 million Americans, we are not talking about them here, but there are 150 million American employees. They are used to reporting and withholding, by the way. We are not proposing withholding. We are proposing backup withholding. But the average America, 150 million of us including everybody on this panel, is used to reporting on your wages. There is no cheating on wages, a one percent noncompliance rate. Where you have no reporting. no reporting like the income for the Schedule C filer, the noncompliance rate is over 50 percent. That is the problem. That is the problem.

Ms. KELLY. That is possibly, sir, because of confusion.

Mr. EVERSON. I would agree on things like depreciation of car expenses, but not on gross receipts. Not that complicated when somebody pays you, when somebody pays you in cash or with a credit card, it is not that complicated.

Ms. KELLY. Mr. Everson, what is your basis for all of this? Have you hypothesized a number?

Mr. EVERSON. No. Forty-six thousand audits were done as a part of the national research program that has been reviewed by GAO and others. What the Chairman was talking about earlier was, with which I agree, he stated accurately what happened. We did not do the research on the C-Corps and the reason we didn't do the

research on the C-Corps was because, as I said, we are already auditing those big firms by over 40 percent a year. So that this was a very intensive effort, cost of tens of millions of dollars to do this research. Looked at by GAO and others, a lot of academics participated in it.

Ms. KELLY. Let me just say that I notice here the reason I am saying, all these yellow boxes have a little code down here saying "dependent on older estimates."

Mr. EVERSON. Yes. Yes.

Ms. KELLY. So I wonder about the metrics you are using on these charts.

Mr. EVERSON. What I would say to you is all of what we have been talking about is over here. I concede freely to you that these are the big corporations right here. Even if this number is doubled because it is off by a factor of 100, what I am suggesting to you is we already have plans in place to attack that. So that where we spend our research effort, our initial—

Chairman MANZULLO. With withholding plans in place, your remedies are aimed solely at small businesses. You want to have backup withholding on credit card companies and on independent contractors solely as small businessman, completely excluding the C corporations.

I am sorry. Ms. Velazquez?

Mr. EVERSON. I'm sorry, Congresswoman. I am happy to come see you and continue to talk about this.

Ms. VELAZQUEZ. Mr. Emerson, thank you for your testimony. Everson, I am sorry.

Mr. EVERSON. Actually, I hate to correct the Chairman, but it is Everson. So if you will give me that opportunity.

Ms. VELAZQUEZ. Everson. Okay.

How much did you say that you spent on this study?

Commissioner EVERSON. I think that study cost us something like $100 million. I could be wrong. Is that? This is the head of our research program, Mark Mazur. He says that is about right.

Ms. VELAZQUEZ. Okay. So you spent all that money to figure out the tax gap?

Mr. EVERSON. Yes.

Ms. VELAZQUEZ. And did you figure out why people were under reporting? Do you have that data, complete data?

Mr. EVERSON. We do not have that. The problem—

Ms. VELAZQUEZ. So is it because they are cheaters or the tax code complexity? What is it? Because let me tell you, if you go to any university and you are going to do a research on a problem and then you make a conclusion without really trying to figure out why these people are not paying or are under reporting so that you can then develop a public policy to tackle the real issue, so why do you think that enforcement is the answer?

Mr. EVERSON. Well, I think that there are a number of studies that have certainly substantiated the impact of the enforcement in terms of both the direct impact if you look at what we have brought in, we have increased the direct monies that have come back to us in the last three or four years, plus the indirect impact that if I am audited and I mention it to my neighbor, they will perhaps file differently. So that is clearly there.

The debate that you are talking about is, which I agree, is on trying to quantify the service impact which we have been looking at. It is very difficult to do that. The statisticians who have looked at that have had a great deal of difficulty trying to find that.

Now when we did the research, to answer your question, our people tried to determine but were not successful because if we go to you, if we find a problem in your return, if we ask you did you intentionally cheat, what are you going to say? You are going to say no. I mean, that is the normal response. Nobody is going to admit, or very few anyway, that they were intentionally violating the law. So it is very hard to determine with the precision that you or I might want when you do the audit the exact reason.

Ms. VELAZQUEZ. But your response and your answer is based on a prejudged finding that they are under reporting because they do not want to pay. In no way you are doing any effort to find out whether or not the tax code complexity is the one preventing these people from paying?

Mr. EVERSON. No. I would not agree entirely with that. I have stated—

Ms. VELAZQUEZ. But let me ask you so enforcement is the sole answer?

Mr. EVERSON. No, not at all. I think—

Ms. VELAZQUEZ. So let me ask you another question.

Mr. EVERSON. Yes.

Ms. VELAZQUEZ. I just want to hear yes or no.

Mr. EVERSON. Yes.

Ms. VELAZQUEZ. So enforcement coupled with what?

Mr. EVERSON. With service. As I said at the beginning, we believe in service and enforcement.

Ms. VELAZQUEZ. Okay.

Mr. EVERSON. You need to do both. And if I can say again what I said in the oral statement, I believe simplification is essential to get after this, particularly for small businesses and people—

Ms. VELAZQUEZ. In terms of reducing the taxpayer assistance programs and the reduce of staffing at your office that have been the trend in the last three to five years?

Mr. EVERSON. You made reference to this in your opening statement. Last year the Administration had a proposal to shutter 68 walk-in centers. We have not done that. The '07 request that is pending before the Congress right now maintains services at a steady state. We are not contemplating any reductions in the services in the request, ma'am, that is before the Congress right now. So I think we got the lesson from last year's difficult discussions.

Ms. VELAZQUEZ. Okay.

Mr. EVERSON. So we are not proposing that again.

Ms. VELAZQUEZ. Okay. So we will hear a lot about what the IRS is doing towards enforcement. But I want to look at Congress' record on the issue. According to a report published by the Democratic staff of the House Ways and Means Committee there were 900 changes to the tax code in the 108th Congress. The FSC/ETI legislation passed—

Mr. EVERSON. Yes.

Ms. VELAZQUEZ. —in 2004 provided for 561 changes and added 250 pages of tax law changes. This does not even include the 2001

and 2002 tax cut that added complexity and thousands of burden of hours on small businesses. How would you assess Congress' record on helping reduce the tax guide?

Mr. EVERSON. Well I take my own self interest seriously and I am not going to take a particular shot at Congress, other than to say that that record that you are talking about adding complexity, it gets us nowhere. What I have said repeatedly is—

Ms. VELAZQUEZ. Give me a grade, A, B, C?

Mr. EVERSON. I've got to say that over time Congress fails in the effort to get a simple understandable tax code.

Ms. VELAZQUEZ. So that is an F? You know, I used to be a college professor and I love—

Mr. EVERSON. I think we can agree on that.

Ms. VELAZQUEZ. Mr. Sullivan and then Mr. Everson—

Mr. EVERSON. Thank you.

Ms. VELAZQUEZ. —would you agree that the tax codes has in 2001 have increased complexity?

Mr. EVERSON. I would agree that the tax code since 1986 over a period of years of control of Congress by both parties has grown in complexity. This is an inevitable process. And what happens is you have got these cycles where people eventually get feed up with all the complexity and there is a real call for reform. I am an advocate of that reform.

Ms. VELAZQUEZ. But five years ago we heard a lot about, you know, this is going to be the Congress and this is going to be the Administration's—

Mr. EVERSON. I am not wading into—

Ms. VELAZQUEZ. Of course.

Mr. EVERSON. Let me make one thing clear. I am not wading into a partisan debate on this. I am giving you the simple fact that over decades this code has continued to grow; that's all.

Ms. VELAZQUEZ. Mr. Sullivan, Advocacy has done numerous reports on the issue of taxes and small businesses. For example, I know that the Office of Advocacy studied the impact of marginal rates on small businesses. That was quite a timely report considering Congress was voting on marginal rates in 2003.

Given the huge impact of this $2 trillion in tax cuts, why have you not done any work to study whether these changes have increased complexity for small businesses.

Mr. SULLIVAN. Congresswoman, actually we have done some studies on the overall complexity. We have not narrowed in on whether specific year tax cuts contribute.

Ms. VELAZQUEZ. Okay.

Mr. SULLIVAN. But I would point the Congresswoman and this Committee to a working paper by an economist in my office, Dr. Saade Radwan that documents what Commissioner Everson was saying, that however well intentioned each different change may be, and this echoes your concerns, Congresswoman Velazquez, the overall complexity actually is harmful to small business.

Ms. VELAZQUEZ. So are you telling me that are you going to commission a study on this? This is huge for small business.

Mr. SULLIVAN. Well as the Congresswoman pointed out, sometimes our timing of studies does not exactly comport with congres-

sional action. Actually, this is not on purpose, but our studies take anywhere from one year to two years.

Ms. VELAZQUEZ. I know. It was coincidental 2003. But can I get a—

Mr. SULLIVAN. But we tried to get that study done as quickly as we could, and we hope that it benefits the debate.

What we will try to do is continue to focus in on what parts of the tax code or the over all complexity of the tax code benefit small business. And as far as focusing in on specific year tax changes, I would direct the Committee's attention to a March report by the Department of Treasury that is peer reviewed that documents a number of different pros and cons of recent tax changes.

Ms. VELAZQUEZ. Thank you, Mr. Sullivan.

Mr. Everson, does Small Business Self-Employment Division of the IRS has served a critical role by meeting with members of the small business community to identify concerns. It has also been helpful to small business and tax practitioners who need a system making determinations about tax code questions.

I am concerned that there have been efforts by the IRS to shift resources in this division from compliance towards more enforcement. Can you talk about the staffing level at your department?

Mr. EVERSON. Sure. And I'll let Kevin talk about it afterwards in more detail. But what we did in the last year was we had people who were on the enforcement side within this division, SB/SE, and we were doing part time work on outreach. And what we did was we consolidated this to make this a year around full time responsibility. Because what was happening was when you get into this busy season that we are in now, they were being taken off of that outreach. We did not think that was particularly effective. So we have made some changes in the last year or two to try and have a more dedicated full time work force on this.

Ms. VELAZQUEZ. So, Mr. Everson, we constantly hear how small businesses are paying less taxes under this Administration and they saw enormous benefit from the tax cuts. If that is the case and rates are lower, it seems there will be less incentive to intentionally taxes by under reporting income. However, the IRS is cracking down on small businesses. Do this not seem kind of backward? Do you disagree with the theory that lower tax rates should lower tax avoidance?

Mr. EVERSON. I think that the debate, I do not want to wade into the policy debate because my job is to administer the code, good or bad, as written. Obviously policy decision are taken to provide incentives for economic activity. There are compliance issues, though. Complexity is one, also stability is another. We have not talked about stability.

The constant changing of the rules is an issue on top of just how complex they are.

If you look at our research, which is for 2001, you are right that each year the revenue stream of the government changes. It changes for rates, it changes for increases in corporate receipts versus individual receipts. So there is a mix effect that takes place over time. But what we would suggest is we're concerned about going after the gap in all the areas, but we do prioritize.

If we go back to the bar chart, one of the things that's very clear from the research is is that, again, where there's no reporting like there is for employees, that the gap is largest. So we want to get after that through not just some more audits, but also through some additional reporting.

Ms. VELAZQUEZ. I would have more questions later, Mr. Chairman.

Chairman MANZULLO. Thank you.

Could you put up that chart, selected IRS coverage rates FY 2005? Sometimes these charts remind me of that guy on Johnny Carson giving the directions to the used car lot. Do you remember that with the freeways, wore the big hat and everything?

Mr. EVERSON. This?

Chairman MANZULLO. How many corporations are there with assets above 250 million? Do you know the figure for that?

Mr. EVERSON. I don't have the figure. I can certainly get it for you. But the number of the largest corporate audits that we did last year were—I guess this would be all of our companies over 10 million in assets. See, Kevin's group has companies with assets up to 10 million; it has got the C-Corps and the individuals filing the Schedule C. Our large and mid-sized business unit is anything over 10 million assets. We did about 13,000 audits last year.

Chairman MANZULLO. Well, how many companies are there? Does anybody know? The gentleman just handed you a—

Mr. EVERSON. Yes. This is the number of audits. It doesn't say with—the number of returns. Okay. I am told it is about 11,000.

Chairman MANZULLO. For corporations with assets over 250 million?

Mr. EVERSON. Yes. Yes. That is correct. I guess we got 11,000 returns filed in calendar 2004, 11,000 had assets over 250 million.

Chairman MANZULLO. Not the estate, but the next one, corporations between 10 and 250 million?

Mr. EVERSON. That would be—

Chairman MANZULLO. You guys can help your boss out. Don't let him guess here.

Mr. EVERSON. Oh, he's got it right here.

Chairman MANZULLO. Okay.

Mr. EVERSON. It's all right here. He is just making me add up the numbers.

Chairman MANZULLO. All right.

Mr. EVERSON. It is about 43,000.

Chairman MANZULLO. But where are the number of corporations that are under 10 million?

Mr. EVERSON. That is a different category. I think that that audit rate is less than 1 percent. For C-Corps assets of 10 million, it is about seven-tenths of one percent, Mr. Chairman, that audit rate.

Chairman MANZULLO. Do you know how many there are?

Mr. EVERSON. Oh, a couple million, I guess.

Chairman MANZULLO. Well—

Mr. EVERSON. Let's see. Yes. Now let me show you one additional—

Chairman MANZULLO. Let me back up. There are 2 million firms that have 10 million—

Mr. EVERSON. Two million C-Corps.

Chairman MANZULLO. Two million C-Corps that have under 10 million in assets?

Mr. EVERSON. C-Corps. Let me show you what is happening with the C-Corps, Mr. Chairman, and why this is not as big an area of emphasis.

Chairman MANZULLO. And the audit rate on that group is about .3 percent.

Mr. EVERSON. Point seven.

Chairman MANZULLO. Point seven. All right. Go ahead.

Mr. EVERSON. Mr. Chairman, this lays this out. Because you have talked to me before about S-Corps what has happened over the years, again, starting at the same point.

1978 we had about 2 million C-Corps and a half a million of the S-Corps. Look at what has happened here, and this line is crossed now. Far more businesses are operating as S-Corps. The C-Corp number—

Chairman MANZULLO. Now let me stop you. What is the audit rate for S-Corps?

Mr. EVERSON. The audit rate for S-Corps, go back to that chart, .3 percent; it is next to nothing.

Chairman MANZULLO. All right.

Mr. EVERSON. That is why—

Chairman MANZULLO. Then how many S-Corps are there?

Mr. EVERSON. Well, it is right here.

Chairman MANZULLO. Okay. Wait a minute. So it is about three and a half million? Okay. All right.

Mr. EVERSON. So what we are doing, this is an area where we were doing nothing. Nothing at all. I am not saying we missed this, but take a look at this. S-Corps, .3 percent. So one of these we have corresponded is about is your concern that the next stage of the research we are putting here. Now we may conclude that there are not problems with the S-Corps, but with an audit rate like that we just do not know.

Chairman MANZULLO. Well, that is the whole point.

Mr. EVERSON. That is why we are doing the research.

Chairman MANZULLO. No. You see, you just do not know and yet you go full ahead pell-mell after the mom and pops?

Mr. EVERSON. Well the S-Corps we're doing the research program with 5,000 returns—

Chairman MANZULLO. I mean you spent $100 million. How much more money and more time do you need to do this? And why do you advocate such draconian withholding measures when your research is not done?

Mr. EVERSON. Let me make sure that I clarify the—I would not agree with the characterization of draconian. We are proposing—

Chairman MANZULLO. Well, how about plutonian then?

Mr. EVERSON. We are proposing reporting and backup of withholding. If you look at backup withholding which is in place for all Americans now for let's say dividends and interest. Let year we got something like 330 million reports on dividends and interest. Only a little over one in a thousand didn't come in with the proper taxpayer identification number. That is what would trigger potentially

the backup withholding. So it is a very de minimis number of people.

Chairman MANZULLO. Let me finish with this before we get into that, because I want you to explain the withholding on it. Well, how many individual businesses are there that fild Schedule C?

Mr. EVERSON. It is now up to about 16 percent of all the returns. So what would that be? About 18, 20 million? Twenty million let us say.

Chairman MANZULLO. So you got 20 million people. So there would be substantially a lot more people would be audited—

Mr. EVERSON. Well, as I indicated, our priority has been to—

Chairman MANZULLO. No. Let me finish. Let me finish. A lot more people would be audited. You have a better chance of being audited if you are a small business person in terms of the personnel that the IRS is dispatching for that?

Mr. EVERSON. Well, those are the rates right there. And we have a high rate. A lot of controversy. I get a lot of comments from Madam Velazquez side of the aisle on EITC audit rates, because look at that. That is 2.4 percent and some people think that is too high. That program has a lot of concern because of the high error rate stemming sometimes from fraud, but largely from the complexity of all the definitions. There are a lot of issues in there.

We try to run a balanced program, but what we have worked on in the last several years has been particularly in the high income area, take a look at that five percent audit rate and also on the corporate areas where we brought that back up and progressively worked on the shelters.

So I would not agree with the characterization that we have focused particularly on small business. I would not agree with that at all.

Chairman MANZULLO. Well, you said that yourself.

Mr. EVERSON. No. I said we are, we need to do more and we need keep forward.

Chairman MANZULLO. You are focusing on small business. What you do not understand here, do you know who comprise a lot of C corporations that have under 10 million in assets? These are lawyers, accountants; these are all service organizations.

Mr. EVERSON. Yes.

Chairman MANZULLO. Service companies. Manufacturing companies and other retailers would have more than 10 million. And there is a whole group of people in there that are under 10 million that you are not even touching as long as they are a C Corporation.

Mr. EVERSON. Well, the thing is, Mr. Chairman, again we measure our effectiveness in part by what I mentioned before, this no change rate. For the small C-Corps the no change rate, that is where we go in and it is Congresswoman's Kelly's issue of we do not find anything. When we have done the C audits on the smallest businesses, that no change rate is something around 40 percent in contrast for individuals that rate is 15 or 16 percent. So—

Chairman MANZULLO. Well wait a second. Your audit rate on two million companies with under 10 million in assets is .7 percent?

Mr. EVERSON. Yes.

Chairman MANZULLO. That is a pretty small number?

Mr. EVERSON. Yes.

Chairman MANZULLO. But you have already made the assumption based on your study that GAO does not like that you are not going to go after these people.

Mr. EVERSON. I did not say we are not going to go after these people. But what we do is we use the studies to risk adjust and also we use our own results. And as I just indicated, when we look at the C-Corps, the very smallest of them, a no change rate means we do not find anything 40 percent of time. There is in our field experience, if you will, we see relatively more compliance in that entity.

Chairman MANZULLO. But the only remedies you are proposing are against non-C entities, mom and pops, withholding, is that correct?

Mr. EVERSON. I think that we are working across three fronts, if you will, to do more across the board. And what we are doing first is we are increasing our enforcement activities. We are improving our procedures, which includes a whole series of productivity and other improvements and using research where we have it. And then we are making, as you suggested, some legislative proposals.

Chairman MANZULLO. Right. Now the legislative proposals, and by the way I found it very interesting that you want to level the playing field. I have never known the IRS that wants to level the playing field between two businesses. I am sure that businesses would rather have less regulations and the IRS trying to make things easier for one and not for the other. I just find that astonishing.

But in terms of the withholding, let me walk you through a scenario.

Mr. EVERSON. Yes.

Chairman MANZULLO. Let us say that I am a restaurant owners, a non-C-Corporation, mom and pop, the way my brother was. And I report a million dollars in gross receipts for tax year 2006. And, hypothetically, through your research IRS estimates that restaurants receive 50 percent of their payments from customers using credit cards and 50 percent in cash.

Then the credit card companies send the IRS information which you want from every credit card company for every business except C corporations. They send you information that my restaurant reports $400,000 in credit card charges. No. I'm sorry. Reports $800,000 in credit card charges. The return shows a million dollars gross, you have $800,000 in credit card charges. What would the IRS do?

Mr. EVERSON. Well, I will not give you a specific answer because I am not an expert in that area. But what we do is we have formulas where we work based on history and research and we select our audits based on those formulas.

Chairman MANZULLO. No, I—

Mr. EVERSON. No, please, let me finish.

Chairman MANZULLO. No, just a second.

Mr. EVERSON. I'm trying to say—

Chairman MANZULLO. I made it easy for you.

Mr. EVERSON. I can't tell you what we would do. It depends on resources we have.

Chairman MANZULLO. Well, let us say you decide to audit. So you decide to audit.

Mr. EVERSON. Right. It comes down to what Congresswoman Kelly was asking about before, having a knowledge of the business. The pattern of credit versus cash receipts might be different in a restaurant than it is in a dry cleaner or a small gardening services.

Chairman MANZULLO. Let me go through it one more.

Mr. EVERSON. Yes.

Chairman MANZULLO. The return shows a million dollars gross receipt.

Mr. EVERSON. Yes.

Chairman MANZULLO. This is a restaurant.

Mr. EVERSON. Yes.

Chairman MANZULLO. Hypothetically, all right, the IRS says 50 percent comes from credit cards and 50 percent comes from cash. And then the credit card companies send you notice that there was $800,000 charged in credit cards which should trigger in somebody's mind that it should be 1.6 million reported as opposed 1 million reported. My question is if the IRS has that information, which is what you want, is that not correct?

Mr. EVERSON. Yes, that is correct. That is what we want.

Chairman MANZULLO. What would you do with it?

Mr. EVERSON. If someone sticks out, if a business sticks and is different from others—

Chairman MANZULLO. And this one would.

Mr. EVERSON. Yes. If it would, it might trigger an audit.

Chairman MANZULLO. All right. And then what would you do? I mean not talking about the audit. Would you ask the credit card company to withhold?

Mr. EVERSON. No.

Chairman MANZULLO. You would not?

Mr. EVERSON. No. Because the backup withholding attaches if you as—let us say you are the credit card issuer.

Chairman MANZULLO. Okay.

Mr. EVERSON. If you forward it to us the wrong number, a number that matched up Everson and you reported that I had a taxpayer identification number, but when we went to match up it didn't match up to what we showed for Everson, that is what would trigger backup withholding.

Chairman MANZULLO. So in the hypothetical that I gave you that would not trigger any backup withholding?

Mr. EVERSON. No, sir. Not at all.

Chairman MANZULLO. Okay. So that is why the documents that you put out are—

Mr. EVERSON. They are unclear.

Chairman MANZULLO. They are unclear.

Mr. EVERSON. Okay.

Chairman MANZULLO. So it is only if there is something wrong with the taxpayer identification number?

Mr. EVERSON. That is it. And that is the same way it works on dividends and interest right now, which people are used to doing.

Chairman MANZULLO. Okay. Let me take you to another scenario. The restaurant owner, not everybody who has a credit card has a TIN number, is that correct? We used to call it an SS-4 when

I practiced law. Has a taxpayer identification number or Social Security number?

Mr. EVERSON. Well if you don't have a Social Security number, you have got a bigger problem than that, because you got to file a tax return with us, you got to have a number that identifies you. So you got to have a number.

Chairman MANZULLO. Okay. Do you need a Social Security number to get a Visa or MasterCard, anybody? Is it normally required? I think it is, would that be correct?

Mr. EVERSON. I think it's a pretty standard piece of information.

Chairman MANZULLO. Am I correct in assuming that?

Mr. EVERSON. Yes.

Chairman MANZULLO. Now there are a lot of small businesses that do not get a taxpayer identification number but report their income on a Schedule C through their own Social Security numbers?

Mr. EVERSON. Absolutely. That is correct.

Chairman MANZULLO. You don't have a problem with that??

Mr. EVERSON. No. No. We are not suggesting we change that.

Chairman MANZULLO. Okay. Well then explain to me, Commissioner Everson, where there's a faulty taxpayer identification number, give me the scenario in that restaurant thing if you could?

Mr. EVERSON. Yes. They haven't been square with you as the credit card issuer. They put down my Social Security number because they don't want the IRS to get the right number. And this is no different than, again, dividends and interest.

Chairman MANZULLO. So this is really actual fraud?

Mr. EVERSON. Yes, or—well, look, what we do is we send out notices. We do not impose backup withholding. Let me be clear here. There can be confusion. A credit card issuer, somebody could have made a mistake just like Merrill Lynch might. We send out notices. Again, let me give you the numbers for last year total returns filed in 2003 for dividends and interest. We got almost 320 million reports. The number where the TINs did not mention up was 334,000. That is a little over one in a thousand. That is what triggers notices and ultimately backup withholding.

Chairman MANZULLO. But notwithstanding, you still would require every credit card issuer or clearinghouse give the IRS information on how much every single small business in the nation was generating in credit card receipts?

Mr. EVERSON. That is the gist of the proposal, that is it, sir. And—

Chairman MANZULLO. No, let me stop you right there.

Mr. EVERSON. Yes.

Chairman MANZULLO. Do you have any idea what that would cost in terms of regulation?

Mr. EVERSON. We are working with the industry. We have the banking—

Chairman MANZULLO. The answer is you do not know?

Mr. EVERSON. We do not know a precise number at this stage.

Chairman MANZULLO. But notwithstanding the fact that you do not know, you are still asking Congress this year for those legislative proposals?

Mr. EVERSON. We have made a broad proposal. We are going to work with the Congress and we will try to minimize the burden, but you are correct?

Chairman MANZULLO. All right. Now let me give you a scenario where I got involved and Ms. Velazquez also got involved. When the HOPE Scholarship for the $1500 tax credit for middle and lower income taxpayers was instituted, Secretary Rubin testified before the Senate and he was asked a question: How much would it cost the 7,000 universities, colleges and community colleges and trade schools across the nation to send out a form showing the source of the payment for the tuition? He said the cost would be the cost of the stamp.

I got involved as Chairman of the Small Business Committee because actually, believe it or not, we have jurisdiction over colleges that have less than 500 employees. The annual cost was $100 million. And I worked with Chairman Rossotti for five years, changed the law and changed the regulations. And, of course the IRS, because the IRS considers itself exempt from the Regulatory Flexibility Act and continually refuses to do any research or reporting or compliance with that Act as to what it would cost the small business people, IRS was off by $100 million. Now I would say with these fine research fellows that you hire for $100 million a year, before the IRS even comes out with any notion of any change in reporting, I would suggest that you figure out exactly how much it is going to cost and you do that before you even come up with a proposal. And that is where this is deficient because Secretary Rubin was so wrong. In fact, I was fighting the software manufacturers and you were in the middle of that also. Remember that?

And it is a good thing that Commissioner Rossotti was a systems person. I mean his background was in computers and analysis. And he recognized the problem right away. And we worked with 7,000 schools across the nation. They could not believe that this burden had been imposed.

Now Congress had imposed that burden. And that is what can happen when legislation is proposed and there is no research done on it.

Ms. Velazquez? Okay. Well then I have just got one other question to conclude.

And that would be I understand fully now the withholding on credit cards would only be triggered in the event that there is some fraud going on.

Mr. EVERSON. Well there could be confusion, sir, and we send notices out.

Chairman MANZULLO. But there's confusion and it is corrected right away and there's no withholding?

Mr. EVERSON. That would be right. We send out notices.

Chairman MANZULLO. Let us say that I have got the restaurant and Mr. Sullivan is a plumber. I do not like to use the words plumber around Congress. But let us say he is a plumber and he does work in my restaurant from time-to-time. And then you notice that Mr. Sullivan is not, maybe he has been late in filing the quarterly estimate from time-to-time and you think that perhaps he is not reporting all the income that comes in. Are you proposing any

remedy that would have me as the payor withhold or report to you on the money that I owe him as the plumber?

Mr. EVERSON. No, sir. We are not changing those. Our proposals do not run to increased reporting from business. I know you do not believe this, Mr. Chairman, but I tried to be sensitive to your concerns. And what we proposed is the more reporting by the credit card issuers, and here ten of those businesses do 84 percent of the $2.2 trillion in credit card issuances around the country or dollars that come in through credit cards, and also governmental entities do some more reporting, not a business doing it; what you are talking about. That is—

Chairman MANZULLO. So under your proposals I, as the restaurant owner would not have to do anything more?

Mr. EVERSON. No, sir.

Chairman MANZULLO. Is that correct? And you would never ask me to withhold on any payments that I would owe to him?

Mr. EVERSON. No, sir.

Chairman MANZULLO. And I understand that there is a present law passed by Congress and for which you are not responsible, that says even in that scenario I am supposed to report any independent contractor payments in excess of $600 a year?

Mr. EVERSON. That is correct.

Chairman MANZULLO. That is the existing law?

Mr. EVERSON. The existing law, I think you are correct in stating—

Chairman MANZULLO. And that is not followed. That is not followed?

Mr. EVERSON. I would not say that it is not followed. I think we could do better on that.

Chairman MANZULLO. The more sophisticated the business, the more that is done?

Mr. EVERSON. Well, yes, that would probably be right. I mean, it gets to some of the issues we were talking about before as to what gets reported. People may if they get the 1099s, they may be reporting the 1099s they get as income, but not the ones they do not get.

Chairman MANZULLO. So let me make sure this is very clear.

Mr. EVERSON. Yes.

Chairman MANZULLO. This helps both you and me. The only additional reporting that, yes I guess I will use the word "only", that you are requesting would be to have the credit card companies issue to the IRS at the end of the year all the transactions—

Mr. EVERSON. No, gross receipts. Just one number.

Chairman MANZULLO. I'm sorry. Gross receipts for unincorporated businesses.

Mr. EVERSON. For all the businesses, yes. That is right.

Chairman MANZULLO. For incorporated businesses also or just unincorporated businesses? It's just unincorporated.

Mr. EVERSON. I think it's just unincorporated. Yes.

Chairman MANZULLO. It is just the little guys?

Mr. EVERSON. Well—

Chairman MANZULLO. Yes.

Mr. EVERSON. —we have not been that specific, sir.

Chairman MANZULLO. Well—

Mr. EVERSON. We said it by general language so you have got an opportunity to weigh in. Do you want to put the companies in there, too.

Chairman MANZULLO. No, I understand. But it is targeted at small businesses? That is your target—

Mr. EVERSON. It is targeted where I showed.

Chairman MANZULLO. I have got your paper here.

Mr. EVERSON. Yes. It showed—I think we have been pretty clear as to where we think we can get the money.

Chairman MANZULLO. No, I want to clear this up before I let you go here.

Mr. EVERSON. Okay. All right.

Chairman MANZULLO. It is targeted at sole proprietorships, the 25 million people out there and the partnerships that are not corporations.

Mr. EVERSON. I think that is fair enough. Fair enough. That is where the biggest under reporting is.

Chairman MANZULLO. Do you think that corporations under report?

Mr. EVERSON. It goes back down that other road.

Chairman MANZULLO. No, I mean—

Mr. EVERSON. Yes.

Chairman MANZULLO. Because if you are doing that much auditing—

Mr. EVERSON. We are doing the auditing, yes. We set up—

Chairman MANZULLO. And you find out that they do not pay the—

Mr. EVERSON. We set up billions of dollars in additional assets from them.

Chairman MANZULLO. But you only want to impose the additional reporting on small unincorporated businesses and not on the incorporated business, is that correct?

Mr. EVERSON. Well, we have not been that specific. If you want to add the big C-Corps, you know, Blockbuster Video to it, I do not know.

Chairman MANZULLO. No, it is here.

Mr. EVERSON. We can certainly put that in there. It is a general proposal. We did not submit language. We have said we want to work with the Congress on the contours of the proposal.

Chairman MANZULLO. Well—

Mr. EVERSON. We have got the American Bankers Association coming in this week to talk to people about this. So we clearly want to talk about this.

Chairman MANZULLO. It says payment cards are a growing form of payment for retail business transactions. And it goes on here. I mean, it is obvious that the additional reporting that you want to have the credit card companies do is only for the little guys because you consider them to be the biggest cheaters.

Mr. EVERSON. "Biggest cheaters," I have not use that word.

Chairman MANZULLO. But it is true. It is true.

Mr. EVERSON. I have showed you where the biggest piece of the tax gap is.

Chairman MANZULLO. No, I understand. People cheat, people cheat.

Mr. EVERSON. What we are trying to do here again is level the playing field so that: (1) The Government gets what it is due. And also so that the small businesses playing by the rules does not get disadvantaged.

Chairman MANZULLO. Let me read your writing here, your proposal. "It is expected that as under current information reporting regulations certain categories of merchant payees such as corporations will be excluded from the reporting and backup withholding requirements." These are your own words.

Mr. EVERSON. If you have a problem with that, we will work with you on that.

Chairman MANZULLO. You think I am sitting here because I enjoy reading this?

Mr. EVERSON. Okay.

Chairman MANZULLO. I mean the reason for this hearing is the fact that in your own words the only people that you think of significance who are not paying their income taxes are these little guys.

Mr. EVERSON. I do not think that. I am not suggesting that, sir. But we do not see—I do not think the revenue line is where we see problems with C-Corps.

Chairman MANZULLO. Well, you know, I think—

Mr. EVERSON. That is what we are talking about here, is the revenue line.

Chairman MANZULLO. What is the revenue line?

Mr. EVERSON. Gross receipts. They have more sophisticated accounting systems and I believe you would find that—

Chairman MANZULLO. You mean like Enron and those clowns?

Mr. EVERSON. I do not think that—

Chairman MANZULLO. How much did those clowns take from the American people? How many corporations out there are the Enrons, the small Enrons?

Mr. EVERSON. Look—

Chairman MANZULLO. Ms. Velazquez, do you have any idea? Would you not like to know?

Ms. VELAZQUEZ. But let me just say that you sound like a Democrat today.

Chairman MANZULLO. Oh, no, no. We are in there with the little people.

Mr. EVERSON. Mr. Chairman, if you talk to your colleagues at Ways and Means and, Ms. Velazquez, nobody would tell you that we have done anything except work on high income and corporate people. You can look at the KPMG matters, the aggressive shelter work we have done with Son of Boss increasing all this.

Chairman MANZULLO. Well, no, I—

Mr. EVERSON. We are not going after just the little guy.

Chairman MANZULLO. No. I am just saying that in your own words you have already said you are going after the little guys.

Mr. EVERSON. No. On revenues the bigger problem is clearly where we have indicated.

Chairman MANZULLO. All right. You know this page 117, this is your document.

Mr. EVERSON. Okay.

Chairman MANZULLO. And I just read from your document.

Mr. EVERSON. Fair enough.

Chairman MANZULLO. Mr. Sullivan, am I correct that this is targeted at little people?

Mr. SULLIVAN. I think the Chairman and Commissioner Everson are actually expressing the same concern, although a little bit differently. The small businesses that come to my office have said that there is reporting in the proposal and they are terrified that the next step after reporting is withholding. That is what they are terrified about. And I think you will hear more about that from the next panel.

Chairman MANZULLO. Okay.

Mr. SULLIVAN. Because that is certainly something that the Taxpayer Advocate has talked about. And I think Commissioner Everson has said he is sensitive to those concerns, which I think—

Chairman MANZULLO. Okay.

Mr. SULLIVAN. But they are fearful of what comes after reporting.

Mr. EVERSON. I understand that concern and I am making no proposal and do not support the withholding. As you know, I have said to you privately to you in the past.

Chairman MANZULLO. Yes. Because my question is, and I will let you go on this finally—

Mr. EVERSON. Okay.

Chairman MANZULLO. Treasury has different compliance suggestions than the Taxpayer Advocate, is that correct?

Mr. EVERSON. Yes. The Taxpayer Advocate is set up to look at issues of problems of dealing with the service and gives us internally as a part of the IRS to try and help us improve our administrative procedures.

Chairman MANZULLO. Right.

Mr. EVERSON. But she also makes an annual report to Congress highlighting 20 areas where her office has concluded that there are particular problems navigating the code or enforcement procedures.

Chairman MANZULLO. But her suggestions for enforcement compliance are separate from yours?

Mr. EVERSON. Absolutely. They are not Administration proposals.

Chairman MANZULLO. All right. And hers are even more pervasive, and we will have fun with her shortly.

Mr. EVERSON. Let her characterize her own thoughts.

Chairman MANZULLO. All right.

Mr. EVERSON. I never try to speak for Nina. I have learned that in my three years on the job.

Chairman MANZULLO. I want to thank both of you for coming. I know we have taken a lot of time, but I wanted to get explicitly clear what the Treasury has proposed in terms of withholding. And I know we have taken a lot of time to do that, but it has been worthwhile to do that.

Again, Commissioner Everson, every time we have called you have come to the office, you have been available. You have been very transparent with us. And I really appreciate the efforts that you are doing at the IRS.

And, Mr. Sullivan also, we did not ask you a lot of questions but we did not have to. I appreciate the work that you do on behalf of the small businesses.

And the first panel is excused.

Mr. EVERSON. If I can say one last thing, Mr. Chairman.

Chairman MANZULLO. Yes.

Mr. EVERSON. I am happy to be here. I appreciate the vigor with which you and your Committee members represent your interest. And I think this is the way that tax policy ought to be reached. Because it should not be done in the dark of night in some appropriations rider where people are doing things that have impact. This is a full debate. We want to work with the Congress on these issues.

Chairman MANZULLO. Thank you, Commissioner. I appreciate it very much.

Let us get the second panel ready.

[Recess.]

Chairman MANZULLO. I'm surprised you guys stuck around after the first panel. We are going to go from left to right. If you could keep it to five minutes, I would appreciate it. Obviously your full statements will be a part of the record.

Our first witness on the second panel is Kevin Brown, who also has been a frequent visitor to the office. And he is the Commissioner of the Small Business/Self-Employed Division at the IRS. We look forward to your testimony. Thank you very much.

STATEMENT OF KEVIN BROWN, SMALL BUSINESS/SELF-EMPLOYED DIVISION, INTERNAL REVENUE SERVICE

Mr. BROWN. Good morning, Chairman Manzullo, and Ranking Member Velazquez, and distinguished members of the Committee. I appreciate the opportunity to talk with you today about the work of the Small Business/Self-Employed Division of the Internal Revenue Service.

The SB/SE organization is made up of 28,000 employees who serve about 45 million taxpayers, roughly one-third of the taxpaying population. Our taxpayer base consists of seven million small businesses, including corporations and partnerships with assets of $10 million or less; 33 million self-employed and supplemental income earners; and five million other taxpayers who file employment, excise, estate, gift, fiduciary and international tax returns.

As I begin, I want to echo a couple of the themes you have just heard from Commissioner Everson. First, whether we are providing service through education, outreach or burden reduction, or we are seeking out noncompliance through our enforcement efforts, our intent is to help all taxpayers, including small businesses, comply with the tax laws and to ensure that these laws are applied fairly to all. Secondly, it takes a balance between service and enforcement to achieve compliance, and SB/SE strives daily to maintain this balance for its taxpayer community.

Today I am going to focus primarily on the service side of the equation by highlighting some of our recent efforts.

We know that the vast majority of small business taxpayers rely on their practitioners to handle their tax returns. Given this situation, it is vitally important that we reach out to the practitioner community so that they can, in turn, support their small business clients. We have built a robust outreach and education program to

do just that, to touch thousands of stakeholders and through them reach millions of small business taxpayers. The result is more than 15,000 relationships with national and local partners including practitioner organizations, small business and industry associations and federal and state agencies and governments. One of the more well-known services we provide is the Small Business Forums which we co-host with the United States Chamber of Commerce, the National Federation of Independent Business and the Small Business Legislative Council. Through these forums small business organizations receive the latest small business information from the IRS and in turn are able to share their members' concerns and issues with us.

Due to the success of the national forums, we are launching local small business forums at the state level this spring.

SB/SE also devotes resources to identifying major sources of taxpayer burden and to developing and implementing ways to reduce this burden. Since 2002 our Office of Taxpayer Burden Reduction has been instrumental in reducing taxpayer burden by over 200 million hours. Here are some highlights.

In January 2006, we implemented the Annual Forum 944 for employers who have a total annual employment tax liability of $1000 or less. Most of the estimated 950,000 eligible Form 944 filers also will be able to pay annually with their form 944.

This year we implemented a new automatic six-month extension period reducing burden by 11 million hours.

Simplification of the office in the home deduction for the small business taxpayer is high in our priority list for tax year 2006. We are looking into several ways to address the burden caused by Form 8829, which is completed annually by about 2.4 million Schedule C filers as well as Schedule A filers.

I also want to mention our SB/SE Disaster Coordination Office. In the aftermath of the recent hurricanes this office played a key role in the IRS' success in providing on the ground assistance to individuals and businesses in dealing with the myriad of related tax issues.

Most recently the IRS has been partnering with the Department of Housing and Urban Development and Mayor Ray Nagin of New Orleans to help make businesses in the hardest hit areas of New Orleans and Louisiana aware of Federal incentive relief that is available to them.

In summary, Mr. Chairman, I believe that the SB/SE Division of the IRS is providing much-needed support to the small businesses of America. We have demonstrated our commitment to service through the outreach and education we are providing, the partnerships we have developed and our numerous efforts to reduce taxpayer burden. At the same time, by using our enforcement resources to detect noncompliance, we are helping compliant businesses by eliminating the unfair advantage created when their competitors fail to comply with the tax laws.

Thank you, Mr. Chairman. I will be happy to answer any questions you and the other Members of the Committee may have.

[Commissioner Brown's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you.

Our next witness is Nina Olson. She is the National Taxpayer Advocate serving as advocate for taxpayers to the IRS and the Congress. We look forward to your testimony.

STATEMENT OF NINA OLSON, TAXPAYER ADVOCATE SERVICE

Ms. OLSON. Thank you. I believe you.

Mr. Chairman, Congresswoman Velazquez and Members of the Committee, as you know, my organization, the Taxpayer Advocate Service devotes a substantial portion of its efforts to assisting small businesses and self-employed individuals who experience problems with the IRS. Through February of this fiscal year, small business cases accounted for about 44 percent of Taxpayer Advocate Service case closures, around 90,000 cases a year. And we have been able to provide relief to small business taxpayers in nearly 75 percent of those cases.

In addition to our case work, the Taxpayer Advocate Service is actively involved in identifying areas of the tax system that impose burdens on small business taxpayers. When we identify systemic problems we make administrative and legislative recommendations to help mitigate these burdens. I discussed several of the recommendations I have made in my written testimony, including recommendations from my 2004 annual report to reduce burdens on small businesses. I am please that Chairman Manzullo included many of these proposals in the Small Employer Tax Relief Act of 2005 that he introduced last fall.

In my annual reports to Congress I have also made administrative and legislative recommendations to reduce the tax gap. The IRS estimates that the net tax gap runs at about 290 billion a year. The IRS expects to receive about 135 million individual income tax returns this year. Therefore, the average individual tax filer is effectively paying a surtax of more than $2100 a year to subsidize noncompliance. As the statutory voice for all taxpayers, I find that to be an unacceptable state of affairs. It is unfair to the millions of taxpayers who pay their taxes in full and it erodes public tax confidence in our tax system. After all, if my neighbor is not paying his taxes, why should I.

When you drill down a level the IRS data show that the cash economy is the largest single contributor to the tax gap. And while 99 percent of wage income earned by employees shows up on tax returns, the IRS estimates that only about 43 percent of self-employment income reportable on a Schedule C shows up.

The low rate at which taxpayers report cash economy income creates two sets of problems. First, it places honest businesses at a competitive disadvantage. If one taxpayer is paying his taxes but a competitor is not, the honest business person will lose out on sales because the noncompliant competitor can use its tax savings to undercut the price of goods and services. Second, taxpayers operating in the cash economy have greater opportunities to be noncompliant because they know the payments they receive are not being reported to the IRS and therefore will be difficult for the IRS to detect.

And as I know from 27 years I spent working with small business taxpayers professionally and as a self-employed person myself for those years, many small businesses operate on tight margins

and plow every cent they can save back into their business. They have enormous difficulty saving money and since there is no mechanism to withhold taxes from their income, they often find they have spent their funds by the time tax payments are due. Then the IRS may come calling and these people would often come to me for help. Unfortunately, the most I could do in some of these cases was to help them request collection alternatives and in other cases it was simply too late. The sheer weight of the tax debt caused the business to go under.

In light of the concerns I've expressed about the high rate of noncompliance in the cash economy and the extreme pressures small businesses face if they are audited, I have tried to offer proposals that strike a reasonable balance between reducing the high rate of noncompliance in the cash economy and avoiding excessive burdens on small businesses. There is no one size fits all solution and my proposals are just that; proposals that I and others may be able to improve on. But I think they represent a useful starting point.

My written statement discusses some of my proposals in greater detail, but I would like to briefly highlight our proposal to amend the Internal Revenue Code to require the IRS to promote making estimated tax payments through its electronic funds transfer payment system and to establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.

One key feature of EFTPS that many taxpayers may find attractive is the ability to voluntarily schedule more frequent automatic estimated tax payments up to—

Chairman MANZULLO. Ms. Olson, could you talk about the most controversial, the backup withholding?

Ms. OLSON. Certainly.

Chairman MANZULLO. I think it starts on about page 11, 11 and 12. You can tell that's where our concern is.

Ms. OLSON. All right.

Chairman MANZULLO. We appreciate the other information and agree with it, but we want you to address the proposal we disagree with.

Ms. OLSON. Okay. But I would like to say about that proposal—

Chairman MANZULLO. Go ahead.

Ms. OLSON. That it is the third in a tiered approach. That my goal is to get people to be able to stay out of trouble by being able to make estimated tax payments as easily as they would make automatic debits from their accounts for a car or a mortgage payment.

And then I also have a proposal about companies that want to do withholding for their independent contractors, that they could come into the IRS, and this would not be the IRS contacting them, but that they would come into the IRS and say we want to treat our people as independent contractors but they are having a hard time saving and we want to do this voluntary withholding. And they would be considered independent contractors for all purposes such as deducting expenses and everything like that, except for the fact that the payor would be withholding.

And I believe that those two proposals will eliminate a large amount of noncompliance and help companies, small businesses stay out of trouble in the first place.

But for those individuals, those persons, those entities that are substantially noncompliant and repetitively noncompliant, and I believe that that is something Congress could determine or you could allow the Secretary to determine, but where there is a repetition of nonpayment of taxes year after year, then I propose that the IRS be able to use backup withholding in order to get the attention of those taxpayers and get them to call us. And once they call us, then we can channel them and say, folks, we will release backup withholding if you will schedule a year's worth of estimated taxes a year in advance so we know that you are not getting into trouble again. We will help you resolve your arrears, but we want to put you in a going forward basis with your estimated taxes.

And so that is the withholding proposal. I am saying that you have to have a demonstrated history of noncompliance, in your words these might be the cheaters, they are cheating other taxpayers.

Chairman MANZULLO. And that would—I have got to get this out in your testimony in chief here. And that backup withholding would be on money coming from?

Ms. OLSON. Payors.

Chairman MANZULLO. Such as a credit card company?

Ms. OLSON. Well, I did not propose the credit card company.

Chairman MANZULLO. Or?

Ms. OLSON. It would be from, for example, if you were in construction and you were working for a large contractor and you were on the framing crew, then you would have the contractor do the backup withholding.

Chairman MANZULLO. But that is done now because of withholding for?

Ms. OLSON. For interest and dividends, that is right.

Chairman MANZULLO. No, no, no. For worker's compensation insurance to make sure it is—

Ms. OLSON. That is correct.

Chairman MANZULLO. But your proposal would also apply in the hypothetical that I gave the Commissioner about the restaurant owner that would owe money to the plumber if you found that the plumber was substantially noncompliant, is that not correct?

Ms. OLSON. That might happen in that instance. Now, I would imagine that the IRS would not be taking it down to that level. That they are going to be looking at persons who are repeatedly noncompliant and that it is worth them implementing—

Chairman MANZULLO. We always look at the worse possible scenario.

Ms. OLSON. I agree. I think that that is a legitimate concern.

Chairman MANZULLO. I interrupted your testimony. Did you get out everything that you had wanted to?

Ms. OLSON. I think so.

Chairman MANZULLO. Okay. Thank you.

Ms. OLSON. Yes. Thank you, sir.

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

Chairman MANZULLO. Our next witness is John Satagaj. And, John, we look forward to your testimony.

STATEMENT OF JOHN SATAGAJ, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you, Mr. Chairman, Ms, Velazquez, Members of the Committee. It is always a pleasure to be here.

I think I noted last time I was here it was just a year ago for the same subject, it was a historic moment because I completed Commissioner Brown for the great work he is doing. So I am going to double it up. He is two-for-two, he continues to do a marvelous job. If we clone Commissioner Brown, we would have a much better situation and maybe not as combative and we have to be with the IRS sometimes. So I compliment—

Chairman MANZULLO. That was combative. The Commissioner is very smart because there's a Proverb that says that a soft answer turns away wrath. And he succeeded in doing that with his great smile and his personality, and also his candor.

Go ahead.

Mr. SATAGAJ. There is always going to be a tax gap; we all know that. And you alluded to the GAO study earlier in your testimony and opening statement. I believe the IRS has been doing tax gap studies since the studies. I think the first one was 1977. The first GAO report was in 1988. It looked at the '77, '82 and '87 tax gap ones And I guarantee if you take that '88 study and put it up against the one you referenced, it would say all of the same things. You know the data is old, we do not know what it is, we are not asking. We have been talking about the same issues about how you analyze the tax gap and how you find it. Nothing has changed between the 1977 tax gap estimate and the one today in terms of understanding what it is really about. And I think you illustrated that very well in your opening statement.

The next point I want to make is about the blue book that you referenced, the five proposals and the one I call it the phantom six, the one on the independent contractors. And with all due respect, I think whoever wrote that did a disservice to the President of United States. Because the words are there and I've heard for the two or three weeks or four weeks since that has been out is "Well, it is a general proposal and we need to figure out what it really means." And your conversation with the Commissioner about the corporations and the credit cards illustrates perfectly how little we know about those proposals and the potential impact. Does it cover C corporations? Is it excluding C corporations and S-Corporations? If it is, and I think for a while there I heard the Commissioner say that, then we are looking at all sole proprietors. How many sole proprietors take credit cards?

And when you exclude all the brick and mortar that our S-Corporations and C corporations, who are you going after? You have got 25 million of them maybe, but how many of them take the credit cards? And if it was not meant for that universe, why did we propose it? But it illustrates that that proposal, those words means things to us in the small business community and we get upset about them.

I was talking to Advocate Olson, Nina, about that sentence, the phantom six. Well, I guarantee every one of us, and I told her this, it was a disservice to her. Because all of us who worked that independent contractor issue read that sentence, the first reaction is, ah ha, the Advocate is getting her proposal through in a different way through that proposal. And you have heard what she has talked about, and it is not that. And so we have a disservice to the President and to all of us if we are not careful how we choose our words. Because it means something to those of us in the small business community, and we did not see that there.

So with those points, one last point. The IRS every year puts out a—they give bunk frivolous myths about filing your return. You know, things that you should not do that people claim, like the 16th Amendment is invalid so I do not have to file my return or if I put all zeros, I do not have to pay a tax.

There was one that was interesting in there, and I pulled it out because I think it's really relevant to today. Filing a tax return is voluntary. A lot of people say I do not have to do it. And this is the IRS' words. Some people mistake the word voluntary for optional. But filing a tax return is not optional for those who meet the law's minimum gross income requirement. The word "voluntary" as used in the IRS publications, court decisions and elsewhere refers to the fact that the U.S. tax system is a voluntary compliance system. Now here is the important sentence in my mind and everything we are talking about here today about whether it is information report, it is backup withholding or it is anything. This is the sentence that we talk about our system. "This means only that taxpayers themselves determine the correct amount of tax pursuant to law and complete the appropriate returns rather than have the government do this for them as done in other countries."

This is what America is about. This is what about being a small business is American is about. And we had better be darn careful if we are taking away any one element of that voluntary system.

Thank you, Mr. Chairman.

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

Chairman MANZULLO. Thank you.

I forgot to state that you are testifying on behalf of the Small Business Legislative Counsel.

Thank you for your testimony.

Next witness is Keith Hall, CPA speaking on behalf of the National Association for the Self-Employed. We look forward to your testimony.

STATEMENT OF KEITH HALL, HALL AND HUGHES, PLLC

Mr. HALL. Thank you.

Chairman Manzullo, Ranking Member Velazquez, I thank you so much for the opportunity to be here today as a small business owner.

To a small business guy like me any number that ends in billions is a touch concept to grasp. The tax gap that we are talking about today is one of those touch concepts.

Through the National Association for the Self-Employed I visit with thousands of small business people each year. Based on that

experience, I hope to shed a little light on some of the proposals and how they effect people like me. I specifically would like to talk about three things.

First, and perhaps the most concern for me, is a proposal to initiate required withholding on non-employee payments. The withholding proposals would be based on gross payments as opposed to taxable income. This would require the same amount of cash withholding from all independent contractors regardless of the nature of their business. The business owner with the lowest profit margin would be hurt the worst, since they would be hit with the same amount of cash withholding even though they have less money to work with.

Tracy Boulware, who is an NASE member from Houston, told us and I quote, "I own a small company. I pay my taxes. Sometimes my profit margin is only 3.5 to 5 percent. This type of legislation could put me out of business. It is that simple."

The small business that has only a 3 to 5 percent profit margin would be devastated and probably could not continue to operate. But that is not the only bad stories that would be out there.

I personally have a client in Garland, Texas that has a business cutting grass at retail strip centers. His total gross income for last year was about $240,000, which seems like a lot of money. But he has two full time crew chiefs and employees a number of college students during the summer. So at the end of the day he has about $40,000 of net income and pays about six grand in taxes. But under a withholding rule he would have $12,000 of his money withheld. That translates into about $500 per month less to manage his family and manage his business.

When I asked him if he could manage on $500 less a month, he also gave me a quote, but I thought I probably should leave it out here.

We talk a lot about creating jobs and we talk about a stronger America, but this guy is actually out there doing it. And because he chooses to put a lot of his money back into the community he is going to be hurt the worst. The key point is that withholding based solely on gross payments would be greatly unfair to many taxpayers and for some it would mean the difference between surviving and not surviving.

A second is the credit card reporting. Almost everyone has some type of information that is reported to the IRS either by their employer, by their bank or by their clients. This proposal would expand that type of reporting to credit and debit card transactions. Now capturing information can only have a positive impact, in my opinion, particularly in light of those taxpayers who consciously choose to avoid reporting income. If requiring the credit card companies to report these payments will help identify those that abuse the system, I am all for it. If reporting is used to match credit card receipts to the tax returns similar to the way 1099s are done today, I think it is a great idea. If, on the other hand, the reporting is used to make judgments regarding other items on the item, I think problems could arise.

Discussions have included taking the total credit card receipts reported for a particular business and then extrapolating that total to total income, thereby making assumptions on amounts that are

not reported. Making assumptions on information that is not reported will, again, paint all small businesses with the same paint brush which can only end up causing more problems then it solves.

Perhaps the most critical problem with this proposal is an estimated return on investment. The Treasury estimated that it would save $225 million compared to 335 billion, which is nominal, especially compared to the burden it is going to place on both the IRS and on business taxpayers.

The bottom line here is I am in favor of increased reporting, I am just afraid that this proposal will provide a lot more numbers but won't really have a big impact on fixing the tax gap.

Lastly is education versus enforcement. Most issues faced by small businesses deal directly with the complexities of the tax code. The IRS' commitment to education over the last five years has made a tremendous difference. Anyone who thinks that the IRS has not been a friendly and more helpful entity has not had a chance to review their website. The commitment to that website changes in the Form 941, 940, the new Form 944; all prove that they have been listening and that they want to help. I am afraid, however, that the commitment to education might be fading. It seems clear that the proposed budget is moving away from education and toward enforcement. Point blank, more education means more compliance. My belief is that $1 in education is worth much more than $1 in enforcement.

When I graduated from college, and I will not say how long that was, my goal was to make a lot of money, to conquer the business world and to be the man. But as I have gotten older I recognize that all we really have a chance to do is make a difference. Today you guys are called on to make a difference, not only for me, but for millions of small business owners just like me in evaluating each one of these proposals. It is my wish that the difference you strive to make is based on reducing overall tax code complexity and maintaining a commitment to education.

Thanks again for the opportunity to be here, and thanks for making a difference.

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

Chairman MANZULLO. I appreciate that.

Our next witness is Michael J. Fredrich. And I am going to touch upon his biography because first of all, I forgive you for graduating from the University of Wisconsin because I went to Marquette.

Mr. FREDRICH. It was a rough time and I forgive you, too.

Chairman MANZULLO. That is all right. It says personal, married 31 years to the same woman, no children, 13 dogs, 10 cats, six horses and no mice. And with that introduction—

Mr. FREDRICH. That is right.

Chairman MANZULLO. But BS degree in nuclear engineering, MBA in finance, corporate turnaround specialist. Industries include manufacturing. You know the time I spend in manufacturing. I really do look forward to your testimony.

STATEMENT OF MICHAEL FREDRICH, MANITOWOC CUSTOM MOLDING, LLC

Mr. FREDRICH. Well, thank you, Mr. Chairman. And thank you Ms. Velazquez.

Chairman MANZULLO. I'm sorry. On behalf of the Small Business and Entrepreneurial Council.

Go ahead.

Mr. FREDRICH. Yes. Thank you.

Well, I am happy to be here today.

And I read the testimony of Mr. Brown and I would have to say, I would not want your job. I think you are trying to do the right thing and you are dealing with really an impossible situation. I mean our tax code is so complex it crosses people's eyes. I mean, I do not know how many people in here actually do their own taxes, but I mean it is just impossible to do.

And I know this is not a debate, but Ms. Olson, I read yours, too. And if you are helping the small business, do not help so much. We do not need that kind of help.

I view this proposal as one more straw on our back of small business. We are, you know, a professional tax collector. We collect federal tax, state tax, Social Security tax, Medicare, unemployment tax, state and federal. We file W2s. We do 1099s. And we do not get paid for any of this service. And on top of this now we are going to become immigration police, which is not the topic of this.

There was competition mentioned that we want to make everybody pay their taxes so we have a level playing field. I would offer this to anybody that thinks adding more burden on small business creates a level playing field and improves competition. I would say this: You are looking at the wrong competitors. Our competitors are not other small businesses in this country. Our competitors are small businesses and companies around the world. And I offer this as an example.

One of our customers, Kohler Engine—we make parts that's Kohler Plumbing, but they also make engines. Most people probably do not know that.

They have a group of people that go around and assess your cost structure and they compare you not just to other people in this country, they compare you to other of your competitors in the world. So we have competitors in China and we have competitors in India. And they look at our cost structure and they say well your costs are too high. So here is your choice. You can lower your price or you can lose the business. And that is fact. And they are not the only company that has it, lots of companies have that. So that is the cost reality that we are dealing with.

In my testimony I have a thing here called the Anthony factor. Small businesses do not and cannot have a high overhead. We cannot employ more people than we absolutely need to. So in situations like our computer system, we cannot have an IT person on staff so we use Anthony. We pay Anthony the way we pay everybody else. We pay him by check an we issue him a 1099. And the thought of having to start now messing around withholding on Anthony is just silly. I mean, it is just one more straw. And at the increment it does not seam like it is a lot, but it is. I mean, you have to look at the whole thing in its total.

Another example. We do not have a direct salesman, we have a guy that we have been trying to leave his current employment where he makes $120,000. He has a salary of $120,000. And we said to him, look it, why do you not start your own company. Be

your own boss. We think you would flourish and you could represent our company in selling our products and we would benefit and you would benefit and it would be good for us.

So now here is a guy, he is going to leave, walk away from $120,000 salary into a situation here he makes zero on day one. Absolute zero. So now you are going to enact some legislation that is going to require us to withhold 28 percent of what we are going to pay him. Well, he cannot afford that. I mean, he is already walking away from $120,000. So, you know, that is how this kind of thinking, I mean you would think you would want to encourage people to start their own business, and that is how businesses start. I mean, they start with people going out on their own and saying, hey, you know, I can do this for myself. And this legislation or this proposal it really dampens that.

One other thing I would like to say. I heard this with regard to audit activity $1 yields $4. That is just bunk.

When you make a calculation like that in a free market transaction where you have a willing buyer and a willing seller and the IRS does not come to you and say hey, we would like to do an audit, what do you think. No. They say we are going to do an audit. Okay. So then you have to go and hire your support, your tax accountant, you have to go hire Kevin here and say hey I need representation that pulls you away. And they do not factor those costs in there. They do not factor the focus that is taken away from the business.

Can you imagine? We do not run on a big staff. I mean, I am not there today. My partner is there today. But we are there everyday that we can be. And to take our focus away to have an audit where somebody thinks they make $4 for every dollar of audit cost ignores the other half of the equation. What is our cost? I mean, that has to be your true yield on what an audit costs.

So I mean they go through this plan of we are going to expand—my time is up. I am sorry. I will summarize quickly.

I think you need to be simpler. You need Hagelian logic; less is more. Our tax structure is too, too complicated.

That is my testimony.

[Mr. Fredrich's testimony may be found in the appendix.]

Chairman MANZULLO. Now I am convinced that you were at the University of Wisconsin. Hagel is the author of Communism.

Mr. FREDRICH. The solution. In business if you want to make something better—

Chairman MANZULLO. You do not get it. Everybody accuses the University of Washington of being very liberal and said—

Mr. FREDRICH. I was in engineering school there.

Chairman MANZULLO. All right. Sorry about that.

Appreciate your testimony.

Mr. FREDRICH. Thank you.

Chairman MANZULLO. The next witness is Dr. Max Sawicky, an economist with the Economic Policy Institute, who has worked at the State and U.S. Treasury Department.

We look forward to your testimony, Dr. Sawicky.

STATEMENT OF MATT SAWICKY, ECONOMIC POLICY INSTITUTE

Mr. SAWICKY. Thank you.

I would like to thank you, Mr. Chairman and Ranking Member for inviting me.

If Ms. Olson does not supply enough disagreement, maybe I can fill in the gap.

The United States has enjoyed a tax holiday for years now. We are, as you know, spending much more than we are taking in, both in terms of the Federal Government in the U.S. relative to the rest of the world. Very few economists think these imbalances can be sustained indefinitely. And because of that the need for revenue, I think, is going to become inescapable. Tax increases are not fun and I think that fact is going to compel renewed and expanded interest in the tax gap, which is another source of solution.

Now, I would take exception to some of my friends. Tax increases, in and of themselves, do not fix this because in the long run we have health care spending increases in both the public and private sector which will need to be paid for one way or another. If they are not paid for by the government, they are paid for by someone else. If they are not paid for, then somebody loses health care. So the problem is much bigger then revenues, but revenues I think are going to be impossible to avoid. And that means the tax gap, among the other things.

Now the elephant in the room here which nobody has really touched upon which pertains to a number of the issues that have come up is resources for the IRS. If there is a lack of service and education of taxpayers, that is amenable to remedy with more resources. If there is a lack of research or an unevenness in the focus of research, that is amenable to more resources. If there is a shortfall in technology, which I think is a particular problem with the IRS, that is a crying need.

Proposals to flat fund the agency or even reduce funding in real terms after adjusting inflation mean that when we talk about more service, it is going to come from somewhere else. The agency absolutely has to process returns; that is an unavoidable expense. If we do more education, it is going to mean less enforcement with all the problems that have come up.

And unlike other issues in the budget, this is not a trade off issue. The research, contrary to my college here, I think is pretty decisive and emphatic that more spending on a variety of measures, not only the ones that have been mentioned here, bring in much more money than they cost. There is very high payoff ratios that have resulted from very elaborate and sophisticated research on this question.

So then of course the question remains what is the right focus. And people are concerned here that small business is being singled out. As the Commissioner said, the IRS uses formulas to determine audit. These are confidential; they have to be. I think nobody from the outside is supposed to know what those are. I think the confidence in terms of what the agency is likely to do with better financing, although it cannot be simply given away without any oversight, is that they are going to go where the money is. And that is not particularly to small business, it is to businesses with

lot of employees and/or high net income. It is not to very short with very high income.

So in terms of small business within that dreaded blue box in the tax gap map there is a lot of differentiation between really small and small compared to Chrysler but not small compared to most Americans. And I think the agency can be relied upon if their mandate is to get the best bang for the buck in terms of revenue to go to where the money is and not to the really small people.

In that final vein, one small business category that has not been mentioned here is, let us say a woman taking in sewing making $13,000 a year, somebody mowing lawns. People receiving the earned income tax credit have been the target, the real target of inordinate attention by the IRS I think at the behest of the Congress in a gross misfocus of priorities from the standpoint of revenues as well as justice. And if there is unfairness there, we cannot be surprised if it bleeds over into other places.

Two more thoughts. One, I think the advance in the computer technology and the economy, the reduction of the cost of transactions which we already see burgeoning ahead is going to make a lot of these discussions obsolete. It is going to be easier and easier to collect and report information, the process, and without necessarily the need for draconian withholding rules, which I am impressed by some of the testimony in terms of the problems in that vein. But reporting, I think, is much less of an issue, will become decreasingly so in the future.

And finally, I cannot disagree with all the commentary about the importance of the simplicity of the tax code and the fact that it has gone radically in the wrong direction really since 1997, I would say. And this complexity for good, bad and different reasons has increased costs all the way around. And everybody in Congress is concerned about this but nobody has roused themselves to really deal with it seriously. And again I come back to the fundamental imbalances in our economy and in the budget which get much worse in the long run, which I believe will compel the political system, Congress and the President, to approach the revenue including the tax gap with high seriousness. And part of that solution will be, I think, significant simplification of the tax code.

Thank you very much.

[Dr. Sawicky's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you. You must have been rejoicing last night with that marvelous basketball game. Was that not something?

Mr. SAWICKY. I have a 6:30 school bus to catch in the morning, so I miss a lot of that late night stuff on TV.

Chairman MANZULLO. You're alma mater.

Mr. SAWICKY. My alma mater is—oh, yes. Yes. Right.

Chairman MANZULLO. Okay.

Mr. SAWICKY. I read about it in the paper. I missed it.

Chairman MANZULLO. It's obvious you do not like basketball, so I will go on to something else here.

Ms. Olson, on withholding, your proposals do not even touch credit card withholding, is that correct?

Ms. OLSON. Well, I did not propose the credit card withholding, the Administration—

Chairman MANZULLO. That comes from Treasury.

Ms. OLSON. The Administration proposed it.

Chairman MANZULLO. So I guess unless you want to talk about, let us go on to—

Ms. OLSON. Right.

Chairman MANZULLO. —what your proposal for withholding is. Could you walk us through a scenario?

Ms. OLSON. Yes. First, when you and I had talked earlier you asked me to get numbers, so now I have numbers.

Chairman MANZULLO. Is it not great to come into the office first?

Ms. OLSON. Yes, it was very helpful.

Chairman MANZULLO. Good.

Ms. OLSON. And it crystallized the mind.

There are for tax year 2004, which would be last year's filing season and are the most recent data that we have since this year's filing season is not finished, there were balance due returns overall, there were approximately 4 million balance due returns. Individual returns they reported tax dollars, they made some payment and here is the dollars that are owed.

Chairman MANZULLO. These are individual returns?

Ms. OLSON. These are individual returns.

Chairman MANZULLO. Okay. Go ahead.

Ms. OLSON. So that will include Schedule C.

Chairman MANZULLO. Okay. Go ahead.

Ms. OLSON. Of those returns 1.45 million were Schedule C returns. So that is first the universe that we are talking about. Out of the 128, 133 million returns that we get every year, to even begin to look at my withholding proposal, we are talking about 1.45 million returns. That is just the starting point.

Now of the dollars that are balance due for 2004. Okay. Let me just say one thing. That Schedule C balance due returns then constituted 35 percent of all balance due returns we got in tax year 2004.

Chairman MANZULLO. Can I stop you right there? What percentage of the total returns do the Schedule C returns comprise, do you know that?

Ms. OLSON. Maybe 18 percent my research guy says.

Chairman MANZULLO. About 18 percent. Go ahead.

Ms. OLSON. Okay.

Chairman MANZULLO. Thank you.

Ms. OLSON. And then when you look at the dollars that are due on these balance due returns, we had about $12 billion on all individual income tax returns due. Okay. A balance due. And I am not talking here about under reported income. I am saying people said this is how much we owed, we were not able to pay.

Chairman MANZULLO. Right. Okay.

Ms. OLSON. So on those 4 million returns for all individual taxpayers, it was about $12 billion due.

And for Schedule C returns what we had was about $6 billion due.

So the Schedule C balance dues were about 50 percent of the dollars, although they were 35 percent of the balance due returns and 18 percent of the overall taxpaying population.

So that is not the end of the equation, though, before you get to backup withholding. I mean, some of those people may be one time people, of those 1.4 million taxpayers that were Schedule C that filed a balance due return. They may just have had a bad year, you know, and they are going to contact us and get into an installment agreement. They may never repeat that problem again.

So what my universe is to even begin to look at backup withholding are people who have had recurring balance due returns where they are getting so far behind, where they are showing a balance due of $5,000 a year and you have three years in a row and you are getting to $15,000 with penalty and interest accruing and you are never going to dig yourself out of that debt. And that goes back to what I was trying to say in my oral testimony. You never dig yourself out of that debt.

And so what we were trying to say there is we have got a repeater, we have got a problem, we have got a trend starting with this taxpayer. And the next thing that is going to happen is that taxpayer is going to go out of business.

So what I want to do because all of our notices that have been sent out to that taxpayers are not bringing him in and we are not getting an arrangement. He is not coming in and he is not scheduling his self-employment, his estimated tax payments on a monthly basis is to institute backup withholding, just like we do with the individual with the interest and the divide where people are not responding.

Chairman MANZULLO. On whom?

Ms. OLSON. On repeaters who are showing a trend on Schedule C.

Chairman MANZULLO. No, I am sorry. The people that would have to withhold?

Ms. OLSON. Okay. If they have 1099s, we would go out to their payors. And I would imagine if you just got a 1099 for $600 or $650 the IRS would not be contacting that person. But if you had someone that it looked like there was one payor, you know you were really working for one person, we would go out to that person and say we want you to withhold.

Chairman MANZULLO. So that could be a corporation?

Ms. OLSON. It could be a corporation.

Chairman MANZULLO. It could be a sole proprietor?

Ms. OLSON. It could be another sole proprietor, that is right.

Chairman MANZULLO. So you would be asking a sole proprietor, a small business person, to withhold?

Ms. OLSON. Yes.

Chairman MANZULLO. And then to send that money to the IRS?

Ms. OLSON. Yes.

Chairman MANZULLO. John Satagaj has something to say about that, is that the segue?

Mr. SATAGAJ. It is hard to believe, I guess is the only words I can use.

Chairman MANZULLO. I am astonished. I am astonished. This is the Taxpayer Advocate.

Mr. SATAGAJ. Yes. I mean, actually, I do not want to get into too—

Chairman MANZULLO. Go ahead. You can argue with her.

Mr. SATAGAJ. I am struggling with the repeat, how many of them are repeaters even.

Ms. OLSON. Actually, we were supposed to have that number this morning and we did not receive that number. But it would obviously be less than 1.45 million because that is the total balance due that we have.

Chairman MANZULLO. So then you would be asking businesses that hire this repeater who is an independent contractor to withhold because this independent contractor is not paying his tax, is that correct?

Ms. OLSON. On a repeated basis, yes.

Chairman MANZULLO. Okay. So then unless that independent contractor comes in with this magic certificate of compliance—

Ms. OLSON. No, we have not gotten to that yet. No.

Chairman MANZULLO. But in any case, but it is correct—

Ms. OLSON. Well, what I would like is that what you would have is that essentially one backup withholding payment would make that taxpayer call the IRS and then part of my proposal is that when the taxpayer calls the IRS, we will release withholding, backup withholding if they will get into this monthly payment plan—

Chairman MANZULLO. That is correct. But now what you are saying now is that the creditors of the guy who—

Ms. OLSON. Right. I am asking this small business employer, right.

Chairman MANZULLO. —is continuously—not the employer. It is not employer. It is the payor.

Ms. OLSON. Right. Okay. The payor. You are right.

Chairman MANZULLO. The payor, that is correct.

Ms. OLSON. The payor. That is correct.

Chairman MANZULLO. You would be asking that person—

Ms. OLSON. Yes.

Chairman MANZULLO. —let us say it is the plumber. Let us say the plumber does, I do not know, 300 jobs a year, whatever it is. So you would be going after all those people—

Ms. OLSON. Well, not necessarily. I mean, those are the questions that the IRS has to decide whether you were going to get money from them or not.

Chairman MANZULLO. The problem is this—

Ms. OLSON. Yes.

Chairman MANZULLO. — is you make a general recommendation. You are smart enough to say general recommendation, a little bit smarter than Treasury that comes right out and says let us do this. You make this general recommendation, but you have done nothing to show the cost of implementing it in terms of the burden that is on the innocent business, like my brother with the restaurant. I mean, he is supposed to be placed in a position to determine whether or not his plumber is paying his taxes?

Ms. OLSON. Well, see that is a valid point. But with all of my recommendations, they are recommendations. The IRS now has a small business burden reduction model. And we will feed this proposal in and look at what it should be.

Chairman MANZULLO. Well, can I help you feed it right now? I think—

Ms. OLSON. So I mean I have been listening to the panel.

Chairman MANZULLO. —it is stupid and it stinks. And may we go on to something else on behalf of all the Frank Manzullo Juniors who went out of business after 41 years. I am sorry. There is no way Frankie ever would have known about a certificate of compliance if you asked him to withhold. He would look at that thing and say well what does this mean? I mean, he has a high school education, actually a business school education, and he is a veteran. And he is a very smart guy.

Ms. OLSON. Well, many of these—

Chairman MANZULLO. But he would have no idea what that means.

Chairman MANZULLO. He already—

Ms. OLSON. Well, many of these small business people have employees in additional to independent contractors.

Chairman MANZULLO. Of course. I understand that.

Ms. OLSON. And they are handling withholding in the context, too.

Chairman MANZULLO. Right. But I mean—

Ms. OLSON. So it is the same mechanism.

Chairman MANZULLO. But look at the different small business groups out there, NFIB members went from the average of three employees to I think it is now about five, and the other groups are somewhere in that particular area. I mean what happens if not only it is his plumber but also the electrician? You know, these small business people hire small business people because it is good for business. That is the culture; it is just the way it is. I mean, there could be a half of dozen people that you would send a notice to, especially if it is an area like Rockford, Illinois that led the nation in unemployment at 25 percent. And now it is still at seven percent where people are struggling to make their payments, taxes are going up and the average wage for the people in the biggest county in my District has gone down because of the loss of manufacturing jobs. And they are struggling. They are hurting.

Ms. OLSON. I understand this.

Chairman MANZULLO. So you would be asking the small businesses that are left to do backup withholding—

Ms. OLSON. No, I would not, sir.

Chairman MANZULLO. —in the event that you find these characters that are not fully compliant with the IRS?

Ms. OLSON. Right. Now so the other point that I want to make is that the IRS in its current levy program, for example, what it has the authority to do under law right—

Chairman MANZULLO. Right.

Ms. OLSON. —now if someone is behind in their taxes and we can tell that someone is working for one individual person or we can see from the 1099s or that they are working for 25 individual people, we can go out to those payors and levy on the payments that they are making on that person right now.

Chairman MANZULLO. Only if they owe money.

Ms. OLSON. Well, that is what I am talking about here.

Chairman MANZULLO. That is correct.

Ms. OLSON. The IRS has tolerances. We do not go out if there are 25 people and they are paying X amount of dollars and it is

below our tolerances, we do not go out to absolutely everybody who shows up on a 1099 when we go out and do our levies.

You know, and the same procedures would occur here. We would be making those tolerance decisions.

Chairman MANZULLO. I mean whenever you have decisions, you are talking about bureaucrats. You talk about bureaucrats, you are talking about forms, you are talking about the forms—you know what my brother would do if you said any future work this plumber does you have to withhold? Do you know what he would do?

Mr. SATAGAJ. New plumber.

Chairman MANZULLO. New plumber.

Ms. OLSON. Well, what is he doing in the current situation when we go out and say to him we're going to levy on—

Chairman MANZULLO. Well, no, that is the whole point. Then you end up putting this guy out of business.

Ms. OLSON. That is happening today in the levy context.

Chairman MANZULLO. Well, no, but it is different in the levy. The levy is where the creditor is actually holding money that is owed. You can't levy on zero.

Ms. OLSON. You can put it on accounts receivables. And if the plumber is working and there is a payment that is due to him, then we can levy on that. And that is—

Chairman MANZULLO. Well you know what he would do as a small businessman?

Ms. OLSON. —precisely what we are doing now.

Chairman MANZULLO. He would just go on to get somebody else. Why should the small—

Ms. OLSON. But I am saying that that is what is happening here and it is happening today.

Chairman MANZULLO. No, I understand it. But I mean you have got so much research you have to do and of course the IRS considers itself exempt from the Regulatory Flexibility Act on any regulation. So you come out with these regulations and you have absolutely no way of knowing what the cost will be.

Ms. OLSON. Well, actually, to that point part of the reason why we have said that these were proposals is because I am making them publicly and I am sitting here willing to discuss them with you.

Chairman MANZULLO. But that's—

Ms. OLSON. And I have stood before 22 small business groups and listened to their concerns, and I have incorporated many of their concerns.

Chairman MANZULLO. John?

Mr. SATAGAJ. I mean to there is the issue of, you have raised the issue. You are going to get rid of that plumber and go to another one. You have got the fact that you are going to have a lag time here between the years involved and when you are getting out the notices. It presumes they keep going back to the same people all the time for the same business. I mean, there are a lot of presumptions in this to get to the point where you're actually going to be able to match up the person that you want to withhold from the person.

Ms. OLSON. Yes.

Mr. SATAGAJ. I mean, you got too many—

Chairman MANZULLO. All right. Michael, how many subs do you have in any given year in your business, in your plastics industry, subcontractors?

Mr. FREDRICH. Oh, I would say five to ten.

Chairman MANZULLO. Okay. What about sub-subs? Of course, you would not be dealing directly with them, would you?

Mr. FREDRICH. We would not. But—

Chairman MANZULLO. How many people do you buy materials from?

Mr. FREDRICH. The materials are all larger customers, people that we use as subcontractors. For example, we have a guy that comes in and runs a machine that measures the tolerance on parts. And we do not have to do that that often because it is just for new parts that are getting approved by the customer. So, you know, he would come in maybe seven/eight times a year and we pay him as an independent contractor.

But I would say this: You know, they are talking about withholding. If you withhold 28 percent of somebody's gross revenue, nobody has a 28 percent profit margin. It is just not there. I mean if you are talking about withholding, maybe you would have to figure out what their profit margin is.

Ms. OLSON. We did do that.

Mr. FREDRICH. And then the percentage of tax. But 28 percent is—

Chairman MANZULLO. It is a lot of money.

Mr. FREDRICH. It is off the wall. I mean you put—

Chairman MANZULLO. Congresswoman Velazquez?

Ms. VELAZQUEZ. Thank you.

Ms. Olson, what will be a liability issue for the payor

Ms. OLSON. It would be the same rules under backup withholding today, which is that if you have the obligation to do backup withholding, then you would be liable just like a bank would today.

If I could make two points. One is my proposal is not to go to anything but payments that are currently subject to 1099 reporting.

Ms. VELAZQUEZ. Okay. In your recommendations would you ask the IRS to put more resources into education?

Ms. OLSON. I have made—

Ms. VELAZQUEZ. Personnel?

Ms. OLSON. —at my number one most serious problem for taxpayers in this past year's annual report the trend in taxpayer service, which includes the outreach and education to taxpayers. And I have criticized some of the changes that have been made in the Small Business Self-Employed Operating Division—

Ms. VELAZQUEZ. And do you hear that more staff people have been shifted around—

Ms. OLSON. I state that in my testimony.

Ms. VELAZQUEZ. —and that the resources will be put into outreach and education?

Ms. OLSON. I am very concerned about that.

Ms. VELAZQUEZ. So how do you expect then for business to understand when they will be in violation or noncompliance?

Ms. OLSON. If I am not satisfied that the IRS is adequately staffing this, then I would not be supporting this. I would not be putting forward this proposal.

Ms. VELAZQUEZ. Right.

Ms. OLSON. This cannot be separated out from just compliance. I mean enforcement.

Mr. BROWN. Excuse me. We do take the service component of our mission very seriously. And there has not been a reduction in the number of resources devoted to it. I mean, there has been a recasting of who performs some of those services. And some have migrated to other divisions. But in terms of sheer number of people and sheer number of hours devoted to the service side of the equation, that has been constant. And we take that very seriously. We have tax forums around the country and they are very important in terms of educating taxpayers.

Ms. VELAZQUEZ. Let me ask: Have you shifted resources from assistance to enforcement?

Mr. BROWN. We are devoting the same amount of resources to service as we did before. We had an organization called Taxpayer Education and Communication and there was an error—

Ms. VELAZQUEZ. But then you are defeating the purpose because if you are going to implement this new proposal and go after all these people now, if you are going to have and devote the same type of resources, that means—

Mr. BROWN. You are suggesting we would devote more resources to it?

Ms. VELAZQUEZ. Correct.

Mr. BROWN. I agree with you that we need to do more in this department. That we need to devote both more research and become—

Ms. VELAZQUEZ. But I understand your funding, your budget will be flat funded.

Mr. BROWN. Our budget will be adequate for what we need to do here. Obviously—

Ms. VELAZQUEZ. That is what I hear from the Administrator of SBA when he comes here and you see the mess that as a nation we have been witness in regarding the victims of Katrina. Why? Because the budget of SBA has been cut by 50 percent in the last years.

Mr. BROWN. We believe we have the resources necessary to do the work here.

Ms. VELAZQUEZ. Okay. Thank you.

Mr. Satagaj, in your testimony you seem to focus on the problem of complexity as a driver of noncompliance. Unfortunately, the President's Commission Tax Reform Panel that put together a report on simplifying the tax code and nearly all of their recommendations have simply been put aside. Why do you believe that efforts to simplify the tax code have failed and this problem only continues to get worse?

Mr. SATAGAJ. A real question. I do not know that I know the answer to that one, and I am honest to say that. It is frustrating that we have not done it. You allude to that report. Former Commissioner Rossotti sat on that panel and I would say that he has been one of the very effective spokesman for small business and he had

some very intriguing proposals in there, and some of them lead to actually the very systems we are talking about here ironically about reporting. Because he talked about checkbooks and he talked about credit card. But the payback to get that was you would have a simpler system.

Ms. VELAZQUEZ. Sure.

Mr. SATAGAJ. And there is something there to make an incentive for the businesses to be part of that system, whereas these proposals there is no incentive to it.

I do not have an answer to why, to be honest with you.

Ms. VELAZQUEZ. Okay. Well would you agree that if our tax bills focus on simplifying the tax code, that concerns about the tax gap will be reduced?

Mr. SATAGAJ. I think so. I think that certainly is a part of it. There are several things that fall in there, but that is one part.

Ms. VELAZQUEZ. Mr. Sawicky, would you like to comment.

Mr. SAWICKY. Sawicky.

Ms. VELAZQUEZ. Yes. Would you like to comment on my questions to Mr. Satagaj?

Mr. SAWICKY. Well, a broader simplification if it broadens the tax base makes lower rates possible. And I think the research and common sense is universal that lower rates reduces the incentives to evade taxes and also reduces the incentives to look for legal ways to reduce one's tax payments. So you cannot have too much base broadening from my standpoint. Why do we not get more? Well, I think it is because half the people in this room are involved in activities to get concessions in the tax code for one or another interest. And as the Commissioner I think said, as these things pile up to the breaking point, at some point I think probably with a financial crises resulting from our trade and budget deficits, they will be compelled to do something serious about simplification for the purpose of gaining revenue. The alternative would be problems in financial markets that cause serious damage to the economy.

Ms. VELAZQUEZ. But in your view both Congress and the Administration bear some responsibility for increasing complexity of the code?

Mr. SAWICKY. Well, the people that write the code are responsible for the complexity of it. And from my standpoint and including the legislation in '97 as well as what came after, we have had increasing complexity in the tax code. And also that entails all kinds of swiss cheese holes that take parts of the base away from taxes.

Ms. VELAZQUEZ. Mr. Brown, in terms of the area of enforcement do you believe that by focusing on corporate tax shelters will be a more efficient use of the IRS resources as opposed to the current efforts to go after small businesses?

Mr. BROWN. I think both are necessary, as the KPMG situation the Commissioner alluded to earlier, many of those taxpayers are involved in a deal called Son of Boss that involved about 1300 individual taxpayers who ended up paying us more than $3.7 billion. And this is not money we hope to collect. This is money that we have received.

Ms. VELAZQUEZ. So would you say that these larger businesses over $250 million or more are better equipped to deal with an audit

in terms of manpower and costs? Would you agree that the relatives costs are much higher for these Schedule C filers?

Mr. BROWN. Yes.

Ms. VELAZQUEZ. And with this measure let us talk about the cost to the honest taxpayer who is subject to an audit?

Mr. BROWN. Well, the credit—

Ms. VELAZQUEZ. Does that represent a win/win for our economy?

Mr. BROWN. Well, I think that is why we really wanted third party reporting. The intent here was to not place the burden directly on the small business. And I realize, of course, that there are some pass-through costs when you are talking about credit card companies having to report this type of information. But that was the genesis of the idea for increased third party reporting as opposed to withholding or going some other way which would put the cost directly on the small business.

Ms. VELAZQUEZ. But you do not think that that will represent a financial burden on small businesses?

Mr. BROWN. I do think it will represent somewhat of a financial burden on small businesses, yes I do.

Ms. VELAZQUEZ. Do you really think so, because you have not done any impact analysis?

Mr. BROWN. Well, we obviously have to meet with the industry. When you are talking about third party reporting, there are always going to be costs that we might not be able to know, but that is exactly why we are meeting with the industry.

Ms. VELAZQUEZ. Mr. Brown, the IRS suggests five initiatives to close the tax gap. And according to your figures the cumulative impact of these changes will reduce the tax gap by one-tenth of one percent. Even that, would not the time of the Administration, the IRS, the Treasury and Congress be better spent on taxing simplification rather than trying to go after such a small amount given the huge administrative burdens that they seem to create?

Mr. BROWN. The proposals we believe do not create huge administrative burdens. I guess I would take issue with that word.

Ms. VELAZQUEZ. Well, we would start $100 million that you pay for a study.

Mr. BROWN. I think Senator Baucus asked the Commissioner at a hearing recently the same question and he said is this enough? This does not represent enough in terms of efforts. So I think the point is valid that this is a minor piece.

As to tax simplification, I applaud any efforts to simplify the code. It is very difficult for our revenue agents to enforce the laws when even they sometimes are not certain about the laws, let alone the small business they're intending to audit.

Ms. VELAZQUEZ. So you agree with me that since 1997 the tax code are more complex?

Mr. BROWN. I have been in this business since 1987 and every year it has gotten more complex.

Ms. VELAZQUEZ. More so after 1997.

Mr. BROWN. 1987 is when I got into this business, and it is been much more complex every year.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman MANZULLO. Thank you.

Now, what side of these proposals do you come down on, with Ms. Olson or with the Commissioner?

Mr. BROWN. Oh, with the Commissioner, obviously.

Ms. OLSON. The Advocate speaks for herself.

Chairman MANZULLO. Are you not glad that the Commissioner went first?

Mr. BROWN. Yes.

Chairman MANZULLO. Right.

Mr. Brown, I guess this was the so called "blue book"?

Mr. BROWN. Yes.

Chairman MANZULLO. On page 117. Do you have it there?

Mr. BROWN. I do somewhere in this rule book, yes.

Chairman MANZULLO. Could you flip to it? This is when it talks about increased information reporting on payment card transactions. Do you see that?

Mr. BROWN. If you will give me a second, I will find that for you. Thank you.

Chairman MANZULLO. Does that say on top increased information at page 117?

Mr. BROWN. It sure does.

Chairman MANZULLO. Okay. Would you go down to where it says "reasons for change" And read the last sentence in there where it says "in addition."

Now this is only, as the Commissioner said, with regard to people that give somebody else's wrong tax number.

Mr. BROWN. That is correct.

Chairman MANZULLO. You want to read it out loud for us?

Mr. BROWN. Sure. "In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden on card issuers."

Chairman MANZULLO. Who came up with the last portion of that sentence?

Mr. BROWN. This was a combined effort between the Treasury Department, the IRS and other parts of the Administration.

Chairman MANZULLO. And I would note that, first, this is put out and then come the meetings with the industry. Is that order correct?

Mr. BROWN. There were some preliminary discussions with people who are familiar with the industry and who worked in the industry before we did this. And there are ongoing discussions as we speak with members of the Credit Card Association, the American Bankers Association.

Chairman MANZULLO. But why would you put this out? I mean, this is a statement of fact. This is a sales piece that you give to Congress. I mean you have made a factual determination that there would be no significant burden on card issuers. I mean, this is not—

Mr. BROWN. Well, this refers to just the backup withholding, this particular sentence.

Chairman MANZULLO. Well, you have to start with that.

Mr. BROWN. But this is—

Chairman MANZULLO. I mean how could you come to that conclusion?

Mr. BROWN. By talking to people who are familiar with the industry. I have worked in the industry. And this is the way the budget process works. We obviously want to work with the Congress to make sure and to work with the industries to make sure that we do this—

Chairman MANZULLO. First of all, I do not believe this. I mean this is factually incorrect because every time you do something else to withhold, it is going to be new software. I mean, the software people must love you. You would have to change programs here.

Mr. BROWN. No. We have backup withholding regimes in place now. This really is designed to mirror the current backup—

Chairman MANZULLO. No, no, no. This is something new. This is credit cards. And what I don't understand is if somebody gives you a bad TIN number, what kind of people are these? Are these crooks? What are they? Who is doing that and why do you not put them in jail or charge them with a crime if they are using somebody else's instead of going after the credit card issuer and saying this guy who was using a bogus TIN number, we want you to withhold on the money you give him? Why do you not just put him out of business or arrest him or something? That sounds like credit card fraud to me.

Mr. BROWN. Well, some of these are just made in error. People transpose number. So we do not jump right to back—

Chairman MANZULLO. Well, I realize that goes on all the time.

Mr. BROWN. That is correct.

Chairman MANZULLO. That proposal does not even address that. Because once the error is brought to their attention, you know somebody could have interposed a number or transposed a number.

Mr. BROWN. The vast majority of them, correct once we notify.

Chairman MANZULLO. Right. But I do not understand this. I mean, if somebody gives a wrong TIN number and it is not an error, what kind of a person is that? Is that a thief?

Mr. BROWN. Well, it can be.

Chairman MANZULLO. Or what?

Mr. BROWN. It can be someone who is generally trying to avoid the information going to the Internal Revenue Service. And there are other reasons that you would—

Chairman MANZULLO. Well, that is pretty serious, is it not?

Mr. BROWN. It can be. And there are also all sorts of Bank Secrecy Act provisions that would be run afoul of here, too, as well. I mean often times you are dealing with banks with taxpayer identification numbers and they want to launder money. There are a lot of reasons why people want to avoid that kind of scrutiny.

Chairman MANZULLO. But I mean you are really not in the business here of going after the money launders.

Mr. BROWN. Unfortunately I am.

Chairman MANZULLO. Well, not with this proposal?

Mr. BROWN. Not with this proposal. But I unfortunately own the Bank Secrecy Act program for the Internal Revenue Service, it is in my division.

Chairman MANZULLO. Okay. Well, that is another part of your portfolio.

And again, this is aimed at the small business people, as finally we got the Commissioner to agree that this particular provision was. I still do not understand how you can make this statement. Because what you are talking about is that for every small business person you are going to make, and I think you said 25 million people, the credit card companies give all that information to the IRS so they can filter through all of that to see who is giving a wrong number, is that not correct?

Mr. BROWN. What we are looking for is an aggregate number on gross receipts, payments made to if you are a restaurant. That is the number we are looking for. And also we are looking to make sure that when the information comes in that there is a proper taxpayer identification number.

Chairman MANZULLO. Well, that it is interesting because now you are talking about withholding on credit cards on an aggregate number and your boss just testified to the fact that the only time that credit cards would be involved is because of a false TIN number.

Mr. BROWN. That is correct. No—

Chairman MANZULLO. Well, why did you mention aggregate number? Because that could be something that you might be looking for, is it not? It could give reason for an audit, could it not?

Mr. BROWN. The third party reporting is specifically designed to give us an aggregate number for credit card receipts—

Chairman MANZULLO. You have it back there? Yes. This stinks because now I know what you are doing. You want to have all the credit card companies report to you so then you can take that information and then compare it against their income tax return. So this is more than the people with the false TIN numbers, is that not correct, on credit cards?

Mr. BROWN. The false TIN numbers only applies to the backup withholding. The TIN numbers do not come into play other than for the backup withholding.

Chairman MANZULLO. Well, yes, but then what would you do? This is just a big net. Just a fishing net out here so you can get more information. Because you know what? Let me share what occurs on page 41 of this report that you guys just love. Page 34. This says, but unfortunately these are not your own words so I can't cross examine you like I did your boss, "Appendix 3 IRS key efforts to reduce the tax gap. The IRS strategic plan outlines, it does not prioritize service and enforcments to improve compliance." That is not good. "Therefore, we asked IRS officials to identify IRS' key efforts to reduce the tax gap. IRS divisions provided lists that totaled 47 efforts which are described in the following examples. The Small Business/Self-Employed Division," that is you?

Mr. BROWN. Yes.

Chairman MANZULLO. Okay. "Identified 15 efforts such as models to identify higher priority collection cases to pursue." Another word for modeling is profiling, is that not correct?

Mr. BROWN. I will agree with that.

Chairman MANZULLO. Good. And another one is a computer matching program to identify under reported income. That is what you want?

Mr. BROWN. Well, what that is referring to is, I mean, it is somewhat like Max explained before. We have a formula we use to assess returns. We do not just audit randomly. We view random audits as a waste of time. I do not want to hassle taxpayer where there is not a high probability of there being something wrong. You know, we do not have the resources to do that and, frankly, neither do the taxpayers. So the idea of the National Research Project was to get us better formulas that would allow us—

Chairman MANZULLO. No. But you want that information from the credit card companies because then you could match that information with what appears on income tax returns. See, that is what you want.

Ms. OLSON. But that is what we do today with the 1099 information.

Chairman MANZULLO. Oh, I understand that. But this would be a 25 million small businesses, we are not talking about corporations. This is just little guys, small businesses. All that information would be going from their credit card company to you so you could take that information and you could measure it against what they are reporting?

Mr. BROWN. Yes.

Chairman MANZULLO. What is that going to cost the IRS to manage all that information?

Mr. BROWN. We do not know right now.

Chairman MANZULLO. You do not know? Do you not think it is important?

Yes, we talked to the credit card people. We did that. We have in our office. Do you want to know the figure? Eight million transactions per second; that is the entire credit card industry.

Ms. OLSON. But I do not think that—I mean, this is not my proposal, but the proposal is a total for the year on a calendar year.

Mr. BROWN. That is right.

Chairman MANZULLO. Wow, goodness gracious. Eight million per second. I cannot even figure that out as a Congressman times 60 what that is. I mean, can you not see why we are excited here? Can you not see why we want to know what is this thing going to cost the taxpayers?

I mean, the first thing that I would do is the guy behind with the $100 million study, all right, and you are with the IRS, right? Okay. Mark. Okay.

The first thing I would do is say before I get Congressman Manzullo all excited, I am going to sit down with Mark and say "Mark, what is this going to cost? Give me a guesstimate. Give me a ballpark figure so that when I come up with efforts to do things, I do not come up with a statement that says without imposing significant burden on cad issuers."

You have no idea what this is going to cost, do you, That 8 million transactions per second?

Mr. BROWN. We do not precise numbers. That is why we are working with the industry right now.

Chairman MANZULLO. Well, you do not have anything. You have got nothing.

Mr. BROWN. That is not true. We did have meetings with people who are familiar with the—

Chairman MANZULLO. No. You can have all the meetings you want. They do not know. They are in the business of issuing credit to consumers, not giving background information to the IRS. That is not their mission.

Mr. BROWN. But we have ready reference point with banks which do report the information to us now.

Chairman MANZULLO. Oh. I mean, sure you got your 1099s. I can understand. But can you not see as the Chairman of the Small Business Committee why we see this as angst? Because one thing that you could never realize is you come up with formulas and you will say well if it is a restaurant, it has got to have this amount and that it has got to be 42 percent has to be credit cards and we are going to set up our computers so that at 42 percent, whatever it is, it is not on credit cards that is going to trigger an audit. Somebody has to come up with all those figures and that is another study and you already have those secret formula that you cannot show the public. Maybe if we shared the formula with the public, then the public would know better than to cheat if they know what you are looking for.

Ms. OLSON. Sir, would you rather us not do those studies and go out and randomly audit taxpayers? Because the point of the studies is that if we do do an audit—I mean, I am supporter of the studies because I do not want us going out and just randomly auditing people. I want the IRS to focus its audit resources on the people who have the highest amount of noncompliance.

Chairman MANZULLO. No, I understand. But the problem is this: You have already spent $100 million of the taxpayer's money on a study that is lousy. If I may, if I may and I went through this last night as I was watching the basketball game. And every time I saw something, I would underline it. Every time I saw a basket made for your old alma mater, which you do not watch, I saw—

Mr. SAWICKY. I was working on my testimony then.

Chairman MANZULLO. That probably put you to sleep.

But I mean where you do not even have provisions to track your data. In other words, you do not even know what you are capturing before you are making conclusions. Let me read this to you.

"Several factors concern IRS about its data on the reasons for noncompliance which could be unintentional or intentional, though IRS is developing the system to capture better examination data." Yes, right. "IRS does not have firm or specific plans to develop better data on the reasons for noncompliance even though lack of such data makes it harder to decide whether it should address specific areas of noncompliance through nonenforcement efforts such as designing clear forms of publications on enforcement efforts."

You do not have the data for that and yet in your testimony you went after your boss where you said I am concerned because when the IRS Small Business/Self-Employed Division, that is you, Kevin, Taxpayer Education and Communication Division was merged with its Communication Liaison or Disclosure Division, education staffing was reduced from 699 in fiscal year 2003 to I believe there is a typo error in the testimony, is that correct?

Mr. BROWN. We might want to confirm that.

Chairman MANZULLO. But this says "Is reduced from 699 to 184." And I think someone from the IRS contacted us and said the real number is 480.

Ms. OLSON. They disagree with us, but we got this off of the time keeping records. So I do not know what to tell you about that.

Chairman MANZULLO. Okay. Is she right?

Ms. OLSON. But I mean I have no numbers.

Mr. BROWN. No.

Chairman MANZULLO. She is wrong?

Ms. OLSON. It is all numbers from the IRS.

Mr. BROWN. I think the number is incorrect.

Chairman MANZULLO. What is the number?

Mr. BROWN. The number is approximately 500. But it is not accurate—

Chairman MANZULLO. You went from 699 to 500?

Mr. BROWN. No, it is not apples-to-apples. That is what annoys me about this. The 699—

Chairman MANZULLO. This is your fruit you are looking at.

Mr. BROWN. Yes. The 699 were people who did not work full time on education and outreach. They went off for half the year to do other duties. Now we have 500 people working full time on this. So—

Chairman MANZULLO. But you are going to have to hire another 5,000 if you are going to have somebody 8 million transactions per second.

Ms. OLSON. If I might, sir, I think that your point about needing to know the reasons for noncompliance is very important. And I have written a lot about that in my annual reports. And I think that that actually was what was motivating to make the proposals about the voluntary estimated tax payments. Because you do not want to use an audit—

Chairman MANZULLO. You mean such as salons?

Ms. OLSON. Well, the salons, exactly, but also to scheduling a year in advance, that you do not—

Chairman MANZULLO. Yes. I do not think that there is much angst in the small business community—

Ms. OLSON. About that?

Chairman MANZULLO. —over a system set up like that to make it easier for people to be in compliance like that, and if it is truly voluntary—

Ms. OLSON. Well, the way that I looked at this was, and this really was me on relying on my own personal experience because I have prepared returns for 27 years for these folks and saw these things happening, that I believe that the vast majority of people who are behind on their payments are self-employed, it really is just a matter that they just cannot save. And I do not think that we should be using all the clubs and all the enforcements actions that the IRS has for those kinds of people. You need to think about—

Chairman MANZULLO. Put them on a budget?

Ms. OLSON. Exactly.

Chairman MANZULLO. Good. Good for you.

Ms. OLSON. And so then what you need to reserve your enforcement resources for are those people who are the most recalcitrant,

who are tending in a direction where they will never get themselves out.

Chairman MANZULLO. True offenders.

Ms. OLSON. Yes.

Chairman MANZULLO. Let me read something else here. This says, this is on page 4, I mean this is some pretty interesting reading. "IRS approach for reducing the tax gap includes improving taxpayer service to increase voluntary compliance and enhance an enforcement of tax laws by detecting and addressing noncompliance, but does not incorporate some steps consistent with results oriented management. To support this approach IRS has established two broad strategic goals and identified over 40 related key efforts which includes using direct enforcement actions to address high income non-filers and using analytical models to pursue higher priority collection cases. However, IRS has not established long term quantitative compliance goals and regularly collected data to track progress is reducing the tax gap which would compliment its current important compliance efforts."

I mean, so you have no way to determine if what you are doing is the right way to go, but you are on your way. And now you are off into a whole area, you with your own proposal, to have individuals withhold and the credit card companies to have them withhold on people that are not paying their taxes. More government, more rules, more regulations, more compliance.

Ms. OLSON. Well, I can only tell you that in my proposal I would insist on those controls. And I think that—

Chairman MANZULLO. Yes, but you will not be there forever.

Ms. OLSON. Well, that is true. But one would hope that you all, someone will be in your chair and we will hope is honest.

Chairman MANZULLO. And it does not work that way. Because unless you have been raised in small business, you have no idea. No idea what is going on.

What this is saying here is that the IRS goes off in new directions in enforcement but does not look where you have been. It does not seem to care because you have no way of measuring it.

I mean you were there so long you dropped off your sleeping bag in the office last night, you stop by and see us so frequently.

Ms. Everson said that the tax gap was reduced from 43.1 to 47.3 billion. Evidently, an extra 6 billion came in approximately, or 4 billion came in.

Mr. BROWN. That is referring to enforcement revenues.

Chairman MANZULLO. Enforcement revenues from one year to the next?

Mr. BROWN. Yes.

Chairman MANZULLO. How much of that came from the small businesses that we're talking about? Do you have any idea?

Mr. BROWN. The increase?

Chairman MANZULLO. Yes.

Mr. BROWN. I do not know.

Chairman MANZULLO. I will bet you do not. That is what they are talking about.

Mr. BROWN. No, I can get—no, I can get—

Chairman MANZULLO. See, you have no way to determine it because you do not have the procedures set up for that.

Mr. BROWN. Oh, I can get you the number. We can get you that number.

Chairman MANZULLO. You have got it there?

Mr. BROWN. I just do not have it now.

Chairman MANZULLO. It is not there? Obviously, you cannot bring everything with you. The point is is that that is important to determine whether or not you are spending your resources in the same area. Do you not agree?

Mr. BROWN. Yes, but—

Chairman MANZULLO. I mean you have to know if you are successful.

Mr. BROWN. Yes, but we have a number of measures that do tell us whether or not we are successful. We look at no change rates; when you have a high no change rate as the Commissioner described in the C-Corporation, area—

Chairman MANZULLO. Right.

Mr. BROWN. — you realize that those are not a fruitful way to spend your audit time.

Chairman MANZULLO. Right. So you go after the little guys?

Mr. BROWN. You have other measures about average adjustment, things like that. I mean, there are a number of measures there that tell you are you auditing in the right areas and are you getting anything out of the audits.

Chairman MANZULLO. Well then if that is the case, then why is this report so damning?

Mr. BROWN. Because they are talking about closing the overall tax gap, which at the time they wrote the report we did not even have a precise estimate for.

Chairman MANZULLO. I mean they said, GAO actually complimented IRS on having the right figure on what the tax gap was, which I thought was quite interesting.

Mr. BROWN. And we are also now in the process of developing. We have gotten a number of the same sorts of questions from the Senate Finance Committee.

Chairman MANZULLO. Why do you not develop all this stuff? Why do you not get all your facts before you come out with these proposals? I mean you know how this Congress is. I mean this could be slipped in. I think Commissioner Everson said himself that he appreciates a hearing like this because he's afraid stuff like this would get slipped in in the middle of the night into something and then everybody's scared.

I know I have prolonged this beyond it. But what happened with the HOPE Scholarship thing, I mean that was $100 million a year that was imposed on higher education that would have been passed on to the students. And that got put into law. President Clinton insisted that the colleges report that. That was his language that was added to it before he signed the bill. And no one had ever done that estimate on the compliance of it.

I mean you guys have got to find out what this stuff is going to cost—

Mr. BROWN. We agree.

Chairman MANZULLO. —before you do it. And then look at the second thing is how much more of the underground economy are you going to create? Word gets out on the streets, IRS is going after

credit card transactions, if you pay me in cash, I will give you 20 percent discount. Do not take any credit cards. How much are you going to push underground with this?

Mr. BROWN. Well, I can tell you unfortunately that is already going on.

Chairman MANZULLO. Well, of course. It is going to go on even more.

Now do you really think that the sophisticated cheater who gets his money from Visa is going to encourage his consumers to say this transaction is priceless. He is going to say pay me in cash. And what you are proposing is going to have even more of an underground economy. It will be counter productive and then we lose on both ends.

Mr. BROWN. Ultimately I think time is on our side. When I can go to the Wendy's drive-through window now and use a credit card, I mean we are moving into—

Chairman MANZULLO. That's Wendy's. They're big.

Mr. BROWN. Yes, but I can—

Chairman MANZULLO. I mean, you know, what about the Shady Grove Drive-In that my dad ran from 1954. No, that was the name of it. 1954 to 1970?

Mr. BROWN. Even taxicab drivers are now frequently taking credit cards.

Chairman MANZULLO. Well, you know what? My brother never took credit cards in his restaurant. You know why?

Mr. BROWN. Probably the fee.

Chairman MANZULLO. No. That is right. His margin was so small that he was not about to pay 3 percent. And he told his customers if they came there, they wanted to give him a Visa, he said give me a personal check. The guy said I left my checkbook at home. And my brother would give him a 3 by 5 card with his name, address and the amount of the bill and the guy would send him a check in the mail.

You know, our goal is to keep things simple. But you are off on a terrible road there. And as long as I sit in this chair, and unfortunately that is only until the end of this year, this will get slipped in in the middle of the night. I understand the guys over in the Senate, the millionaires over there, most of them are millionaires that do not know what it is like to meet a payroll to be raised in small business, are trying to come up with a proposal to slip this in somewhere. Okay. Well thank you guys for coming. I appreciate what a diverse background we have.

Did you have fun, Michael?

Mr. FREDRICH. I had a thrilling time today.

Chairman MANZULLO. Have you ever testified before Congress before?

Mr. FREDRICH. I did one time on minimum wage.

Chairman MANZULLO. Well, to each of you thank you so much for coming, especially those that traveled a long distance.

And this hearing is adjourned.

[Whereupon, at 12:59 p.m., the Committee was adjourned.]

Committee on Small Business
Hearing: *IRS Latest Enforcement: Is the Bulls-eye on Small Businesses?*
Room 2360, Rayburn House Office Building
April 5, 2006, 10:00 AM

Opening Statement of Chairman Manzullo

Good morning and welcome to this hearing on a very important topic for small businesses around the country – analyzing the activities and proposals of the IRS to close the so-called "tax gap" or the estimated difference between what taxpayers pay to the Treasury and what is actually owed.

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

The Commissioner is now utilizing the data to provide greater and greater scrutiny of our nation's small businesses. Just two weeks ago the IRS released its examination data for fiscal year 2005. This data demonstrates that from 2004 to 2005 the IRS increased audits for all categories of small businesses. For small business that reported greater than $100,000 of gross receipts, IRS audits actually doubled. Last week the Commissioner stated that even greater enforcement resources would be directed at small businesses in the future.

The IRS is utilizing the NRP study to direct ever-increasing resources to audit our nation's small businesses even though it has not completed the study of all taxpayers. In particular, the NRP study has not been updated to provide an estimate of the "tax gap" for C corporations or flow-through entities, such as partnerships. The data for these entities is still from the 1980's – a time that is far removed from the aggressive tax strategies that many "blue chip" accounting and law firms developed during the late 1990's.

In addition to the study being incomplete, the GAO highlighted in July 2005 that the IRS has not determined the reasons why taxpayers are non-compliant even though this data was collected during the NRP study. Unless this data is analyzed, there is no way for the IRS to determine how much of its resources to allocate to IRS enforcement versus taxpayer service.

While I understand the push to lower the budget deficit and the readily-available statistics that support increased enforcement, imposing increased burdens on small businesses through more audits cannot be the only answer. Many times, small business owners are attempting to the best of their ability to comply with the complex tax code. It is not that they don't want to comply; rather, the system and paperwork are so complex that it's difficult to comply.

No matter how many additional auditors and collection agents are added to the IRS, there will still be a more pressing need to educate taxpayers about their obligations. The IRS will never have enough resources to police everyone and thereby enforce compliance. Small businessmen and women are not tax experts, and they face real difficulties with complying with the tax system.

In addition to increasing audits, the IRS also proposed closing the "tax gap" by imposing new withholding regimes on small businesses in the 2007 budget. The Taxpayer Advocate has even gotten on this bandwagon. These proposals take money away from our nation's small businesses upfront before they know how much, if any, tax they owe. If this regime ever became a reality for the majority of this nation's small businesses, most of these businesses would no longer be in business.

While I understand the need to foster compliance among taxpayers, we must ensure that the approaches used by the IRS do not create excessive burdens. We can ill afford to burden our small businesses with these new withholding proposals. Rather, to the extent possible, we must keep small businesses free from government regulation and interference. This is the only way our nation's small businesses will continue to thrive.

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

DONALD A. MANZULLO, ILLINOIS
CHAIRMAN

NYDIA M. VELÁZQUEZ, NEW YORK

Congress of the United States
House of Representatives
109th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
of the
Honorable Nydia M. Velázquez, Ranking Democratic Member
House Committee on Small Business
Full Committee Hearing on "Tax Gap"
Wednesday, April 5th, 2006

Thank you, Mr. Chairman.

With April 15 right around the corner, taxes are undoubtedly on everyone's mind. Today's hearing will focus on the tax gap – the difference between what the IRS is supposed to collect and what is actually collected. According to the IRS, the tax gap is estimated to be $345 billion per year and growing.

As the budget deficit mounts – around $400 billion – the administration is looking for ways to recover lost revenue that was supposed to come flowing in as a result of their fiscal policy. But it has not.

Unfortunately, it appears the administration is trying to make up for these shortfalls and balance the budget by unfairly targeting small businesses. Today, we will hear from the IRS about a plan in the President's FY 2007 budget to crack down on small firms by granting the IRS even greater authority for enforcement.

This proposal, while having a significant impact on entrepreneurs will only reduce the tax gap by 1/10th of 1 percent. This is a large price to pay for a solution that will not even fix the problem.

However, any attempt to solely blame the IRS is wrong. What seems to be lost in this discussion is the impact wrong policy choices – specifically tax policy – made by congressional Republicans and the administration, have had on this nation's small businesses.

While providing minimal relief for entrepreneurs, the bulk of the reform passed has only further complicated the process. It has added thousands of pages to the tax code, which will only exasperate the growing tax gap problem.

For proof, one only has to look at the 2004 tax bill. Even the Chairman of the Ways and Means Committee testified that this legislation set back efforts to simplify the tax code. Small businesses are being hit twice – once with the ever-increasing complexities of the tax code and again with the rising possibility of an audit.

Given the growing complexity, tax assistance is needed now more than ever for small businesses. Unfortunately, rather than providing assistance, the administration is closing taxpayer assistance centers. It simply does not make sense for the IRS to shift these resources when the complexity of the tax code is increasing.

Congress will be voting on the budget this week and we will see just how much commitment there is to fairness for small businesses. The question at hand is – will Members support the administration's budget proposal to further reduce tax compliance assistance efforts and impose strict enforcement efforts? Or will they reject these proposals?

While many in the President's party are more than happy to vote for his tax cuts and trump all the supposed good they are doing, when it comes to the consequences – increased compliance costs and a growing tax gap – they are vehemently opposed. Unfortunately, you simply can't have it both ways.

As has been the case with tax, energy and health care policy, the administration continually favors large corporations. It is no surprise that while the tax gap is not only made up of small business taxpayers, this administration lets the big corporations off the hook and instead focuses on entrepreneurs. At the same time, many small firms have little or no resources to defend themselves.

Small businesses are the drivers of this nation's economy, and they deserve every effort possible to decrease the burdens they face. If the goal today is to reduce the costs to small business, Congress should first look to reduce the complexity of the tax code.

Most entrepreneurs are doing everything they can to pay the taxes they owe. They should not be blamed for the tax gap. This administration needs to come to terms with the role their policies have had in furthering the tax gap. They need to admit the problem – then work to reduce the effects – rather than point the finger, which is exactly what is happening with this current debate.

WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE SERVICE
MARK EVERSON
BEFORE
HOUSE COMMITTEE ON SMALL BUSINESS
ON
THE TAX GAP
APRIL 5, 2006

Good morning Chairman Manzullo, ranking Member Velazquez, members of the Committee on Small Business. It is good to be back with you this morning to update you on the tax gap. Since I was here almost a year ago, we have updated our tax gap numbers and we have begun a new National Research Program (NRP) study. I will discuss both of those later in my testimony.

Let me begin, however, by assuring you that I have a healthy respect for small business men and women and the critical role they play in our nation's economy. Small businesses represent more than 99 percent of all employers. They employ half of all private-sector workers, and they create two-thirds of the net new jobs in our economy. President Bush's Small Business Agenda perhaps says it best, "*Small businesses are the heart of the American economy.*"

At the IRS we do not want to do anything to deter the entrepreneurial spirit that drives individuals to start-up and to grow small businesses into larger ones. Having said that, I would be disingenuous if I did not concede that one of the impediments to all small businesses is the inherent complexity of the tax code.

The final NRP numbers tell us quite a bit about the tax gap, but there is one critical piece we still do not know. We cannot determine how much of the gap is attributable to willful non-compliance and how much is the result of a lack of understanding by the taxpayer of his or her full tax obligation.

As you have heard me say many times, our operating philosophy at the IRS is that Service *plus* Enforcement equals Compliance. This is a balanced approach that we believe best serves not only small businesses but all taxpayers.

This means that we need to do outreach and education to assist small businesses in fully understanding their tax obligations. We need to reduce, wherever possible, the paperwork and reporting burdens small businesses face. Finally, through enforcement, we need to make sure that all small businesses are playing by the same rules. No small business should gain an advantage over a competitor because he willfully decides to underreport his income, overstate his deductions, or fail to properly remit payroll taxes.

On the next panel, you will hear from Kevin Brown. Kevin is the head of the IRS' Small Business/Self Employed (SB/SE) Division. Within that division is our office of Taxpayer

Burden Reduction (TBR). The focus of that office is to decrease the amount of time and money taxpayers must spend to meet IRS requirements. Kevin will talk about some of the things that SB/SE and the TBR office have been doing to lessen the burden on small businesses.

A Level Playing Field

The counterbalance to service in our compliance formula is enforcement. This is equally important to the long term viability of tax compliant small businesses as anything we do from a service perspective. The challenges that a small business faces are difficult enough without having to compete directly with a competitor who is willfully not paying his/her share in taxes. We have an obligation to those compliant small businesses to make sure that their competitors are also compliant. This is not only a matter of fairness, but also a way of supporting compliant small businesses in their efforts to remain compliant.

Three weeks ago, I testified before the Senate Permanent Subcommittee on Investigations on the issue of federal contractors that are delinquent on their taxes. This includes both income and payroll taxes. At that hearing, the Governmental Accountability Office (GAO) released a report that indicated more than 3,800 Federal contractors had tax debts totaling $1.4 billion. We have been working hard on this issue along with the General Services Administration (GSA), the Justice Department, and the Department of Defense, but based on these numbers, we still have a way to go.

Perhaps the most troubling information in the context of today's hearing was the suggestion that many of these contractors had been able to underbid their competitors for these Federal contracts by factoring in the savings they would receive by not paying income tax or remitting payroll taxes.

Small businesses play an important role in Federal contracting. According to the Federal Procurement Data System's Report on Annual Procurement Preference Goaling Achievements, during fiscal year (FY) 2001, there were over 5 million individual government purchases from small businesses, totaling $50 billion.

I believe that most of the small businesses acting as Federal contractors are making every effort to be fully compliant with the tax laws. However, some contractors are willfully non-compliant and are thus able to underbid compliant small businesses. I suspect those compliant businesses would want us to be as aggressive as necessary to make sure, at least from a tax perspective, everyone is competing on the same basis.

This is not just an issue with Federal contractors. A few years ago we had the same problem with motor fuel excise taxes. Non-compliant fuel marketers were not remitting Federal excise taxes and were using that as a competitive advantage to take business away from legitimate motor fuel marketers. These legitimate businesses actually were urging the IRS to be more aggressive from an enforcement perspective, and they worked with us to change both the law and regulations governing excise tax collection, thus making enforcement easier.

This is important to understand because enforcement is not a bad thing for small businesses in particular, or taxpayers as a whole. In fact, you might be surprised to learn that taxpayers understand the importance of everyone paying their fair share. In a survey conducted by the IRS Oversight Board, 88 percent of those surveyed said that it was "not at all" acceptable to cheat on one's taxes. This is up from 81 percent when the Oversight Board conducted a similar survey in 2003. Only 7 percent said that is was acceptable to cheat on their taxes "a little here and a little there".

Last year Congress approved a $442 million increase in IRS enforcement budget that has allowed us to focus our enforcement efforts in several key areas. This will allow us to build on the progress made in FY 2005. Consider that in the last fiscal year we:

- Audited nearly 220,000 high income taxpayers, more than double the number audited in 2000.
- Increased audits for individuals to 1.2 million, 20 percent more than 2004 and almost double the level five years earlier.
- Audited nearly 5,000 businesses with assets over $250 million, an increase of 11 percent. In addition, we audited one out of every five companies with assets over $10 million. Finally, audits of businesses with less than $10 million in assets rose 145 percent from 2004, as we redirected resources (previously devoted to the NRP audits of individuals) to target a known areas of noncompliance among personal service corporations and other companies.
- Generated more than $4.7 billion in revenue through two prominent settlement initiatives aimed at reducing examination and litigation expenses while deterring the use of abusive tax shelters.
- Increased total enforcement revenues by 10 percent, from $43.1 billion in 2004 to $47.3 billion in 2005.

We are asking for an additional $137 million enforcement increase in the form of a program integrity cap adjustment as part of the FY 2007 budget. This increase will allow us to maximize our return on the investment made in enforcement last year.

We have done a lot of work at the IRS regarding our return on investment (ROI) for the enforcement dollars we are spending. Based on that work, we estimate that when we receive the full productive benefits of the FY 2006 increase, that the ROI for additional enforcement resources will be 4:1. Stated another way, we estimate that each dollar invested in enforcement will return four dollars in additional enforcement revenue, although this should not be interpreted as a fixed ratio.

The critical importance of these enforcement dollars will become more apparent as I provide an update to you on the tax gap.

The Tax Gap

Our most recent individual income tax gap estimates are based on a National Research Program (NRP) study of individual returns from Tax Year 2001. It is the first such

comprehensive study done since 1988. We have done several much narrower studies since 1988, but nothing that would allow us to comprehensively update our estimates of the individual income tax gap.

Prior to the early 1990s, our estimates of reporting compliance were based on the Taxpayer Compliance Measurement Program (TCMP), which consisted of in-depth audits of random samples of returns. The data from TCMP provided us with information on compliance trends and allowed us to update our audit selection formulas. The NRP was born out of our effort to find a less intrusive way to measure compliance with the tax laws and to improve the overall fairness of the tax system.

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

We now estimate that the overall gross tax gap for all types of tax is approximately $345 billion, leading to a noncompliance rate of 16.3 percent. Both of these numbers are in the upper end of the range of estimates that I provided at your hearing last spring. Our estimate of the corresponding net tax gap, or what remains after enforcement and other late payments, is $290 billion, also in the upper end of the earlier range.

Noncompliance takes three forms: not filing required returns on time; not reporting one's full tax liability even when the return is filed on time; and not paying by the due date the full amount of tax reported on a timely filed return. We have separate tax gap estimates for each of these three types of noncompliance.

Underreporting constitutes nearly 83 percent of the gross tax gap, up slightly from our earlier estimates. Nonfiling constitutes 7.8 percent and underpayment 9.6 percent of the gross tax gap.

Individual income tax accounts for 46 percent of all tax receipts. However, individual income tax underreporting is approximately $197 billion. This constitutes about 57 percent of the overall tax gap.

While no tax system can ever achieve 100 percent compliance, the IRS is committed to finding ways to increase compliance and reduce the tax gap, while minimizing the burden on the vast majority of taxpayers who pay their taxes accurately and on time. Moreover, because the complexity of our current tax system is a significant reason for the tax gap, fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions in the tax gap.

As in previous compliance studies, the NRP data suggest that well over half ($109 billion) of the individual underreporting gap came from understated net business income (unreported receipts and overstated expenses). This is over 31 percent of the total tax gap.

Approximately 28 percent ($56 billion) of the individual underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. The remaining $32 billion came from overstated reductions of income (i.e. statutory adjustments, deductions, and exemptions), and from overstated tax credits.

The corresponding estimate of the self-employment tax underreporting gap is $39 billion, which accounts for about 11 percent of the overall tax gap. Self employment tax is underreported primarily because self-employment income is underreported for income tax purposes. Taking individual income tax and self employment tax together, then, we see that individual underreporting constitutes about two-thirds of the overall tax gap.

The NRP study also tells us that compliance rates are higher on tax returns that are subject to both third party information reporting and withholding and are, therefore, the most "visible" (e.g., wages and salaries). The net misreporting percentage (NMP) for wages and salaries is only 1 percent. This has not changed dramatically since the last compliance study in 1988.

Amounts subject to third-party information reporting, but not to withholding (interest and dividend income), exhibit a somewhat higher misreporting percentage. For example, there is about a 4% percent misreporting rate for interest and dividends.

Amounts subject to partial reporting by third parties (e.g., capital gains) have a still higher misreporting percentage (e.g., 12 percent for capital gains). As expected, amounts not subject to withholding or third party information reporting (e.g., sole proprietor income and the "other income" line on form 1040) are the least "visible" and, therefore, are most likely to be misreported. The misreporting estimate for "other income" is 64 percent or $23 billion of tax.

Before leaving this discussion of the tax gap, I want to make two more important points. First, perhaps the greatest value of the NRP study is that it allows us to update our audit selection formulas. These formulas help us select those returns which merit further examination and to avoid examining compliant taxpayers.

Using the recent NRP study data, we have developed new formulas to determine audit targets for several examination classes. IRS implemented these new formulas in January 2006, and we will begin examining Tax Year 2005 returns selected using these new formulas in October 2006. We believe using the new formulas will allow us to improve productivity and reduce taxpayer burden by reducing significantly the number of examinations resulting in little or no change to the taxpayer's tax liability.

Second, it is important to understand the limitations of the NRP study. The focus of the study is on individual income tax returns. It does not provide estimates for noncompliance with other taxes, such as the corporate income tax or the estate tax. The numbers we use for those estimates of compliance with taxes other than the individual income tax are still based on rough projections that assume no change in compliance

behavior among the major tax gap components since the most recent compliance data were compiled (i.e.,1988 or earlier).

I would note, however, that we have just announced the newest NRP study which will support our efforts to close both the individual and corporation income tax gaps.

Latest NRP Study

The newest NRP study will focus on S Corporations and is part of a strategy of conducting reporting compliance studies each year. Each study will address a component of the overall tax gap. By measuring compliance for various types of taxes and taxpayers, we will be better able to target resources to encourage compliance, deter non-compliance and reduce the burden on taxpayers.

Since 1985, S corporation return filings have increased dramatically. In that year there were 722,444 Form 1120 S returns filed by companies with less than $10 million in assets. In 2002 that number had grown by four times to over 3.1 million. Compare that to other corporate returns which declined by approximately 450,000 over the same period.

By 1997, S corporations became the most common corporate entity. In 2003, nearly 3.4 million S corporations filed tax returns, accounting for over 58 percent of all corporate returns filed that year. The last time we conducted an S corporation study was 1984. As a result, we do not have reliable reporting compliance data for these entities.

In FY 2004, the IRS examined 6,402 S corporation returns, or less than one-fifth of one percent of all S corporation returns filed. That coverage rate is one of the lowest for any type of tax return examined by the IRS. In comparison, the IRS examined 17,097 C corporations and 6,226 partnership returns in FY 2004, producing coverage rates of 0.71% and 0.26%, respectively.

The current NRP study of reporting compliance involves approximately 5,000 Form 1120S returns from a nationwide random sample. We used asset size of the S corporation in the return selection process. Even with the increased focus from the NRP study, the overall audit rate for S corporation returns remains below that for C corporations.

I know, Mr. Chairman, that there has been some concern that these NRP studies (the individual income tax study and the S Corporation study) are targeting small businesses. Let me assure you that is not the case. When we designed the NRP studies, our primary consideration was to balance the need for reliable estimates for reporting compliance against the burden of collecting compliance data. In this way, we are far less likely to pursue compliant small businesses.

Our intent is to learn as much as we can about the extent of non-compliance and its causes so that we can devise cost-effective ways to increase compliance with our tax laws. The NRP office consulted stakeholders inside and outside the IRS throughout the

development and refinement of the methodology for the studies and applied lessons learned from past compliance measurement efforts.

We are committed to applying our limited resources where they are of the most value in reducing non-compliance while ensuring fairness, observing taxpayer rights, and reducing the burden on taxpayers who comply. We do not have the resources to return to the high audit rates of the past, but we are using the NRP results to more effectively manage our compliance programs and design pre-filing activities that help taxpayers comply with the law.

Legislative Proposals

IRS understands that the complexity of the current tax system is a significant reason for the present size of the tax gap. It is easy for even sophisticated taxpayers to make honest mistakes. Fundamental tax reform and simplification of the tax law are both essential to achieving more significant reductions in the tax gap.

Until we have fundamental tax reform, however, there are some changes in the law that will improve compliance, without imposing a significant burden on taxpayers. Furthermore, those changes can provide us with additional tools that we can use to pursue taxpayers unwilling to pay their legal obligation.

The President's FY 2007 proposed budget includes five legislative recommendations, the enactment of which is critical to closing the tax gap. Collectively, these five changes should generate $3.6 billion over the next ten years. Allow me to address each proposal individually.

The first and perhaps most important proposal would increase reporting on payment card transactions. Our tax gap study shows clearly that increased information reporting and backup withholding are highly effective means of improving compliance with tax laws. More than 150 million wage earners already have their information reported directly by their employer to the IRS and the non-compliance rate for this group is less than 1 percent. All of these wage earners are also subject to mandatory withholding of taxes.

Payment cards (including credit cards and debit cards) are a growing form of payment in retail business transactions. The failure of some merchants to accurately report their gross income, including income derived from payment card transactions, accounts for a significant portion of the tax gap and creates a significant competitive advantage for those businesses that underreport.

Specifically, the Administration proposes that the Treasury Secretary be given the authority to promulgate regulations requiring annual reporting of the aggregate reimbursement payments made to merchants in a calendar year, and to require backup withholding by payment card companies in the event that a merchant payee fails to provide a valid taxpayer identification number.

Because reimbursement information is already provided to merchants, requiring this information to be reported to the IRS on an aggregate annual basis will impose minimal burden on payment card companies and no burden on the affected merchants. In addition, implementing a backup withholding system for payment card reimbursements to businesses would lead to material improvements in the compliance rates of these taxpayers without imposing a significant burden on the card companies. Finally, the IRS will be able to use payment card reporting information to better focus its resources and relieve the burden that existing audits place on businesses that accurately report their gross income.

The second legislative proposal would clarify when employee leasing companies can be held liable for their clients' Federal employment taxes. Employee leasing is the practice of contracting with an outside business to handle certain administrative, personnel, and payroll matters for a taxpayer's employees. Typically, these firms prepare and file employment tax returns for their clients using the leasing company's name and employer identification number, often taking the position that the leasing company is the statutory or common law employer of the clients' workers.

Non-compliance with the Federal employment tax reporting and withholding requirements is a significant part of the tax gap. Under present law, there is uncertainty as to whether the employee leasing company or its client is liable for unpaid Federal employment taxes arising with respect to wages paid to the client's workers. Thus, when an employee leasing company files employment tax returns using its own name and employer identification number, but fails to pay some or all of the taxes due, or when no returns are filed with respect to the wages paid by a company that uses an employee leasing company, there can be uncertainty as to how the Federal employment taxes are assessed and collected.

The Administration's proposal would set forth standards for holding employee leasing companies jointly and severally liable with their clients for Federal employment taxes. The proposal would also allow employee leasing companies to qualify to be solely liable if they met certain specified standards.

Our third proposal would amend collection due process procedures for employment tax liabilities. Currently, we are authorized to take various collection actions including issuing Federal tax levies to collect past-due taxes. Before a tax levy can be issued, however, the IRS generally must provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review.

Frequently, an employer who fails to satisfy its Federal tax liabilities for one period will also fail to satisfy them for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing or judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for the subsequent periods cannot be collected by levy until the employer has been given notice and opportunity for a hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by

depriving the government of enforced collection as a tool to encourage employers to satisfy their current Federal employment tax obligations.

Our proposal would allow the levy to be imposed prior to a CDP hearing in a fashion similar to current law provisions for levies issued to collect a federal tax liability from a state tax refund. Taxpayers would have the right to a CDP hearing with respect to employment tax liabilities within a reasonable time after the levy. Taxpayers would also continue to have access to existing pre-collection administrative appeal rights other than CDP.

I have already discussed the problem of Federal contractors who themselves are delinquent in their Federal taxes. The fourth proposal would require increased information reporting and backup withholding for certain government payments for property and services. It should be noted that present law requires information reporting for the provision of services and direct sales, but does not for provisions of goods. This proposal will extend information reporting, with some exceptions, to the purchase of goods by federal, state, and local governments.

Our proposal would authorize the Treasury Secretary to promulgate regulations requiring information reporting and backup withholding on non-wage payments by Federal, state and local governments to procure property and services. Certain payments would, of course, be exempt. These include payments of interest, payments for real property, payments to tax exempt entities or foreign governments, intergovernmental payments, and payments made pursuant to a classified or confidential contract.

The final legislative proposal would expand the signature requirement and penalty provisions applicable to paid tax return preparers. Under current law a paid tax return preparer is required to sign and include his/her taxpayer identification number (TIN) on an income tax return and related documents that he/she prepares for compensation. Paid return preparers, however, are not required to sign and include their TINs on non-income tax returns, such as employment tax returns, excise tax returns, and estate and gift tax returns, and tax return related documents filed with the IRS. The Administration's proposal would expand preparer identification and penalty provisions to non-income tax returns and tax return-related documents prepared for compensation. Further, it would impose penalties for preparing tax return related documents that contain false, incomplete, or misleading information or certain frivolous positions that delay collection.

These five legislative changes strategically target areas where (1) research reveals the existence of significant compliance problems, (2) improvements will burden taxpayers as little as possible, and (3) the changes support the Administration's broader focus on identifying legislative and administrative changes to reduce the tax gap.

In addition to these specific legislative proposals, we will study the distinction between independent contractors and employees under current law. The improper classification of employees as independent contractors is a significant problem and substantial contributor to the tax gap.

Conclusions

In summary Mr. Chairman, I would emphasize the following points:

- I appreciate fully the important contribution made by small business to our economy and believe that the best way that IRS can serve small business men and women, and indeed all taxpayers, is through a balanced approach of strong taxpayer service and enhanced enforcement that will level the playing for all competitors;

- We have a net tax gap of nearly $300 billion and over 80 percent of that involves the underreporting of income;

- Compliance is higher in instances where there is third party reporting;

- The NRP is a tool to help us understand more about non-compliance and to assist us in selecting for audit those returns most likely to have adjustments and reducing the number of examinations that result in little or no change to the taxpayer's liability; and

- The most immediate way to reduce the tax gap is by fully funding the President's proposed FY 2007 budget for the IRS, including the $137 million for enforcement that is part of the program integrity cap adjustment, and by enacting the five legislative proposals recommended by the President.

Thank you, Mr. Chairman. I will be happy to respond to any questions that you may have.

Advocacy: the voice of small business in government

Testimony of

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

U.S. House of Representatives
Committee on Small Business

Date:	April 5, 2006
Time:	10 A.M.
Location:	Room 2360 Rayburn House Office Building Washington, D.C.
Topic:	IRS' Latest Enforcement: Is the Bulls-eye on Small Businesses?

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit ***http://www.sba.gov/advo****, or call (202) 205-6533.*

Good morning Chairman Manzullo and Members of the Committee, I thank you for this opportunity to appear before you today. My name is Thomas M. Sullivan and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). The Committee invited us here today to discuss the recent proposals by the Department of the Treasury (Treasury) related to increased information reporting and withholding as a means to improve tax collection from small businesses and self-employed taxpayers. When I say "small business" I mean that term to include sole proprietors, self-employed, independent contractor or any other form of business that meets the SBA size standards. Congress established the Office of Advocacy to represent the views of small business before Congress and Federal agencies. The Office of Advocacy is an independent office within the SBA, and therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. This statement was not circulated to the Office of Management and Budget (OMB) for comment.

I would like to take a moment to commend Commissioner Everson and the staff of the Small Business and Self-Employed Division (SB/SE) on their efforts to increase outreach to the small business and self-employed community. In the past year, SB/SE has expanded its "Small Business Forums" to include forums across the country. These forums bring small businesses and their representatives in contact with state and Federal agencies in addition to creating a venue for addressing Federal tax issues.

Last year around this time, we were sitting in this same place. The Commissioner and I were here discussing the 2001 tax year estimated tax gap. Since your last hearing on the tax gap, Treasury and the Internal Revenue Service (IRS) have finalized the tax gap results and reported that the 2001 tax year had a net gap of $290 billion. Today we are here to talk about the measures Treasury and IRS have suggested for improving their collection ability. The small business community has communicated with Advocacy to express concern about the impact that these measures may have on small businesses. First, I will focus my testimony on the need to strengthen the compliance assistance and taxpayer education provided by the IRS and then on the enforcement proposals that require increased reporting and withholding by third parties.

The IRS often uses its motto of "service plus enforcement" to explain its relationship with taxpayers. Advocacy believes this is a fine goal; and we believe that the IRS must continue to work to ensure that there is balance between service and enforcement. The Commissioner has spoken frequently on the tax gap issue, and the small business community is concerned that the primary focus of these discussions has been on increasing enforcement.[1] The associations and industry groups with whom we have discussed tax enforcement issues believe the best approach to improved taxpayer compliance should include balanced measures of compliance assistance, taxpayer education and enforcement.

Small business industry groups have expressed to Advocacy concern that the IRS has focused on small entities as a primary means of improving tax compliance. News

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[1] See generally, *Everson Says IRS Could Collect Up to $100 Billion More Per Year*, 2006 TNT 32-1 (February 16, 2006) and *Everson Speaks at the National Press Club*, 2006 TNT 50-40 (March 14, 2006).

articles illustrate the reason why trade groups view IRS' focus to be trained on their members. On March 20, 2006 *Tax Notes Today* reported that the IRS increased its number of audits primarily through a spike in small business audits.[2] In recent testimony before the Senate Committee on the Budget, Commissioner Everson highlighted the return on investment for resources spent on enforcement: each dollar spent generated $4 in additional taxes collected.[3] A similar analysis of how the service function of IRS realizes a return on investment would go far to demonstrate the balance of service plus enforcement.

Research shows that the connection between enforcement and tax compliance is not as clear as some would like to think. In fact, a report by economists Bruno Frey and Lars Feld suggests that excessive enforcement can lead to less compliance.[4] Obviously enforcement is an important method for maintaining a compliant tax paying public. As the IRS attempts to improve taxpayer compliance it is imperative that taxpayer education and compliance assistance be included to balance an appropriate level of enforcement.

Nina Olson, National Taxpayer Advocate (NTA) has on numerous occasions, and recently at a hearing held by the Senate Committee on the Budget, encouraged the IRS to "recognize the central role taxpayer service plays in achieving compliance and do more to study the optimal ways to deliver taxpayer service and the magnitude of the impact."[5] The Government Accountability Office (GAO) has encouraged the IRS to conduct research on the reasons for taxpayer noncompliance.[6] In 1996 GAO made similar recommendations.[7] This type of research can guide the IRS' education and taxpayer compliance programs.

Now let me turn my attention to some of the specific proposals which Treasury has developed to add to IRS' enforcement tools as part of the FY 2007 Budget proposals. I will focus on two of the Treasury proposals, as well as proposals put forth by the NTA. All of the proposals require third party reporting and increased withholding requirements.

The Administration has proposed that payment card issuers (debit and credit cards) annually report reimbursements made to merchants. Under this proposal, card issuers would be required to withhold taxes on payments made to merchant taxpayers if the card issuer does not have a valid tax identification number (TIN) for the merchant taxpayer.

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[2] Audits Up, Costs Of Tax Collection Down, IRS Data Book Reveals, 2006 TNT 53-2 (March 20, 2006).
[3] Testimony of Mark Everson, Internal Revenue Service Commissioner, before the Committee on the Budget United States Senate on *The Tax Gap and How to Solve It*, 15 February 2006.
[4] Frey, B.S. and Lars, PF. "Deterrence and Morale in Taxation: an Empirical Analysis." *CESifo Working Paper No. 760, 2002*, available at http://www.cesifo.de/pls/guestci/download/CESifo%20Working%20Papers%202002/CESifo%20Working%20Papers%20August%202002/760.pdf.
[5] Testimony of Nina E. Olson, National Taxpayer Advocate, before the Committee on the Budget United States Senate on *The Tax Gap and How to Solve It*, February 15, 2006.
[6] Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).
[7] Government Accountability Office, GAO/GGD 96-109, *Tax Research: IRS Has Made Progress but Major Challenges Remain* (June 1996).

Second, the Administration has proposed to require information reporting and back-up withholding on all non-wage payments made by Federal, state and local governments to government contractors.

An unintended consequence of increased withholding will be its harm to the cash flow of small businesses. In general, cash flow, i.e. liquidity, is one of the most significant constraints small entities face in managing their business.[8] According to a recent National Federation of Independent Business (NFIB) survey, cash flow issues ranked in the top ten of important problems faced by small businesses. Small entities have a more difficult time paying their bills when their cash flow is interrupted. Small businesses must either borrow additional capital or forego early payment discounts to manage cash flow shortfalls.[9] Both alternatives increase small entities' costs of running the business.

Another unintended consequence of increased withholding is that tax deductible expenses of small entities may unnecessarily be taxed. Payments received by small entities for the services and products they provide include both their expenses and profits. Expenses are generally tax deductible, while profits are subject to tax.

Before Treasury and IRS impose new reporting and withholding requirements, it is important to determine the impact that small card issuers and small local governments will need to absorb. For instance: What impact will annual reporting and withholding have on small payment card issuers and small local governments? What type of system changes will be required for small payment card issuers and local governments? I pose these questions because these types of proposals impose burdens in two directions: those entities affected by the increased scrutiny and those entities charged with additional reporting and withholding requirements.

The National Taxpayer Advocate has proposed other reporting and withholding regimes.[10] First, the self-employed could volunteer to have their payors withhold taxes on the payments they are due. Second, the IRS could actively encourage self-employed taxpayers to participate in the Electronic Federal Tax Payment System (EFTPS).[11] Self-employed taxpayers who have a history of noncompliance would be required to have payors do backup withholding. Finally, the NTA has recommended that the IRS issue "Compliance Certificates" to self-employed taxpayers who have a history of tax compliance. Presenting the Compliance Certificate to a payor would exempt the self-employed from backup withholding. Without the Compliance Certificate, payors would be required to withhold taxes from payments due the self-employed taxpayer.

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[8] *Small Business Problems and Priorities*, Bruce D. Phillips, National Federation of Independent Business Research Foundation (June 2004).
[9] *Getting Paid*, National Federation of Independent Business Small Business Poll, Vol. 1 Issue 7 (2001).
[10] Olson, supra note 5.
[11] EFTPS is an IRS system that allows taxpayers to have their tax payments made by electronic funds transfers. EFTPS is voluntary for small taxpayers and mandatory for large taxpayers.

These types of proposals, while presented as voluntary, really impose additional administrative burdens on small businesses that contract with self-employed taxpayers. Small businesses currently shoulder exceedingly high tax compliance costs. In fact, according to a recently updated Advocacy sponsored cost of regulations study, tax compliance costs employers with less than 20 employees a total of $1304 per employee.[12] Additionally, requiring the payors of self-employed taxpayers to withhold may distort the line between being an employee versus being an independent contractor. Payors of self-employed taxpayers may become vulnerable to employer liability issues such as workman's compensation and unemployment taxes.

A reliable cash flow stream is important to the viability of the self-employed. To mitigate variability in cash flow, the self-employed would rely on credit. Yet, Advocacy data shows that the fixed rate loan terms are more favorable for larger sized loans. In other terms, the smaller the loan value the higher the interest rate applied.[13] Thus, increased withholding has the potential unintentional effect of increasing the expenses of the self-employed taxpayer.

America's small businesses succeed because of their ingenuity and innovation. Research sponsored by Advocacy continues to show that the cost of tax compliance is 67 percent higher in small firms than in large firms.[14] What can the IRS do to limit this disproportionate burden? The IRS can evaluate the service they provide taxpayers so that the importance of taxpayer service is not lost as they attempt to improve tax compliance. And, this hearing is an opportunity for IRS to consider some alternatives that may minimize the unintended impact of some proposals on small businesses.

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

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[12] *The Impact of Regulatory Costs on Small Firms*, Crain, W. M., September 2005, U.S. Small Business Administration, Office of Advocacy (SBHQ-03-M-0522), available at http://www.sba.gov/advo/research/rs264tot.pdf (tax compliance cost large firms $780 per employee).

[13] *The Small Business Economy: A Report to the President*, Table 2.1 Published by the U.S. Small Business Administration, Office of Advocacy (2005). See also generally, *Overcoming the Self-Employed Stigma When Applying for Business Loans*, Moss Jeffery, National Federation of Independent Businesses (January 24, 2003) available at https://www.nfib.com/object/3649352.html

[14] Crain, supra note 12.

WRITTEN STATEMENT OF
KEVIN M. BROWN
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION
INTERNAL REVENUE SERVICE
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES
April 5, 2006

Good morning, Chairman Manzullo, ranking Member Velazquez, and distinguished members of the Committee. I appreciate the opportunity to talk with you today about the work of the Small Business/Self-Employed (SB/SE) Division of the Internal Revenue Service.

The SB/SE organization is made up of 28,000 employees who serve about 45 million taxpayers – roughly one-third of the taxpaying population. Our taxpayer base consists of seven million small businesses, including corporations and partnerships with assets of $10 million or less; 33 million self-employed and supplemental income earners; and five million other taxpayers who file employment, excise, estate, gift, fiduciary and international tax returns.

As I begin, I want to echo a couple of the themes you have just heard from Commissioner Everson. First, whether we are providing service through education, outreach or burden reduction, or we are seeking out noncompliance through our enforcement efforts, our intent is to help all taxpayers, including small businesses, comply with the tax laws and to ensure that these laws are applied fairly to all. Secondly, it takes a balance between service and enforcement to achieve compliance, and SB/SE strives daily to maintain this balance for its taxpayer community.

Today I am going to focus primarily on the service side of the equation by highlighting some of our recent efforts. I will touch only briefly on the tax gap and our enforcement work since Commissioner Everson has devoted much of his testimony to those topics.

Outreach and Education

We recognize that most small business taxpayers are too busy running their businesses to become experts in the tax issues that stem from those businesses. Undoubtedly, that is why more than 80 percent of small businesses rely on their tax practitioners to handle their tax matters. Given this situation, it is especially important that we leverage our resources to reach out to the practitioner community so that they, in turn, can support their small business clients. Within SB/SE's Communication, Liaison and Disclosure organization, we have built a robust outreach and education program to do just that – to touch thousands of

stakeholders and, through them, reach millions of small business taxpayers. This has resulted in the development of over 1500 relationships with national and local partners including practitioner organizations, small business and industry associations, and federal and state agencies and governments. Some of these established relationships include the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, the U.S. Chamber of Commerce, the National Association of the Self-Employed, the National Federation of Independent Businesses, the Small Business Legislative Council, the Small Business Administration, the Federation of Tax Administrators, and the National Association of State Workforce Agencies.

One of the more well-known services we provide is the Small Business Forums, which we co-host with the U.S. Chamber of Commerce, the National Federation of Independent Business (NFIB), and the Small Business Legislative Council (SBLC). Through these forums, small business organizations can alert the IRS about issues that are a burden to their members, provide feedback to IRS on policies, practices and procedures, and learn new ways to assist small businesses in navigating through the IRS. The forums also allow members of the Chamber, NFIB and SBLC to receive the latest small business information from the IRS and provide them an opportunity to share feedback and concerns on behalf of their members. In January 2006, I had the opportunity to attend one of our national Small Business Forums and solicit input from the attendees on innovative and creative ways to address the tax gap. Due to the success of the national forums, we are launching local small business forums at the state level this Spring.

In November 2005, the IRS rolled out a new and improved IRS.gov website, which incorporates some features of particular interest to SB/SE taxpayers and tax practitioners. Examples include:

- An Alternative Minimum Tax (AMT) calculator to assist taxpayers in determining whether they may be subject to the AMT and whether they need to complete Form 6251.

- The Online Learning and Educational Products section which allows business owners to view a streaming video of an IRS Small Business Workshop, take an IRS course, or complete an online, self-directed version of a workshop taught live around the country.

- Online ordering capability for Small Business products which gives customers access to free products that help them meet their tax requirements. They can choose from a variety of products, developed especially for the Small Business/Self-Employed community, as well as get updated information relating to any of those products.

During FY 2005, more than 14 million people visited the SB/SE web pages on IRS.gov. That's up from almost 10 million visits the year before, and we anticipate even greater use in the coming months.

Another service that we offer on a regular basis is Tax Talk Today. This monthly Web cast features IRS representatives and tax experts discussing current tax issues such as getting ready for the 2006 filing season, preparing Forms 1099, and the impact of the Bank Secrecy Act on cash businesses. More than 60,000 viewers are registered for the Web casts.

Burden Reduction

In addition to offering a variety of educational and outreach services, SB/SE also devotes resources to identifying major sources of taxpayer burden and to developing and implementing ways to reduce this burden. Our Office of Taxpayer Burden Reduction – TBR for short – works with internal and external stakeholders to identify burden reduction opportunities and to coordinate and champion these efforts throughout the IRS. Since 2002, TBR has been instrumental in reducing taxpayer burden by over 200 million hours. I'd like to highlight a few of the burden initiatives which we have implemented recently and mention some that we have on the drawing board.

- In January 2006, we implemented the Form 944 Annual File/Annual Pay Program for employers who have a total annual employment tax liability of $1000 or less. This program allows eligible employers to file one annual employment tax return per year, rather than four quarterly Forms 941. The vast majority of the estimated 950,000 eligible Form 944 filers, many of whom are small businesses, also will be able to pay annually with their Form 944.

- Our redesign of the extension to file process is complete. A new automatic six-month extension period went into effect this year, resulting in a uniform extension period for all taxpayers. We expect the use of the redesigned Forms 4868 and 7004 will reduce taxpayer burden by 11 million hours.

- We released the new 2005 Schedule K-1 for Form 1041, *Beneficiary's Share of Income, Deductions, Credits, etc.*, for the 2006 filing season. The revised Schedule K-1 features an improved layout and open design. It provides streamlined instructions for beneficiaries and can be scanned, reducing transcription errors. The new Schedule K-1 will reduce the compliance burden for over 3.5 million taxpayers.

- Simplification of the Office in the Home deduction for the small business taxpayer is high on our priority list for tax year 2007. We are looking into several ways to address the burden caused by Form 8829, including the

possibility of devising some type of standard rate similar to the standard automobile mileage rate. The Form 8829 is completed annually by about 2.4 million Schedule C filers as well as Schedule A filers.

- Another effort in the works for 2007 is the creation of a series of stand-alone forms to be used to amend employment tax returns such as Forms 941, 943, 944, and 945. The creation of these forms was suggested by several tax practitioner groups as well as internal stakeholders. We anticipate that the new forms will expedite amended return processing and reduce the need for additional correspondence with taxpayers.

- We also are looking to simplify the S-corporation election process through legislative and/or processing changes that would minimize the impact of Form 2553, *Election by Small Business Corporation*, on the processing of Form 1120-S returns. The changes we are recommending are expected to improve the filing process for approximately 700,000 taxpayers annually.

- Finally, we are working on improvements to the Form 940, *Employer's Annual Federal Unemployment Tax Return*, and its associated processes. This project involves revising Forms 940, 940EZ and 940PR, simplifying the instructions, and ensuring the redesigned forms are scannable. Forms 940 are filed by 5.6 million taxpayers annually.

Disaster Assistance

Before I leave the subject of service, I would like to spend a few minutes telling you about the SB/SE Disaster Coordination office which oversees the IRS' disaster program. In the aftermath of the recent hurricanes, this office played a key role in our success in providing on the ground assistance to taxpayers and to dealing with the myriad of related tax issues.

The team we put in place coordinated the issuance of over 30 news releases and a dozen legal guidance documents announcing various details of tax relief made available to affected individuals and businesses. We extended deadlines for filing returns and making payments, suspended compliance activities and related correspondence, temporarily waived certain rules, and increased the standard mileage rate. The team also arranged for on-site IRS assistance in dozens of FEMA disaster recovery centers, where we aided taxpayers with filing claims and amended returns, and expedited requests for free transcripts and copies of tax returns. As part of this effort, we established agreements with seven tax professional organizations to partner with the IRS in providing assistance to affected taxpayers. In addition, we worked with partners in the business community to promote the leave donation program, which allowed businesses to convert employees' leave contributions into deductible cash donations to charities providing hurricane relief.

Most recently, the IRS has been partnering with the Department of Housing and Urban Development (HUD) and Mayor Ray Nagin of New Orleans to help make businesses in the hardest hit areas of New Orleans and Louisiana aware of Federal incentive relief that is available to them. To kick off this awareness program, HUD representatives and IRS tax experts hosted a free half-day "tax summit" for small businesses on March 24 in New Orleans. Additional events are planned to provide further information about this Federal plan to jump start business activity and job growth in these areas.

Enforcement

Now let me turn briefly to the enforcement side of the balanced equation. Enforcement is a necessary part of tax administration. Without it we cannot reassure the vast majority of Americans who comply with the tax laws that the tax system is administered fairly. Moreover, it is important that we continue to fine tune our enforcement efforts to ensure fairness among less compliant groups of taxpayers.

As Commissioner Everson has testified, the data from our recent National Research Program (NRP) suggest that understated net business income accounts for more than half of the individual underreporting gap. This finding confirms that our focus in recent years on noncompliance associated with unreported income has been appropriate. In addition, the NRP data also point to significant noncompliance for reporting self-employment tax. These two categories (underreported business income and self-employment tax) account for $148 billion (or 52 percent) of the $285 billion tax gap due to underreporting.

The SB/SE examination program is based on the concept of balanced coverage to both encourage and maintain compliance among our taxpayers. While it is true that our coverage levels are increasing, our current coverage levels are still below the levels of the mid 90's. In FY 2005, for example, the coverage level for self-employed businesses was 2.92 percent, compared to 3.48 percent in FY 1996. For small business corporations with assets less than $10 million, the FY 2005 coverage was only 0.79 percent. This coverage is not only less than half of the 1.88 percent coverage for FY 1996, it is significantly lower than the FY 2005 coverage of 20 percent for those corporations with assets greater than $10 million.

With regard to our compliance programs, we plan to stay the course in FY 2006. We will be paying particular attention to two areas where the NRP data indicate compliance has decreased – reporting of net income from flow-through entities and reporting of business income and expenses, such as gross receipts and various deductions. And, in our collection area, we will continue to focus on curbing the high-risk behavior of businesses which pyramid unpaid employment (trust fund or payroll) taxes.

Conclusion

In summary, Mr. Chairman, I believe that the SB/SE Division of the IRS is providing much-needed support to the small businesses of America. We have demonstrated our commitment to service through the outreach and education we are providing to all taxpayers, through the partnerships we have developed with the practitioner community and business industry groups that support small businesses, and through our numerous efforts to reduce taxpayer burden. At the same time, by using our enforcement resources to uncover and correct noncompliance, we are helping compliant businesses by eliminating the unfair advantage created when their competitors fail to comply with the tax laws.

Thank you, Mr. Chairman. I will be happy to answer any questions you and the other Members of the Committee may have.

Written Statement of

Nina E. Olson
National Taxpayer Advocate

Before the

Committee on Small Business
U.S. House of Representatives

Hearing on

The Effects of Tax Compliance Initiatives on Small Business

April 5, 2006

Mr. Chairman and distinguished Members of the Committee:

Thank you for inviting me to testify today about IRS enforcement and small business. I believe that small business is an essential component of the nation's economy. At the same time, small businesses bear a large share of regulatory burdens. And for many small business owners, tax issues are the single largest contributor to these regulatory burdens.[1] I commend Chairman Manzullo and this committee for introducing last year's Small Employer Tax Relief Act of 2005,[2] and thank you for the opportunity I was afforded to offer testimony on that legislation.

That bill contained several proposals that I have long advocated and believe would benefit small businesses considerably by helping to reduce certain tax burdens. These proposals include:

1. Amending the Internal Revenue Code (the Code) to allow married couples operating businesses as co-owners to elect out of the partnership provisions of the Code;[3]

2. Amending the code to allow a small business corporation to elect to be treated as a subchapter S corporation under the Code in conjunction with filing its first Form 1120S (U.S. Income Tax Return for an S Corporation);[4]

3. Repealing section 162(l)(4) of the Code to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment;[5]

4. Amending the Code to reduce or eliminate the Federal Tax Deposit avoidance penalty when a taxpayer has made a timely deposit but failed only to make such deposit in the prescribed manner,[6] and

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[1] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 386-87.

[2] H.R. 3841, 109th Cong. (Sept. 21, 2005).

[3] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 401-402 and 2002 Annual Report to Congress at 172-184.

[4] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 390-393 and 2002 Annual Report to Congress at 246.

[5] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 388-389 and 2001 Annual Report to Congress at 223.

[6] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 400 and 2001 Annual Report to Congress at 222.

5. Repealing the alternative minimum tax (AMT) for individuals.[7]

In addition to these proposals, I have also recommended that Congress alleviate small business tax burdens by (1) regulating unenrolled return preparers to help ensure that small business tax returns are prepared accurately, which would serve to prevent the burdensome IRS administrative and enforcement procedures associated with incorrect returns,[8] and (2) authorizing the Secretary of the Treasury to grant a one-time abatement of the failure-to-file and failure-to-pay penalties for taxpayers who have a history of compliance.[9]

The Office of the Taxpayer Advocate and Small Business

As I testified last year, the Taxpayer Advocate Service (TAS), expends significant efforts to assist small businesses with their tax burdens and IRS entanglements. Through February of fiscal year 2006, small business cases accounted for 43.7 percent of TAS' total case closures. Of these cases, 79.5 percent came into TAS because of systemic problems, most notably delays, rather than because the taxpayer experienced economic hardships. Table 1 shows the top ten issues identified in TAS cases encountered by small business and self-employed (SB/SE) taxpayers for fiscal year 2006 (through February 2006), and the percentage of those cases in which TAS was able to provide either full or partial relief.

TABLE 1, SMALL BUSINESS / SELF-EMPLOYED TAXPAYER ISSUES IN TAS FOR FISCAL YEAR 2006 THROUGH February 2006

Core Issue Description	% of Total SB/SE Cases	% Where Relief Provided
Criminal Investigation	10.3%	60.8%
Levies	6.1%	61.0%
Processing amended returns	6.0%	77.5%
Audit Reconsideration/Substitute for Return (SFR)	5.2%	74.6%
Processing original returns	4.3%	82.5%
Open audit	3.4%	70.9%
Expedited refund requests	3.2%	55.6%
Missing/incorrect payments	3.1%	83.2%
Combined Annual Wage Reconciliation (CAWR)/ Federal Unemployment Tax Act (FUTA)	3.0%	86.1%
Failure to File/Failure to Pay penalties	2.7%	74.4%

[7] *See* National Taxpayer Advocate 2005 Annual Report to Congress at 375, 378; 2004 Annual Report to Congress at 383-385; and 2003 Annual Report to Congress at 5-19.

[8] *See* National Taxpayer Advocate 2003 Annual Report to Congress at 270-301 and 2002 Annual Report to Congress at 216-230.

[9] *See* National Taxpayer Advocate 2001 Annual Report to Congress at 188-192.

Since I became the National Taxpayer Advocate more than five years ago, I have identified a number of issues affecting small businesses in my reports to Congress. Many of these issues are reflected in TAS' case inventory. Some of the problems I have addressed include:

- Training of Private Debt Collection Employees.[10] – This year, the IRS will begin using private debt collection agencies to collect tax delinquencies under the authority granted to it by the American Jobs Creation Act of 2004.[11] It is unclear whether the IRS intends to expand the Private Debt Collection (PDC) initiative to Schedule C or employment tax collections. We are concerned that the private debt collection agency employees are not receiving recurring training on taxpayer rights that is equivalent to IRS employee training on this subject.

- Complexity of the Employment Tax Deposit System.[12] – Recent data shows that the IRS assesses failure to deposit (FTD) penalties on one out of every 16 employment tax returns, yet eventually abates more than 60 percent of the FTD penalty amounts it originally assessed. This suggests that the rules and regulations governing federal employment tax deposits are overly complex, presenting significant compliance problems for employers and administrative challenges for the IRS.

- Automated Collection System Levy Releases.[13] – Collection efforts through the IRS's Automated Collection System (ACS) can result in levies of bank accounts, wages or other income. Both the Code and Treasury Regulations require that the IRS promptly release levies when taxpayers enter into installment agreements with the IRS or when they demonstrate the existence of a financial hardship. Some taxpayers encounter delays, errors, or other problems when requesting a levy release.

- Limitations of the IRS Allowable Expense Standards for Collection Decisions.[14] – Each year, the IRS publishes schedules of national and local expense allowance standards. These standards reduce the subjectivity involved when IRS employees consider collection alternatives for taxpayers having difficulty paying the IRS. The IRS relies on the subjective judgment of its employees to allow more than the standard amounts when appropriate. Many practitioners report, however, that the IRS often fails to allow such

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[10] National Taxpayer Advocate 2005 Annual Report to Congress at 76-93.

[11] Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004).

[12] National Taxpayer Advocate 2005 Annual Report to Congress at 192-208; National Taxpayer Advocate 2003 Annual Report to Congress at 197-205.

[13] National Taxpayer Advocate 2005 Annual Report to Congress at 209-222.

[14] National Taxpayer Advocate 2005 Annual Report to Congress at 270-291.

additional amounts and uses the standards as an excuse to reject reasonable collection alternatives. This inflexibility adversely affects both business and individual taxpayers.

- Inadequate IRS Education and Outreach Efforts to Small Business.[15] – Tax law and administrative complexity can baffle all taxpayers and lead to compliance problems. Small Business taxpayers cannot always afford sophisticated tax advice. These taxpayers need IRS help and assistance in understanding and complying with their tax obligations. I believe the IRS could do more to educate small business and self-employed taxpayers about complying with their tax obligations.

- IRS Examination and Collection Strategies.[16] – As the IRS increases its enforcement activities, I am concerned that the IRS does not have sufficient information and research to determine how best to allocate its resources between examination, collection, and taxpayer service. Nor do we know the right approach, including taxpayer service, for the particular type of taxpayer. The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities on tax revenues.[17] The IRS should also use more information from state and local governments to identify noncompliant taxpayers. Because business taxpayers have frequent dealings with the IRS, the IRS focus will significantly impact these taxpayers.

- Navigating the IRS.[18] –In fulfilling their tax obligations, small business owners have multiple contacts with the IRS. Business taxpayers file employment and excise tax returns in addition to income tax returns. They also are required to make employment tax deposits and file information returns such as Forms W-2 and 1099. Finding the right IRS employee to address a particular problem, or finding the program "owner" to point out program failure and discuss improvements, is often a difficult task.

- Combined Annual Wage Reporting (CAWR) Reconciliation.[19] – The IRS and the Social Security Administration (SSA) jointly administer the CAWR program, which matches earning and withholding statements from Form 941 (Employer's Quarterly Tax Return) and Form W-2 (Wage and Earnings Statements) for each employee and Form W-3 (Transmittal of Income Tax Statements). Ideally, all information reported on Form 941 should match the

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[15] National Taxpayer Advocate 2004 Annual Report to Congress at 51-66.

[16] National Taxpayer Advocate 2004 Annual Report to Congress at 211-245.

[17] *See generally* Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).

[18] National Taxpayer Advocate 2003 Annual Report to Congress at 122-134; 2002 Annual Report to Congress at 7-14.

[19] National Taxpayer Advocate 2003 Annual Report to Congress at 220-226.

information on Forms W-2 for a given year, but this is not always the case. The IRS and SSA try to resolve discrepancies and may contact the employer. If the employer does not respond or does not file the correct forms, the IRS can assess a penalty against the employer for intentionally disregarding its filing requirements. These penalties, however, are frequently abated. The frequent abatement of penalties indicates a serious problem with the administration of this program that adversely and unnecessarily affects small business.

The Cash Economy and the IRS

In addition to the issues affecting small business listed above, I have also identified noncompliance in the "cash economy" as a serious problem affecting taxpayers.[20] Although there is no universally accepted definition of the term cash economy, I have used the term to mean payments for transactions that are not reported to the IRS by third parties.[21] Research indicates that there is a strong correlation between IRS information reporting and tax reporting and compliance. These findings make intuitive sense – if taxpayers think income is being reported by third parties to the IRS, they are more likely to report the income because the IRS already knows about it.

Taxpayers report 99 percent of income subject to withholding, 96 percent of income subject to third-party information reporting, and 57 percent of income not subject to withholding or information reporting.[22] The income reporting percentage drops to 20 percent for income earned by certain sole proprietors (called "informal suppliers") who operate "off the books" on a cash basis in areas such as street vending, door-to-door sales, or moonlighting in a trade or profession.[23] Nonfiling, underreporting, and underpayment make up the tax gap – the difference between what taxpayers should have paid and what they actually paid on a timely basis.[24] The latest IRS estimates indicate that the gross tax gap is approximately $345 billion. IRS enforcement activities and late payments reduce the gross tax gap by about $55 billion, leaving a net tax gap of $290 billion.[25]

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[20] *See* National Taxpayer Advocate, 2005 Annual Report to Congress at 55-75.

[21] *Id.*; *The Causes and Solutions to the Federal Tax Gap: Hearing Before the Senate Committee on the Budget*, 109th Cong. (2006) (written statement of Nina E. Olson, National Taxpayer Advocate at 2), available at http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf.

[22] *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

[23] IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001* 22-23 (Feb. 24, 2004).

[24] *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

[25] *Id.*

More than a third of the tax gap may be attributable to the cash economy. The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy, but according to IRS estimates:

- About 43 percent of the gross tax gap, $148 billion per year, is attributable to underreporting of business income and self-employment taxes by individuals.[26]

- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.[27]

- For tax year 2004, about 36 percent of all returns with a balance due after remittance were filed by taxpayers with Schedule C liabilities, and these returns accounted for about 50 percent of the total tax year 2004 balance due liability for all taxpayers.[28]

- According to IRS Research, taxpayers who owe a balance upon filing their return are more likely to understate their tax liability than other taxpayers, and more than 20 percent of taxpayers with a balance due fail to pay in full.[29]

This data suggests that self-employed taxpayers who file returns but underreport their income (or self-employment) taxes represent the single largest component of the gross tax gap, accounting for about a third of the gap.

The Role of Taxpayer Service and Education in Reducing the Tax Gap

The tax gap requires the IRS to perform a sometimes difficult balancing act. The IRS should provide the best customer service possible in order to help taxpayers who want to comply with their tax obligations understand these obligations fully. The IRS must make complying with these obligations easy and convenient.

In this respect, the IRS has a particularly critical responsibility to small business. Small businesses carry a disproportionate share of regulatory burdens, most of which is attributable to their tax compliance obligations. A recent study by the U.S. Small Business Administration Office of Advocacy found that small firms pay 67 percent more to comply with the tax laws than do their counterparts at large firms.[30]

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[26] Taxpayers who underreport business income on individual returns account for $109 billion of the gross tax gap and those who underreport self-employment income account for another $39 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 14, 2006).

[27] *Id.*

[28] Compliance Data Warehouse Individual Returns Transaction File, Tax Year 2004.

[29] IRS Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

[30] *See* W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2005), available at http://www.sba.gov/advo/research/rs264tot.pdf.

Furthermore, the tax complexity small businesses face is staggering for them. Business taxpayers must grapple with a patchwork of rules that cover such items as equipment depreciation, numerous and overlapping filing and deposit requirements for employment taxes, and vague factors that govern the classification of workers as either employees or independent contractors. For these reasons, educating the small business community about their tax obligations is imperative. Overall burdens, for both small businesses and the IRS, are reduced when small business taxpayers understand their tax obligations and can keep their dealings with the IRS to a minimum. A business can use its resources to operate and grow the business, rather than to wrestle with the IRS over compliance issues.

On this front, I commend the IRS's efforts to educate small business and self-employed taxpayers through such measures as:

- Participation in small business workshops administered by the Small Business Administration Development Centers,
- The Small Business and Self-Employed Online Classroom, which provides taxpayers with a number of resources in a variety of formats, such as video, CD-ROM, and online documents, and
- Small business forums with stakeholders.

I am concerned, however, that the IRS is not doing enough to adequately educate the small business community. In fact, the IRS recently significantly downsized its small business education programs. When the IRS Small Business/Self-Employed Division's (SB/SE) Taxpayer Education and Communication (TEC) division was merged with its Communication, Liaison and Disclosure (CLD) division, education staffing was reduced from 699 in fiscal year 2003 to 184 as of October 18, 2005.[31] I believe reducing small business education resources is a mistake and that the IRS could do much more to educate small business taxpayers striving to understand their tax obligations and to help them voluntarily comply with the tax laws.

Many small businesses need access to face-to-face communication with the IRS. TAS focus groups show that small businesses use paid preparers for their annual returns, but try to resolve their tax issues occurring throughout the year by themselves to avoid additional expense.[32] Some very small businesses may be best served by meeting with IRS representatives in a face-to-face setting where they can ask questions about their specific situation and circumstances. Face-to-face contact between small businesses and the IRS also can be done in small business town hall meetings, at trade shows, or in focus groups with representatives from different industries. It is not clear whether the IRS restructuring of TEC will allow for these

[31] IRS SB/SE CLD Realignment web page and fact sheet (April 13, 2005).

[32] *See* Russell Marketing Research, Inc., *Findings From Task 149 – The Taxpayer Advocate Service Research Program* (Sept. 2002) (on file with TAS).

face-to-face opportunities. It is also unclear what impact limiting services in IRS Taxpayer Assistance Centers (TACs) will have on face-to-face meetings between the IRS and small businesses.

On the other hand, the IRS is also charged with enforcing these tax laws. Some taxpayers choose not to voluntarily meet their tax obligations. Some of these taxpayers seek to skirt their responsibility by operating in the cash economy where the lack of information reporting presents ample opportunities for noncompliance. For these, the proverbial "carrot" is not enough. The IRS's enforcement "stick" is also necessary to combat deliberate noncompliance. My concern is that the IRS use this stick only where appropriate and necessary.

Reasons for Focusing on the Cash Economy

As the advocate for *all* taxpayers, the National Taxpayer Advocate must be concerned about the tax gap attributable to the cash economy for two significant reasons: fairness and burden.

Cash Economy Fairness Issues

It is quite simply unfair to force compliant taxpayers to pay more than their share of the tax burden in order to supplement those who willfully do not comply. Given the size of the net tax gap, the average tax return includes a "surtax" of about $2,200 to make up for tax revenue lost to noncompliance.[33]

Even more egregious from a small business perspective, however, is the resulting unlevel playing field when certain taxpayers chose to skirt their tax obligations by operating in the cash economy. As a former self-employed individual who operated my own small business for nearly 27 years and who prepared returns for and represented small business taxpayers in tax controversies during that time, I am convinced that the vast majority of small business owners are honest people who make every effort to correctly report and pay their taxes. These folks are put at a competitive disadvantage, however, when a bad apple enters their midst and begins to use cash transactions to avoid paying taxes. The honest businesses' sales are hurt because the noncompliant competitor can use its "tax savings" to undercut the prices of goods and services. The honest businesses may also lose workers to the noncompliant competitor who promises "tax free" cash payments for services performed. Noncompliance in the cash economy causes the scofflaw to unfairly profit at the expense of the honest small business owner. This situation should be addressed both administratively and legislatively.

[33] The IRS receives approximately 133 million individual income tax returns each year. IRS Pub. 1136, *Statistics of Income Bulletin, Spring 2005* (Feb. 2004) (Table 22). The net tax gap of $290 billion divided by the number of individual income tax returns (133 million) is $2,180 per return.

Taxpayer Burdens and the Cash Economy

I am also concerned with the compliance burdens placed upon small businesses. As noted above, I worked for 27 years preparing tax returns and representing individual and small business clients before the IRS and Tax Court. Many of my small business clients operated, and lived, at the margins. That is, every penny that they earned went back into the business and it was very difficult for them to save and make estimated tax payments. When the IRS came calling, these folks would come to me for help. By the time I became involved in many of these cases, however, the most I could do was help with collection alternatives. In some instances, it was too late to help – the sheer weight of the tax debt caused the business to go under.

When income from a transaction is not reported to the IRS, it is much easier for a taxpayer to "fudge" his or her own tax reporting with respect to that income. This does not mean that taxpayers who receive income not reported to the IRS are "bad" people and taxpayers whose income is subject to third-party reporting or withholding are "good" people. It means simply that taxpayers whose income is subject to third-party reporting or withholding do not have the opportunity to be noncompliant because the IRS knows about their income. Participants in the cash economy, on the other hand, have a significantly greater opportunity for noncompliance. Opportunities for noncompliance can present problems for those operating at the margins. When circumstances cause taxpayers to take advantage of these opportunities for noncompliance, they risk IRS enforcement and collection actions. When the IRS can bring these taxpayers back into compliance before they have ventured too far down the wrong road, the process can be relatively painless. By the time the IRS catches up with some noncompliant taxpayers, however, it may be too late. In these cases IRS enforcement can severely cripple or destroy a small business.

I am convinced that these problems could be avoided if, among other things, there were a system that would make paying estimated tax payments as simple as making a mortgage or automobile payment. In order to be effective, however, such a system must be minimally burdensome to small businesses –particularly those businesses that are making payments to workers for services.

With these thoughts in mind, I made several legislative proposals in the National Taxpayer Advocate's 2005 Annual Report to Congress that, if enacted, would reduce the burdens on taxpayers operating in the cash economy by helping them make easy and convenient voluntary tax payments.

One proposal is to amend Code section 6302(h) to require the IRS to promote estimated tax payments through its Electronic Funds Transfer Payment System (EFTPS) and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.[34] EFTPS is an existing system

[34] *See* National Taxpayer Advocate 2005 Annual Report to Congress at 389-391.

that allows both individual and business taxpayers to voluntarily have tax payments debited from their bank account and transferred to the U.S. Treasury. Taxpayers may enroll in EFTPS and schedule payments on the EFTPS website.[35] The website is accessible 24 hours a day, seven days a week. Individual taxpayers can use EFTPS to schedule automatic payments up to 365 days in advance.

Making estimated tax payments is burdensome. Many self-employed individuals find it cumbersome to estimate income, keep track of the estimated tax payment dates that do not coincide with calendar quarters[36], and save enough money to pay each quarter. EFTPS can alleviate some of these burdens because paying through EFTPS is more convenient than making traditional quarterly estimated payments. One key feature that many taxpayers may find attractive is the ability to schedule automatic payments to be debited from a taxpayer's bank account. A taxpayer can use this feature to voluntarily make more frequent automatic estimated payments and not worry about coming up with the required amount every quarter. Using EFTPS in this way could make estimated tax payments almost as automatic as one's automobile or mortgage payment.

Code section 6302(h) required the IRS to develop and implement an electronic fund transfer system to collect depository taxes and to collect at least 94 percent of depository taxes by fiscal year 1999.[37] In response, the IRS created EFTPS and now collects 95 percent of all employment tax dollars through EFTPS.[38] The statutorily mandated percentage gave the IRS incentive to promote the payment of depository taxes through EFTPS and to make paying these taxes through EFTPS convenient. Because EFTPS is already available for making estimated tax payments, legislation is not absolutely required, but – as with depository taxes – a legislative goal to collect a certain amount of estimated tax payments through EFTPS will encourage the IRS to promote EFTPS as a way to make these payments.

One way the IRS could promote EFTPS is by sending self-employed taxpayers a letter to remind them when estimated tax payments are due and offering the option of paying through EFTPS.[39] A recent IRS study found that "investors" (defined as taxpayers with a balance due of between $100 and $10,000 with non-wage income in excess of $4,000 and wages of less than $500,000) receiving reminder letters increased both estimated tax payments and withholding by a statistically significant amount.[40] I believe letters to self-employed taxpayers would have a similar effect.

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[35] www.eftps.gov.

[36] The four installment dates are April 15, June 15, September 15, and January 15. IRC § 6654(c).

[37] This percentage was phased in beginning at three percent in fiscal year 1994. IRC § 6302(h)(2).

[38] *See* National Taxpayer Advocate 2005 Annual Report to Congress at 390, note 28.

[39] *See* National Taxpayer Advocate 2005 Annual Report to Congress at 71-73.

[40] IRS Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters, 6-8 (Jan. 16, 2004).

A legislative goal will also encourage the IRS to make paying estimated taxes with EFTPS easier. Reports from practitioners indicate that scheduling estimated tax payments through EFTPS is cumbersome and not user-friendly. A legislative percentage goal would encourage the IRS to redesign the EFTPS interface to make scheduling estimated tax payments more user-friendly. Making e-payment of estimated taxes easy should be a high priority for the IRS because it is a way to encourage voluntary compliance. Furthermore, research indicates that a dollar spent on making it easier for taxpayers to comply with their tax obligations (and answering tax law questions) has a positive indirect effect on compliance.[41]

Another proposal is to amend Code section 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service recipients,[42] and to specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow such independent contractors to deduct ordinary and necessary business expenses under Code section 162(a).[43] The goal of this proposal is to make it easier for independent contractors to voluntarily pay taxes when the service recipients for whom they perform work are willing to set up withholding accounts as a convenience to these independent contractors. Some taxpayers may find that a withholding agreement, entered voluntarily, is a less burdensome way to pay estimated taxes than saving and making quarterly, or even monthly, payments.

Another proposal in my Report aims to help noncompliant taxpayers return to voluntary compliance before their tax debt causes a business failure or other severe consequences. This proposal would use the current backup withholding provisions of the Code as leverage to get the attention of taxpayers that have recurring instances of noncompliance. Under this proposal, backup withholding would apply only to those taxpayers who had demonstrated a history of noncompliance. The goals of this proposal are to help these taxpayers begin to make regularly scheduled voluntary estimated tax payments through EFTPS and to help them return to voluntary compliance before their tax debts become too great to deal with.[44] And because this proposal would only impose backup withholding on a select group of noncompliant taxpayers, the burden on the businesses making payments to these taxpayers would be minimal.

This proposal also provides that in rare instances where we have clear evidence that there is specific, demonstrated, and recurring noncompliance within a particular

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[41] IRS researchers estimate that every dollar the IRS spent on return preparation generated $396 of additional tax revenue. *See* Alan H. Plumley, Pub. 1916, The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness 41 (Oct. 1996).

[42] As defined in Code section 6041A(a)(1).

[43] *See* National Taxpayer Advocate 2005 Annual Report to Congress at 391-394.

[44] *See* National Taxpayer Advocate 2005 Annual Report to Congress at 383-389.

industry, we should consider using a "compliance certificate" to provide a safe harbor for businesses operating within these industries. A business would be assured that there were no backup withholding issues with respect to any taxpayer holding such a certificate. The United Kingdom has used a similar program in the construction industry for 30 years. If this part of the proposal were to be used in the construction industry in the United States, if would affect a small universe of taxpayers.[45]

Offer In Compromise Program

The above proposals would help bring taxpayers into compliance looking forward, but what about the existing tax debts of small business taxpayers who find themselves in trouble with the IRS? These taxpayers should be able to receive help through the IRS Offer in Compromise (OIC) program. Unfortunately, however, the IRS's administration of the OIC program is not providing these taxpayers with the assistance Congress intended when it established the program.

Offers Provide A Win-Win Solution

The Offer In Compromise (OIC) Program provides small businesses and other taxpayers who have fallen behind on their tax deposits or payments a way to compromise their tax debts and make a fresh start. The IRS also benefits when it accepts an OIC. The IRS collects the most it is likely to get, and simultaneously promotes future compliance by requiring, as a condition of the OIC agreement, that the taxpayer file returns and pay taxes for the following five years.[46] Moreover, one study found that 80 percent of the taxpayers whose offers were accepted remained in compliance with their tax obligations over the five-year period following offer acceptance.[47]

Neither taxpayers nor the IRS receive any comparable benefits when the IRS rejects or returns an OIC. For more than half of the offers from individual taxpayers that it rejected or returned, the IRS eventually collected less than 80 percent of what taxpayers were offering, and it collected nothing in more than 20 percent of those cases.[48] In addition, on average, accepted offers have been bringing in 16 cents for every dollar owed, which is higher than the 13 cents per dollar that the IRS collects on other debts that are two years old.[49] Thus, when the IRS accepts an OIC it

[45] For the Construction Industry Schedule C Returns (based on NAICS Codes 230000 through 239999), for tax year 2004 there were 233,413 Schedule C Balance Due After Remittance Returns Filed.

[46] Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992); Form 656, Offer in Compromise (Rev. 7-2004).

[47] SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program (September 2004).

[48] *Id.*

[49] SB/SE, Offer in Compromise Program, Executive Summary, FY 2006 - January 2006; IRS Automated Collection System Operating Model Team, Collectibility Curve (Aug. 5, 2002).

converts a noncompliant taxpayer into a compliant one, and collects taxes that would otherwise remain uncollected.

Offer Program Expansion

In RRA 98, Congress expanded the bases for compromise to include "effective tax administration" (ETA).[50] The Conference Report to RRA 98 suggested that the IRS was to adopt a "liberal acceptance policy,"[51] and to "take into account factors such as equity, hardship, and public policy."[52] However, Treasury regulations provide that the IRS will not compromise with business entities based on economic hardship.[53] Further, as of FY 2004, the IRS was not using its ETA authority to compromise based on equity and public policy (non-hardship).[54] Therefore, I recommended that Congress provide more specific guidance to the IRS to ensure that a new "equitable consideration" standard be applied in a broader array of cases.[55] The good news is that in late 2004, the Small Business/Self-Employed division began using factors similar to many of those that I identified in my 2004 report to evaluate ETA offers and accept more of them. Unfortunately, as of today, this guidance has not been formalized.

Continuing Challenges for the Offer Program

Another problem for the OIC program is that fewer and fewer taxpayers are actually submitting offers. As of the first four months of FY 2006, new OIC receipts declined by 28 percent, with new cases at 19,026 as compared to 26,503 for the same period during FY 2005.[56] This decline follows steep declines in prior years. Although the IRS's $150 OIC processing fee and revised OIC Form, which makes it more clear when offers will not be accepted, may have reduced the number of unrealistic OIC submissions,[57] the decline may also be due to an increasing number of taxpayers and practitioners reaching the conclusion that the offer process is not working as well as it should.

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[50] RRA 98, Pub. L. No. 105-206 (1998).

[51] H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998).

[52] H.R. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that "[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes.... The conferees believe that the ability to compromise tax liability ... enhances taxpayer compliance.").

[53] *See* T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (Aug. 20, 2002).

[54] National Taxpayer Advocate 2004 Annual Report to Congress at 311-341.

[55] For more detail, *see* National Taxpayer Advocate 2004 Annual Report to Congress 433-450.

[56] SB/SE, Offer in Compromise Program, Executive Summary, FY 2006 - January 2006.

[57] TIGTA has concluded that the OIC fee, imposed in November 2003, is responsible for reducing OIC submissions by 28%, but it is difficult to conclude that the continued reduction in OIC submissions in FY 2005 is due to the OIC fee. *See* Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). The Form 656, Offer in Compromise, was revised in July 2004, and the revision was publicized in October 2004.

TAS continues to receive complaints from taxpayers and practitioners concerning the IRS process for determining an acceptable offer amount, which generally involves a comparison of income to "allowable" expenses. One common complaint is that the IRS uses allowable expense "standards" that are sometimes unreasonably low.[58] In January, 2006, the IRS actually lowered the national allowable expense standards for food, housekeeping supplies, apparel and services, personal care, and miscellaneous expenses, even though overall consumer prices have generally been increasing.[59] This decision is likely to reduce offer submissions even further by reducing the IRS's willingness to reach reasonable compromises with small businesses and other taxpayers who are working to resolve prior year delinquencies and come back into compliance.

I appreciate this opportunity to testify before you regarding IRS enforcement and small business. I hope that my remarks prove helpful as you work on proposals to reduce small business burdens through changes to the Internal Revenue Code. We continue to look for ways to reduce opportunities for noncompliance and to make the IRS work smarter with respect to its audits.

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[58] *See* National Taxpayer Advocate 2005 Annual Report to Congress 270-291 (MSP: Allowable Expense Standards for Collection Decisions); IRC § 7122(c)(2)(B) provides that "...officers and employees of the Internal Revenue Service shall determine, on the basis of facts and circumstances of each taxpayer, whether the use of schedules published under subparagraph (A) is appropriate...."

[59] IRS, *National Standards for Allowable Living Expenses, available at* http://www.irs.gov/businesses/small/article/0,,id=104627,00.html. For example, the national standard expense allowance for a single person making less than $833 per month declined from $403 in 2005 to $367 in 2006.

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

April 5, 2006

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

As the great philosopher Yogi Berra says, "It is déjà vu all over again." Here we are once again discussing the tax gap. While we all can agree that there is a tax gap and there are individuals, large corporations, and small businesses out there that are not paying their fair share of the tax burden, we do not believe the statistics tell the story of "why" that is the case and, as a result, it appears we and the IRS have different views on what to do to rectify the situation.

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

We have a tax gap number and it sounds big. But what are we trying to achieve here? Perfect compliance? Call me a foolish optimist, but I am willing to tolerate a certain amount of underreporting, if the alternative is to squash the entrepreneurial spirit—and I believe third-party reporting and/or withholding regimes will do just that. I believe we get more net benefit from keeping alive the notion that anybody has the right to start and own their own business than we do from having in place the perfect tax compliance system.

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I know the government cannot publicly state that some underreporting is okay, but I do believe we should make certain that the IRS allocates its resources to remedy the most abusive problems.

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

The IRS has put a number on the size of the tax gap and given us some observations about the nature of the gap. The Administration, in its 2006 fiscal year budget, has put forth five proposals plus one "phantom" proposal to reduce the gap.

According to the IRS, so far we know the following:

"The updated estimate of the overall gross tax gap for Tax Year 2001—the difference between what taxpayers should have paid and what they actually paid on a timely basis—comes to $345 billion. This figure falls at the high end of the range of $312 billion to $353 billion per year, an estimate released last March. IRS enforcement activities, coupled with other late payments, recovered about $55 billion of the tax gap, leaving a net tax gap of $290 billion for Tax Year 2001."

"As with prior estimates, the updated estimate of the tax gap shows that the largest component of this gap, more than 80 percent, comes from underreported taxes."

"Nonfarm sole proprietor income, which is reported on a Schedule C and is subject to little third-party reporting or withholding, has a net misreporting percentage of 57 percent, contributing about $68 billion to the tax gap."

"The Administration's fiscal year 2007 proposal includes:

- Expanding third-party information reporting to include certain Government payments for property and services;
- Expanding third-party information reporting on debt and credit card reimbursements paid to certain merchants;
- Clarifying liability for employment taxes for employee leasing companies and their clients;
- Expanding beyond income taxes the requirement that paid return preparers sign returns, and imposing a penalty when they fail to do so; and
- Authorizing the IRS to issue levies to collect employment tax debts prior to collection due process proceedings."

There is the "phantom" sixth proposal in the "blue book":

"In addition to these five proposals, the Treasury Department will continue to consider other ways to close the tax gap and, in particular, will study the standards used to distinguish between employees and independent contractors for purposes of withholding and paying Federal employment taxes."

Where do we begin?

Underreporting

We continue to struggle with the notion of why so many Americans would be underreporting income? Is it intentional or is it a matter of education? Is the tax code just too complicated? Is the underreporting across the board, or is it sectoral?

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

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

The President's Commission on Tax Reform made some interesting suggestions with respect to a small business friendly tax code. We are disappointed that Congress has not spent more time exploring the feasibility of the recommendations put forth by the Commission.

As the National Commission on Restructuring the IRS stated "The Commission believes that good customer service and taxpayer education, which assists taxpayers in meeting their tax obligations to the government, leads to increased compliance."

We at SBLC fear that by focusing on enforcement, at the expense of education, the pendulum will swing back to the days of the 1990s and earlier when taxpayers were "guilty until proven innocent."

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

One of the great successes of the IRS Restructuring and Reform Act of 1998 was the creation of the Small Business/Self Employment Division (SB/SE) and its taxpayer education and communication efforts. We at SBLC believe that a greater emphasis on education can have a significant impact by helping to bring in those individuals that want to pay their taxes but for one reason or another are not doing so. The SB/SE Division is doing a great job educating and informing small business and self-employed taxpayers and their representatives about their tax obligations by developing educational products and services focusing on the needs of small businesses and the self-employed. Through these activities, the SB/SE Division has consistently provided top quality pre-filing services to help taxpayers understand and comply with the often complex tax laws.

The Stakeholder Liaison function within the SB/SE Division has been very helpful. Over the past few years the Stakeholder Liaison and SBLC, along with our colleagues at the National

Federation of Independent Businesses (NFIB) and the U.S. Chamber of Commerce, have hosted a bi-monthly small business forum where small business leaders come together to meet with the IRS and hear about their latest programs. The forum also serves as a valuable resource for small business leaders to discuss issues affecting the small business community.

Withholding

I generally hold to the axiom, "Don't ask a question that you don't know the answer to." I will break my rule today. Do we know if there is a difference in underreporting in business to business transactions versus consumer to business transactions?

As you know, businesses that engage the services of sole proprietors have to issue a 1099 for amounts over $600. For years, the debate has focused on these business to business (B2B) service transactions. Are there the bulk of B2B transactions under $600? Or is there a failure to file 1099s? Are there statistics on the amount of underreporting when 1099s have been issued? It is not clear to us that anyone has demonstrated that switching from information reporting to withholding in B2B transactions will improve compliance.

In recent years I have come to think the problem might be more prevalent in the direct consumer to business transactions. There is no information reporting, and it does not lend itself to withholding. But, I have not seen an analysis that drills down below the generalization that sole proprietors underreport.

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

To require that a small business withhold say five percent, would, be unfair to the small businesses engaging the independent contractor as well as to the independent contractor. Many small businesses are one-person operations and to be burdened with the task of collecting money for the government would be time consuming. Also, in some cases the amount withheld would be more than the profit on the service performed thus making some jobs a money losing proposition for the independent contractor.

Expanding Third-Party Information Reporting On Debt And Credit Card Reimbursements Paid To Certain Merchants

We are still struggling to figure out exactly who is the "target" here. According to the blue book, "It is expected that, as under current information reporting regulations, certain categories of merchant payees, such as corporations, would be excluded from the reporting and backup withholding requirements." So that would translate once again into primarily sole proprietors – engaged in MERCHANT (product selling) transactions –AND taking credit card payments.

The only universe of problem taxpayers we can divine from that observation is that these are entrepreneurs selling on the Internet.

On balance it sounds like the proposal to address the problem has the potential of being a huge "data dump" that gives the IRS a ton of information, with little or no way to use it effectively.

Conclusion

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

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Testimony of

Keith Hall, CPA
Hall & Hughes, PLLC

On behalf of the
National Association for the Self-Employed

House Committee on Small Business
"IRS Latest Enforcement: Is the Bulls-eye on Small Businesses?"

April 5, 2006

Chairman Manzullo, Ranking Member Velazquez and Members of the Committee, thank you for allowing me to testify today regarding the issue of the tax gap and the Fiscal Year 2007 Revenue proposals addressing this issue. According to IRS data from the National Research Program (NRP), the data indicated that the nation's tax gap, the difference between what taxpayers should pay and what they actually pay on a timely basis, falls somewhere between $312 billion and $353 billion. The tax gap has three key components which include underreporting of income, underpayment of taxes and non-filing of returns. There have been numerous proposals regarding how to effectively address the tax gap and increase compliance. Most recent have been the proposals put forth in the Administrations FY2007 budget.

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

In my testimony today, I would like to address three key areas:

- imposing withholding on non-employee payments, specifically payments made to independent contractors;
- proposed increase in information reporting on payment card transactions as a way to mitigate the tax gap;
- resource allocation of IRS funding, in particular the service vs. enforcement paradigm.

Withholding on Non-Employee Payments

The NASE and I as a tax practitioner are still gravely concerned about circulating proposals recommending withholding on non-employee payments. We feel that proposals regarding additional withholding are the most burdensome to the self-employed and micro-businesses. For sole proprietors and business owners hiring independent contractors, additional withholding in the range of two to five percent on payments made to contractors will only add to the compliance burden with a whole new set of perplexing and – for many – unmanageable and

costly filing requirements. NASE Member Courtney Browning owns Browning Parcel Service in Oklahoma City, Oklahoma. He states, "If this proposal had been in effect the first few years I was in business, things were so financially tight that five percent withheld could have put me out of business. Small business does not need this extra burden." Tracy Boulware of Houston, Texas remarks, "I own a small company. I pay my taxes. Sometimes my profit margin is only 3.5%-5%. This type of legislation could put me out of business. I need that money for operating capital. It's that simple."

We have concerns of potential requirements associated with the implementation of an additional withholding mechanism. Specifically, in regarding the requirement to withhold based on gross versus taxable income, a technical flaw that would overstate employers' liability, since gross income often includes legitimately deductible business expenses. Also, the application of withholding on sole proprietors (Schedule C filers) only would clearly discriminate against this type of legal business structure. Incorporated firms would not be held to this requirement.

NASE Member Ross Kaminsky of Boulder comments, "The scourge of small business is regulatory paperwork including complicated record-keeping for taxes. Adding withholding on contractors will only make that more complicated, increasing the incentive for contractors and their employers a like to hide that business rather than waste more time and money on paperwork. Furthermore, contractors can have complex issues of income and deductions which would make calculating proper withholding nearly impossible." The NASE feels that rather than adding to the burden of compliance faced by micro-business taxpayers through increased regulations, the goal should be to simplify the tax regulations surrounding independent contractors. We currently have this reporting mechanism on independent contractors through the issuing of 1099 forms. We feel that rather than continue to shift both the cost and overall burden of compliance to business owners already fulfilling their tax responsibilities, the IRS should focus on fair and balanced education and enforcement efforts for those individuals that they have submitted 1099 forms on, yet have either unintentionally or willfully not complied with their tax liability.

Increased information reporting on payment card transactions

Currently, most taxpayers are subject to some level of information reporting and withholding requirements. Employers on behalf of employees must report wages and withhold applicable payroll taxes and federal income taxes. Businesses must report payments made for services in connection with their trade or business of more than $600 per year. Banks must report payments of interest and dividends made to deposit holders. Almost everyone has some type of income that is reported to the IRS by their employer, their bank, or their clients. Each of these forms of reporting also include some form of backup withholding if the taxpayer fails to provide a taxpayer identification number or if the number is found to be inaccurate.

The Administration has proposed for FY2007 increasing information reporting by requiring credit and debit card issuers to report to the IRS annually on aggregate reimbursement payments made to businesses. Also, if the business fails to provide a taxpayer identification number (TIN) or if that number is incorrect, it would require card issuers to backup withhold on all payments. This is basically the same process that is currently in place for wages, interest, dividends and payments for services reported via form 1099. Capturing information can only have a positive impact particularly in light of those taxpayers who consciously choose to avoid reporting income.

While I believe that increased information reporting can be positive, I feel that this particular proposal could have a negative impact on the self-employed and small businesses. The main concern is what would be done with the information that is provided. As will current 1099 reporting, providing a simple match of reported credit card receipts to the applicable income tax return would be positive. The match could provide the IRS with valuable data related to underreported income by businesses with credit card receipts. The small business that simply chooses not to file a return will automatically be identified as having underreported income and appropriate steps could be taken. Taxpayers that willfully avoid their reporting and payment responsibility should be identified then required to comply. This is what the reporting program is designed for.

However, if the credit card receipts were then used to make judgments regarding other items on the tax return, problems will arise. Discussions have included taking the total credit card receipts reported for a particular business and then extrapolating total income based on industry averages. The averages will only provide an additional discrimination against those businesses that have higher then average credit card receipts. That higher average could be a function of the affluence of their community, their own efforts in managing the cash flow of their business and even their own decision of whether to accept a particular credit card. It will be very difficult to determine an applicable average for a particular small business that is relevant. Therefore, any action that would be available to the IRS in the form of examination, request for additional information or even tax assessment could be correspondingly irrelevant.

Another concern for this proposal is that these amounts are most likely already reported anyway. The taxpayer who willingly underreports income would not knowingly choose to exclude credit card receipts since those items show up on their bank statements anyway. It is clear that the sales via credit cards are documented and would be revealed upon review and therefore it is unlikely that those amounts would be the key source for intentional underreporting. Therefore, this approach may not be targeting the source of underreporting and could serve only to increase the costs associated with credit card usage without identifying any additional taxable income that would not have already been reported.

Perhaps the most critical aspect of this proposed is its estimated return on investment. The Treasury's estimate of $225 million related to this proposal compared to the $353 billion tax gap is nominal compared to the burden it may place on both IRS resources and business taxpayers.

The Department of Treasury, specifically the I.R.S., is attempting to strike at the cash economy and those underreporting or not reporting income. However, this proposal addresses income on revenue already being reported and an area (credit card transactions) where there is not a lot of misconduct. In fact, the enhanced backup withholding provisions could cause micro-businesses to face significant cash flow issues. Many micro-businesses operate on limited margins of revenue and withholding on payments could be detrimental to the financial well-being of their business. Additionally, the proposal unfairly targets sole proprietors and all other business entities other than corporations. Finally, and as a general rule, I am always in favor of improving

the collection of data and reporting of actual business transactions. However, based on the fact that I believe these transactions are not the source of taxpayer underreporting and the fact that I am uncertain of how the IRS plans to utilize this additional data obtained through increased information reporting in their enforcement efforts, I am concerned about the ultimate benefit of this proposal.

Service vs. Enforcement

I have yet to hear commentary from any group or individual that did not include the goal of providing a fair and equitable solution to the existing tax gap. I believe everyone agrees that any solution should include at it core the goal of providing equity for all taxpayers. However, we also feel that any recommendations seeking to increase compliance and lessen the tax gap should also seek to refrain from increasing the regulatory burden on taxpayers. Furthermore, we feel that ensuring comprehensive, effective taxpayer services is essential to accomplish taxpayer compliance.

As we have highlighted before, the IRS has made positive changes through enhancement of educational and outreach efforts which have had positive affects. Our concern is with the shifting of resources from taxpayer education and services to enforcement. It is evident in the FY2007 Budget that enforcement is being emphasized, and taxpayer services are being cut.

Accurate tax reporting and compliance is extremely important to small business. Those who make a good faith effort, yet are inaccurately complying should be assisted through education and tax simplification efforts. Those willfully disregarding their tax liability should be held accountable. The more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. However, increased enforcement at the expense of taxpayer education will not in the long term accomplish sustained, improved compliance.

Conclusion

Tax compliance and its affect on the tax gap is a significant problem faced by our nation. Yet, in the fervent drive to recoup revenues for our fast depleting federal coffers, we must take the necessary steps to make certain the path we choose is balanced and effective, rather than detrimental. Our collective focus should be on supporting their efforts for survival, growth and innovation as a foundation for long-term economic vitality.

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

National Association for the Self-Employed

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Micro-business Perspectives

The Affect of Withholding on Non-Employee Payments

Tracy Boulware owner of Altra Industries in Houston remarks, "I own a small company. I pay my taxes. Sometimes my profit margin is only 3.5%-5%. This type of legislation could put me out of business. I need that money for operating capital. It's that simple."

Tracy Boulware
Altra Industries
Houston, TX 77227

Dorie Geniesse states, "My business would suffer tremendously if there was withholding on my independent contractor income. The majority of my work is seasonal so though I make more money early in the year, I make virtually nothing for the second and third quarters. My total taxable income after all is said and done is only $12,000 per year. This would cause me terrible hardship and probably put me out of business."

Dorie Geniesse
Madison, WI 53711

Courtney Browning owns Browning Parcel Service in Oklahoma City, Oklahoma. He states, "If this proposal had been in effect the first few years I was in business, things were so financially tight that five percent withheld could have put me out of business. Small business does not need this extra burden."

Courtney Browning
Browning Parcel Service
Oklahoma City, OK 73179

Ross Kaminsky of Boulder feels, "The scourge of small business is regulatory paperwork including complicated record-keeping for taxes. Adding withholding on contractors will only make that more complicated, increasing the incentive for contractors and their employers a like to hide that business rather than waste more time and money on paperwork. Furthermore, contractors can have complex issues of income and deductions which would make calculating proper withholding nearly impossible."

Ross Kaminsky
Boulder, CO 80302

Jennifer Hassani, a Mary Kay Independent Beauty Consultant from Newnan, Georgia comments, "I was for many years an independent contractor and plan to use them in my business. I feel that creating a Withholding Requirement for businesses will cause undue cost to businesses in the form of extra paperwork and salaries which will cause the businesses to rethink the decision to use independent contractors and therefore many people will no longer be able to make a living. As a future user of independent contractors, I do not have the time to worry about withholdings and paying them to the IRS on a weekly or monthly basis. I will pay "invoices" and print out a 1099 at the end of the year. I will be forced to not use independent contractors if this measure is passed. Not fair to us small businesses and budding entrepreneurs!"

Jennifer Hassani
Newnan, GA 30265

Prepared Statement of
Michael J. Fredrich
President and Owner
Manitowoc Custom Molding, LLC
On behalf of the
Small Business & Entrepreneurship Council

On

IRS Activities and Proposals to Close the "Tax Gap" and Impact on Small Businesses and the Self-Employed

Before the

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

April 5, 2006

Chairman Manzullo, Ranking Member Velazquez and members of the House Small Business Committee, thank you for holding this hearing today and providing me the opportunity to present my views regarding the specific activities undertaken by the Internal Revenue Service (IRS), and some of the various solutions that have been proposed to close the "tax gap."

My company, Manitowoc Custom Molding located in Wisconsin has 100 full-time employees. Hourly compensation ranges between $8.00-$23.00 per hour. Top salary is $72,000. The company is engaged in the custom molding of thermoset plastic parts.

In general, the thrust of IRS activity as well as various proposals to deal with the "tax gap" burdens compliant small business owners with additional costs and work. Particularly given the thin margins and tight cash flow of most small businesses, combined with the competitive pressure we face both domestically and from abroad, asking small firms to take on more responsibilities is not a sound approach to short falls in the tax collection system.

Just One More Straw

The proposal to close the "tax gap" through a complicated withholding scheme is just one more straw on the back of small business. Lest you forget, small business is the economic engine that drives our economy and employs the majority of the private sector employees. This latest straw will only add to the current burden. Our small company, in addition to trying to serve our customers and make a profit, must also perform the following tax related activities:

- Federal Tax Collection
- State Tax Collection
- Social Security Tax Collection
- Medicare Tax Collection
- Unemployment Tax Collection-Federal
- Unemployment Tax Collection-State
- W-2 Preparation
- 1099 Preparation
- Personal Property Tax Return
- Real Estate Tax Return
- Federal Income Tax Return
- State Income Tax Return

Now we are being asked to add one more activity to this already cumbersome list. We are being asked to make sure some of our suppliers pay their taxes. Enough.

Small Business Environment

Most people in government do not have a concept of what it takes to operate a small business. Start with the basic fact that we cannot afford to employ more people than absolutely necessary. In our company we have 2 ½ people in the management office -- including me. I handle all the administrative, financial, insurance, and IT functions. Our Controller takes care of accounts receivable, accounts payable, payroll, financial statement preparation, and all human resource questions. The half person performs the shipping function.

In order to compete we must keep our overhead costs low. Customers insist that we run a lean operation. An example is The Kohler Company. Kohler is our second largest customer. They have a group of people who access our cost structure. We are compared to other suppliers — not just domestic, but worldwide. We compete directly with suppliers in China and India. If our cost structure is out of line with our competition we have two choices; (1) lower our price or (2) lose the business.

We can compete with anyone in the world because our productivity is higher. However, regulation, control, and taxes diminish our ability to compete because the added cost of this burden offsets our productivity advantage.

The Anthony Factor

Our company uses outside contractors. We are not alone. The trend in all industry is to hire outside contractors, people who wish to be independently self-employed, because it is cheaper and more efficient than employing a full-time person. A good example is our IT requirement. We cannot afford to have a full-time IT person so we hire Anthony on a when-needed contract basis. We issue him a 1099, pay him by check, and that is all we want to do. Anthony's personal tax situation is his own business. His payment or non-payment of taxes is not, and should not, be our responsibility. We do not need one more IRS mandated straw on our back. We have enough to do to keep our business operating so we can continue to employee 100 people, improve productivity through new capital, and remain competitive in the world market.

Macro View and Comment

Our country is, and has been, a great incubator of new businesses. Small business is the foundation of our economic system. It is important to have an environment that encourages people to take the risk necessary to start a new business.

Our company cannot afford to employ a full-time salesman. We have been working with a highly qualified technical person to help him form his own technical sales company and become the exclusive sales representative for our company. It would be good for us and great for him. The proposed withholding places a burden on startup companies. His company would not be profitable for at least a year. Withholding 28% of his revenue would make this venture financially impractical. To undertake this venture he is walking away from a $120,000 salary and into a venture with zero income on day one. We are confident he will be successful and so is he. He is willing to take the risk. Why create barriers to this kind of entrepreneurship?

Increased Audit Activity

The assertion that the IRS has trimmed the cost of collecting $100 in taxes to $0.44 is myopic. There are two sides to every transaction. This figure ignores the time and effort of the taxpayer to assemble the data, engage professional representation, and participate in meetings. Most importantly, it ignores the cost of lack of focus. Small business owners will not survive if they lose focus. Our business is not unique. If we are not paying attention to the details of the business it does not take long for the income statement to suffer. This is a tenet of all businesses — large and small — but small business is more adversely affected due to lack of management depth.

Conclusion

The current tax system is oppressively complex and costly. Adding more complexity and reporting requirements only worsens the situation. If a "tax gap" is the problem then simplify. Every country that has simplified its tax collection system has been rewarded with higher revenues and better compliance. Eastern Europe is replete with examples. Our country is competing against a vibrant world market and we need to remain competitive. We can compete on productivity but we cannot compete on labor and other external (government mandated) costs. The proposals for withholding and focus on expanded audits on small businesses attack

the foundation of our economy. It will diminish the competitive advantage that remains.

I thank you for your leadership Chairman Manzullo, and look forward to the opportunity to discuss this issue with committee members. Thank you again for the opportunity to present my views on this important subject.

Michael J. Fredrich
President and Owner
Manitowoc Custom Molding, LLC
1315 S 41st Street
Manitowoc, Wisconsin 54220

THE BULLS-EYE IS ON EFFICIENT GOVERNMENT: THE IRS, SMALL BUSINESS, AND TAX ADMINISTRATION

TESTIMONY BEFORE THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

Max B. Sawicky
Institute Economist
Economic Policy Institute
April 5, 2006

I would like to thank the Committee for the opportunity to present my views. I particularly compliment Chairman Donald Manzullo, who deserves credit for opening this issue up to vigorous debate.

The dramatic shift in the budget outlook since 2001 will compel a search for revenue. About this there should be no doubt. Projections from the Congressional Budget Office document the inevitable growth in deficits, primarily due to the national demand for increasing expenditures on health care.

While there should be no dispute that tax cuts have played an important role in current and near-term deficits, it does not follow that rescinding the cuts solve the long-term problem. Even with a budget that was balanced next year, the budget outlook would be unsustainable in the long run.

The rising demand for health care spans both the public and private sectors. It is said that "we" cannot afford it. But if "we" don't pay, somebody must, or somebody must forego medical care. Economies can surely be squeezed out of the system, but the fact of growing usage of health care services would remain, along with increasing costs. There are few less-pressing issues in public policy today.

Earmarks and other controversial uses of discretionary spending are often pointed to as culprits in deficits, but the fact is that under current trends, the entire discretionary budget could be zeroed out and the deficit problem would remain. Revenue increases will be inescapable.

Thus far the nation has enjoyed a bountiful tax holiday resulting from the willingness of foreigners to buy U.S. Federal debt. Absent this indulgence, which cannot persist indefinitely, interest rates would rise and real damage to the economy would follow.

Congress would be compelled to act. It *will* be compelled to act. Few informed observers expect current trends in the trade deficit to endure.

Tax increases will be required, but the logical distaste for tax hikes will encourage a look at the tax gap. By the latest estimates, nearly $350 billion a year in Federal taxes are not paid voluntarily and on time. This is the same order of magnitude as the cost of tax cuts enacted since 2000.

To its credit, the Bush Administration has recognized the potential for improved enforcement by proposing modest measures to reduce the tax gap. They have also defied the misgivings of some economists and scored the returns to their proposals, to the tune of $3.6 billion over ten years. Compared to the proposed increase of $46 million in IRS outlays, this is an impressive return. Estimates of the payoffs from assorted enforcement measures indicate there is much more where that came from.

Unfortunately, the $46 million is not maintain the IRS budget in the face of inflation, so only $46 million more for enforcement means less resources for other IRS functions. A single percentage point of inflation reduces IRS resources by over $100 million.

The Bush proposals and upgraded enforcement since 2001 constitute a modest U-turn from the disastrous legislation of 1997 that reduced the ability of the Internal Revenue Service to enforce the law. This legislation followed hearings in the Senate featuring testimony by witnesses of grave abuses by the IRS.

We should not doubt that the IRS would be the first to admit that abuses have occurred in the past. The respected periodical *Tax Notes* reported that the specific charges aired at the hearings were later investigated by the General Accounting Office and found to be without foundation. The GAO report was never released to the public. It sits somewhere in a file cabinet, mute testimony to the potential for public hysteria to motivate ill-considered legislation.

The IRS is engaged in careful study of the roots of the tax gap, under the auspices of the National Research Project. This research should be augmented to cover all sectors of the economy, not confined to individual returns. Additional investments will be required, but it will be money well spent. The better the information, the more effective the IRS will be in allocating dollars to improved compliance, and the better they will be in finding the right bulls-eye.

In past research, evasion rates for small business have been found to be particularly high. Worries about unfair emphasis on unincorporated business are natural. I would encourage the following points as a way towards a better perspective on this matter:

- The big fish in tax evasion are high-roller tax shelters, crafted by the same sort of accounting legerdemain that gave us the Enron debacle. They are holders of offshore accounts that hold undeclared income. They are blue-chip corporations, accounting firms, and attorneys able to outgun the IRS in litigation, due solely to their resources and not the merits of their case. They are recipients of unreported capital gains – the income of the truly rich in America. Genuinely small business firms – as opposed to very short people with high profits – are not the top priority in this game. Even a business person with net income of $100,000 had income well over that of 80 percent of Americans in 2001.

- From a benefit-cost perspective, it would behoove the IRS to focus on business firms with high income and many employees because, after all, that's "where the money is." Businesses struggling on the margins of profitability with low income and few workers are not likely to owe much in the way of taxes in the first place. From a revenue standpoint, the logical course for the IRS is to pursue opportunities with low cost and high payoff, free of reverse favoritism.

- If the IRS estimates of evasion are correct, it is likely that some taxpayers are enjoying unfair advantage over others with whom they compete. On top of unfairness, this is bad for the productivity of the sector, entrepreneurship, and the economy as a whole.

- One such advantage is the use of "off-the-books" workers, including those who have entered the country illegally. For such workers, the greatest tax would be on payroll. Increasing the IRS capacity to enforce the *payroll tax* would augment enforcement of immigration laws, reduce the adverse affect of immigration on low-wage labor market, and not incidentally improve the outlook for Social Security.

- Regarding the IRS interest in classifying so-called "independent contractors" as small business, we might consider that every worker is a small business, and as such they deserve the full benefits of fair labor standards.

- With additional resources, the IRS could do more to assist taxpayers of all types. In this context, Bush Administration proposals to reduce funding for taxpayer assistance and technology modernization are ill-advised. In the same vein, closing walk-in centers and neglecting the potential of the voluntary tax assistance community are the wrong direction to go.

- Tax enforcement entails much more than sensational raids by IRS agents and high-stakes criminal prosecutions. There is also increased information reporting, withholding of taxes on non-labor income (as on labor income), and expanded collection of tax debts that are already known to the IRS.

- Simpler taxes would be easier to comply with, and easier to enforce. Tax changes since 1997 have gone in the wrong direction on this count. In general, broader tax base – fewer deductions, exclusions, and credits – enable lower tax rates. Lower rates reduce the incentive to spend time and money exploring legal tax avoidance, as well as the incentive to cheat.

- If there is one danger to small business, it would be the possibility of enactment of the national sales tax as a replacement for the current system. This tax would put the entire responsibility for tax payment on retail merchants. As such, it would focus the entirety of tax enforcement on these same people. In effect we would see an IRS person behind every cash register.

For all of our problems, the U.S. tax system relies substantially on voluntary compliance. The absence of a need for onerous enforcement measures is an asset to the U.S. economy, including our competitiveness in world markets. This invaluable asset deserves the highest safeguards, not least because of the problem noted above – America's unsustainable economic imbalances in the Federal budget and international trade.

A favorite cartoon of mine shows a suburban homeowner standing in his doorway. In the wake of a nuclear war, nothing is left of the houses on his block but the facades. With singed hair and tattered clothes, he is scanning his mail, complaining "Bills bills bills!"

I hope we all gain the best perspective on where we are in the matter of tax enforcement. Thank you again for the opportunity to address this committee.

Testimony of Alvin S. Brown

Chairman Manzullo, Ranking Member Velazquez, Members of the Committee, I am submitting testimony dealing with the proposal in Treasury Blue Book, page 21, regarding the proposal to **Amend collection due process procedures for employment tax liabilities.**

My name is Alvin S. Brown[1], a tax attorney, with the law firm of Alvin Brown & Associates, LLC, a boutique tax law firm specializing all IRS issues and taxpayer controversies. The tax law firm represents clients throughout the U.S. and abroad. In that IRS "controversies" tax practice, we are regularly involved with Collection Due Process appeal cases. For that reason we can provide some actual case experiences and practical insight relevant to the consideration of the proposed amendment.

I am also the director of The IRS Forum, a start-up non-profit 501(c)(3) educational organization located on the internet at www.irsforum.org. The IRS Forum is a platform on the internet for all taxpayers to learn about the IRS and document their IRS experiences and also provide **transparency** of the IRS with recorded actual case histories[2]

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[1] Prior to the tax law practice of representing taxpayers before the IRS. I had a full career as a managing interpretative tax attorney in the office of the IRS Chief Counsel.

[2] The IRS complaint traffic received by Members of Congress is wasted. That data could become statistically significant if those constituents are able to record their IRS experiences within the IRS Forum. The tax data is organized by issue, and the taxpayers are empowered by becoming a member of a larger group with the same issues or problems and also by communicating with one another with a message board.

The proposed changes in the "collection due process" (CDP) appeal rights would have the following effect: **levy actions will not be halted as a result of an appeal of the levy action in a Collection Due Process (CDP) appeal.** Under present law, levy actions are suspended when a CDP hearing is pending[3].

Impact of the Proposal on Corporate Employers

A levy of a corporations' accounts receivable and notes receivable are subject to levy as longs as the right to the receivables are "fixed and determinable[4]." The levy of an employers' accounts receivable or notes receivable is continuous until the receivable is paid.

The Internal Revenue Code requires that the IRS must release a levy if the levy creates an ***economic hardship*** within the meaning of § 6343 (a) (1) (D) of the Code on the taxpayer. Notwithstanding the unqualified language of § 6343 (a) (1) (D), it is the position of the IRS that a corporation cannot have an economic hardship[5]. It is my professional opinion that the decision of the IRS to preclude corporations from the mandatory levy release provisions of § 6343 (a) (1) (D) is a prohibited legislative determination and therefore an abuse of power; the technical analysis and rationale for my analysis and conclusion is found in Attachment B.

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[3] Section 6330 (e) suspends collections during a CDP proceeding.
[4] See Attachment A

[5] I have first hand experience in a matter decided by Nina Olson, the NTA. Ms. Olson (presumably with the concurrence of Treasury) determined that the IRS will not release a levy on a Subchapter S corporation's only gross revenue (gross income payable in installments from the sale of software). Ms. Olsson stated that a corporation cannot have an "economic hardship." Without any gross income, the corporation was forced to go out of business.

Consequently, the IRS will not stop a levy on the accounts receivable or other receivables even if that garnishment has the immediate effect of closing down the corporation.

This is the major reason for my testimony today. The impact of the CDP proposal to permit levies on employers does not take into account the fact that the IRS can destroy a corporation because the IRS has decided that it has the unrestricted right to levy corporate receivables, bank accounts and assets . As noted above, the IRS cannot levy individuals if the levy causes an "economic hardship" but that restriction does not apply to any other entity.

A levy on an employer's accounts receivable or notes receivable is a levy on "gross income" (income before the reduction of administration expenses, before operating expenses, and before taxes are paid.)

It is an obvious point that no employer can survive if its gross income is levied, because that income is necessary to pay administrative expenses and all business expenses including payroll and income taxes (see footnote 5). How can any employer stay current with its payroll taxes if its gross income is levied? How long can any employer survive without income to pay administrative expenses and business expenses? These questions answer themselves. A levy on any employer's **gross income** will result in the liquidation of all business operations either immediately or within a few weeks. A levy on an employer's business bank account which at any time contains money for taxes and payroll is also a devastating business catastrophic.

The second reason for being opposed to the proposed CDP proposal is that it is in conflict with the intent of Congress to provide alternatives to collection, including the right to challenge the underlying liability and the statutory restrictions on collection in § 6331.. For example, if there is no liability, the levy action is unjustified. The right to CDP appeals began in the Internal Revenue Service Restructuring and Reform Act of 1998[6]. Section 6330 (c) (2) (A) (iii) provided that a person may raise at a CDP hearing ***offers of collection alternatives, which may include the posting of a bond, the substitution of other assets, an installment agreement, or an offer-in-compromise.*** As indicated by section 6331 (k) (1) collection actions are prohibited when an installment agreement or an offer in compromise are being processed. The language of § 6330 (c) (2) (A) would be undercut if the IRS were allowed to levy employer gross income or assets in circumstances where it conflicts with the tax policy encourage installment agreements and offers and compromise for qualifying taxpayers.

Since taxpayers need time to make the lawful challenges under § 6330 (c) (2) (A) (iii), Congress added the provisions of § 6331 (k) (1) and § 6331 (k) (2) which provide that no collection action is permitted for both offers in compromise and installment agreements, respectively. The proposed change in the levy law conflicts with these provisions. It is also contrary to the tax policy of § 6331 (k) to encourage Installment Agreements if the IRS is permitted to levy employers who are trying to pay their tax liability in installments. Similarly, in the case of offers in compromise, the Congress stated that *the IRS should make it easier for taxpayers to enter into offer-in-*

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[6] Sections 6320 and 6330 of the Code were added as part of the Internal Revenue Service Restructuring and Reform Act of 1998. See pages 263 – 267 of the RRA 1998 Conference Report, Report 105-599, 105th Congress, 2d Session.

compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements[7].

Some failures to pay employment tax are inadvertent or beyond the control of the employer (e.g., illness, a natural disaster, bankruptcy of a major customer, embezzlement). In many of these situations, the business problem is cured. All businesses have set-backs. In many of those cases, the business can cure the problem and pay the back taxes. Viable businesses should not be closed by unrestricted levies of gross income and business bank accounts. These correctible situations cannot be cured with ongoing collection actions. Since the levy of gross revenue cannot be stopped, the business will likely be closed by the time the CDP hearing is ready. It normally takes at least three months for a CDP appeal to take place from the time the appeal is requested on a Form 12153.

The Presaent Practice of the IRS in CDP Hearings is Effective

It is my experience when participating in CDP hearings, the Appeals Settlement Officer will know whether or not an employer is not in current tax compliance. If a taxpayer-employer is not in compliance, the hearing can be canceled. If the hearing is cancelled, collection actions can commence. In most cases, the Settlement Officer will not proceed with the CDP hearing until tax returns are filed and current payments made.

For these reasons, there is no facilitation of the pyramiding of employment taxes in many of the CDP cases.

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[7] Conference Report, page 289, H.R. Report 105-599, 105th Congress 2d Session.

Revenue Raiser Considerations

If the present proposal is rejected, much more revenue can be raised by eliminating the filing of tax liens against all taxpayers, including the employers who are the subject of this hearing.

The IRS files tax liens in the public records for all taxpayers who owe the IRS $5,000 or more[8]. Congress did not write any statute requiring the IRS to file a Federal tax lien in the public records for any amount of money. Without a Congressional mandate requiring the filing of a tax lien in the public records, the $5,000 standard is an abuse of power and an abuse of discretion. All liens that are filed in the public records are picked up by the credit agencies and held on credit reports for seven years. Most businesses cannot function without adequate credit. Individuals and businesses will have trouble getting credit cards, purchasing real estate, renting property, getting a bank loans, or anything else where credit is important. In the case of businesses with loans or lines of credit, loans will be recalled and lines of credit eliminated. In short, tax liens are counterproductive to the economy and the income received by Treasury. Consider the following examples:

Example 1: The IRS filed a tax lien against a small business employer because the employer, a key employee, was ill for three months and missed either payment of one quarter's employment tax or the appropriate employment tax. The IRS filed a tax lien in the public records. The business was able to be immediately current on all taxes from cash reserves or from the assistance of a family member. Nevertheless, the tax lien

[8] IRS Internal Revenue Manual 5.12.2.4.1.1 (05-20-2005).

stayed on its credit report for seven years thereby encumbering the ability of the business to grow its business and pay more tax revenue. In this case, the tax lien is economically counter productive to economic growth and increased tax revenue.

Example 2[9]: The IRS misapplied tax payments. As a result the IRS claimed that the taxpayer small business has a deficiency that is in dispute. The IRS filed a tax lien against the business, and the bank immediately eliminated the line of credit of the business. After twenty years of business growth and progress, the business is on the verge of closing down because of the tax lien and the resulting loss of an essential line of credit. If the business is terminated, substantial economic and tax revenue is lost.

Substantial revenue can be raised if the IRS is prohibited from filing mandatory tax liens that are counterproductive to the economy. Reasonable thresholds (e.g., similar to those described in § 6323 (j)) can be created before tax liens are filed in lieu of the present proposal and raise far more income for Treasury than the present proposal.

[9] This is a current case of mine pending before the IRS

ATTACHMENT - A

§ 6343 (a) – INTERNAL REVENUE CODE

6343 (a) (1) IN GENERAL. --Under regulations prescribed by the Secretary, the Secretary **shall release** the levy upon all, or part of, the property or rights to property levied upon and shall promptly notify the person[1] upon whom such levy was made (if any) that such levy has been released if -- * * * *

6343(a) (1) (D) the Secretary has determined that such levy is creating an **economic hardship** due to the financial condition of the taxpayer * * *

TREASURY REGULATIONS

§301.6343-1., Requirement to release levy and notice of release (a) ***In general.*** --A district director, service center director, or compliance center director (*director*) **must promptly release a levy** upon all, or part of, property or rights to property levied upon and must promptly notify the person upon whom the levy was made of such a release, if the director determines that any of the conditions in paragraph (b) of this section (conditions requiring release) exist. * * * *.

(b) ***Conditions requiring release.*** --The director must release the levy upon all or a part of the property or rights to property levied upon if he or she determines that one of the following conditions exists --

[1] Section 7701(a)(1) of the Code - The term "**person**" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation

(4) **Economic hardship**

(i) ***General rule.*** --The levy is creating an economic hardship due to the financial condition of an individual taxpayer. This condition applies if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses. The determination of a reasonable amount for basic living expenses will be made by the director and will vary according to the unique circumstances of the individual taxpayer. Unique circumstances, however, do not include the maintenance of an affluent or luxurious standard of living.

(ii) ***Information from taxpayer.*** --In determining a reasonable amount for basic living expenses the director will consider any information provided by the taxpayer including --

(A) The taxpayer's age, employment status and history, ability to earn, number of dependents, and status as a dependent of someone else;

(B) The amount reasonably necessary for food, clothing, housing (including utilities, home-owner insurance, home-owner dues, and the like), medical expenses (including health insurance), transportation, current tax payments (including federal, state, and local), alimony, child support, or other court-ordered payments, and expenses necessary to the taxpayer's production of income (such as dues for a trade union or professional organization, or child care payments which allow the taxpayer to be gainfully employed);

(C) The cost of living in the geographic area in which the taxpayer resides;

(D) The amount of property exempt from levy which is available to pay the taxpayer's expenses;

(E) Any extraordinary circumstances such as special education expenses, a medical catastrophe, or natural disaster; and

(F) Any other factor that the taxpayer claims bears on economic hardship and brings to the attention of the director.

(iii) ***Good faith requirement.*** --In addition, in order to obtain a release of a levy under this subparagraph, the taxpayer must act in good faith. Examples of failure to act in good faith include, but are not limited to, falsifying financial information, inflating actual expenses or costs, or failing to make full disclosure of assets.

ATTACHMENT B

§ 6343 (a) – INTERNAL REVENUE CODE

6343 (a) (1) IN GENERAL. --Under regulations prescribed by the Secretary, the Secretary **shall release** the levy upon all, or part of, the property or rights to property levied upon and shall promptly notify the person[1] upon whom such levy was made (if any) that such levy has been released if -- * * * *

6343(a) (1) (D) the Secretary has determined that such levy is creating an **economic hardship** due to the financial condition of the taxpayer * * *

TREASURY REGULATIONS

§301.6343-1., Requirement to release levy and notice of release

(a) ***In general.*** --A district director, service center director, or compliance center director (*director*) **must promptly release a levy** upon all, or part of, property or rights to property levied upon and must promptly notify the person upon whom the levy was made of such a release, if the director determines that any of the conditions in paragraph (b) of this section (conditions requiring release) exist. * * * *.

(b) ***Conditions requiring release.*** --The director must release the levy upon all or a part of the property or rights to property levied upon if he or she determines that one of the following conditions exists –

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* * * * *

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(C) The cost of living in the geographic area in which the taxpayer resides;

(D) The amount of property exempt from levy which is available to pay the taxpayer's expenses;

(E) Any extraordinary circumstances such as special education expenses, a medical catastrophe, or natural disaster; and

(F) Any other factor that the taxpayer claims bears on economic hardship and brings to the attention of the director.

(iii) ***Good faith requirement.*** --In addition, in order to obtain a release of a levy under this subparagraph, the taxpayer must act in good faith. Examples of failure to act in good faith include, but are not limited to, falsifying financial information, inflating actual expenses or costs, or failing to make full disclosure of assets.Section 6343 (a) (1) (D) of the Code does not distinguish between individuals, businesses, corporations or partnerships. It merely states that the IRS must remove a levy if the levy creates an ***economic hardship.***

The Reasons Why The Mandatory Levy Release Law In § 6343 (a) (1) (D) of the Code Applies to Corporations, Partnerships and Other Entifies That Are Not Individuals

Section 6343 (a) (1) states "**In General**" the levy must be released under regulations. The term ***in general*** is not a specific delegation to Treasury to decide who qualifies for "economic hardship." The delegation to Treasury to write regulations only gives Treasury the authority to write the rules on the **conditions requiring levy release** and the definition of ***economic hardship*** in the manner applied to "individuals" as

indicated in **§ 301.6343-1 (a) of the regulations.** Congress did not write a rule that corporations and partnerships do not qualify for the mandatory "economic hardship" relief provisions of § 6342 (a) (1) (D). The term ***economic hardship*** in the § 6342 (a) (1) (D) statute is unlimited by any conditions. If Congress did not limit the application of "economic hardship" to any entity, how did the IRS and Treasury find the legislative authority to limit the mandatory levy release rule only to individuals? Treasury has the power to set tax policy but it does not have the power to legislate. The IRS has the power to interpret the law that Congress writes, but it does not have the power to legislate. The power to exclude entities other than individuals from the mandatory levy release provisions of § 6343 of the Code is a legislative function. The determination of taxpayer "remedies" is inherently and uniquely a legislative function.

There is nothing in the legislative history to indicate that Congress wants to put corporations out of business (an obvious result) by allowing the levy of gross income and bank accounts. A levy can also result in the seizure of assets critical to the business of a corporation. The levy of corporate gross income is an empowerment to force the closure of a business because no business can survive with the garnishment of all or most of its gross income.

The NTA and Treasury have ignored the general rule of the regulations. "Section 301.6343-1(a) ***In general"*** is self-limiting as only a general rule that provides the definition of "economic hardship" for individuals. For this reason, additional regulations may be provided to provide an "economic hardship" rule for corporations and partnerships.

Pre-pay Back Payroll Taxes Before a Hearing (Pg. 121 Treasury Blue Book)

Amend collection due process procedures for employment tax liabilities
Current Law
Employers are required to withhold and pay Federal Insurance Contribution Act (FICA) taxes and income taxes, and are required to pay Federal Unemployment Tax Act (FUTA) taxes (collectively "Federal employment taxes") with respect to wages paid to their employees. Employers are generally required to file annual returns (Form 940) reporting FUTA taxes and are generally required to file quarterly returns (Form 941) reporting FICA taxes and income tax withholding. For small employers, the taxes reported on Form 941 are generally required to be deposited on a monthly or semi-weekly basis.
In order to ensure the payment and collection of employment taxes, the IRS is authorized to take various collection actions, including issuing Federal tax levies. Before a tax levy can be issued, however, the IRS must generally provide the taxpayer with notice and an opportunity for an administrative collection due process (CDP) hearing, and for judicial review. An exception to the requirement for pre-levy CDP proceedings applies to levies issued to collect a Federal tax liability from a State tax refund. In this context, the taxpayer is provided an opportunity for a CDP hearing within a reasonable period of time after the levy.

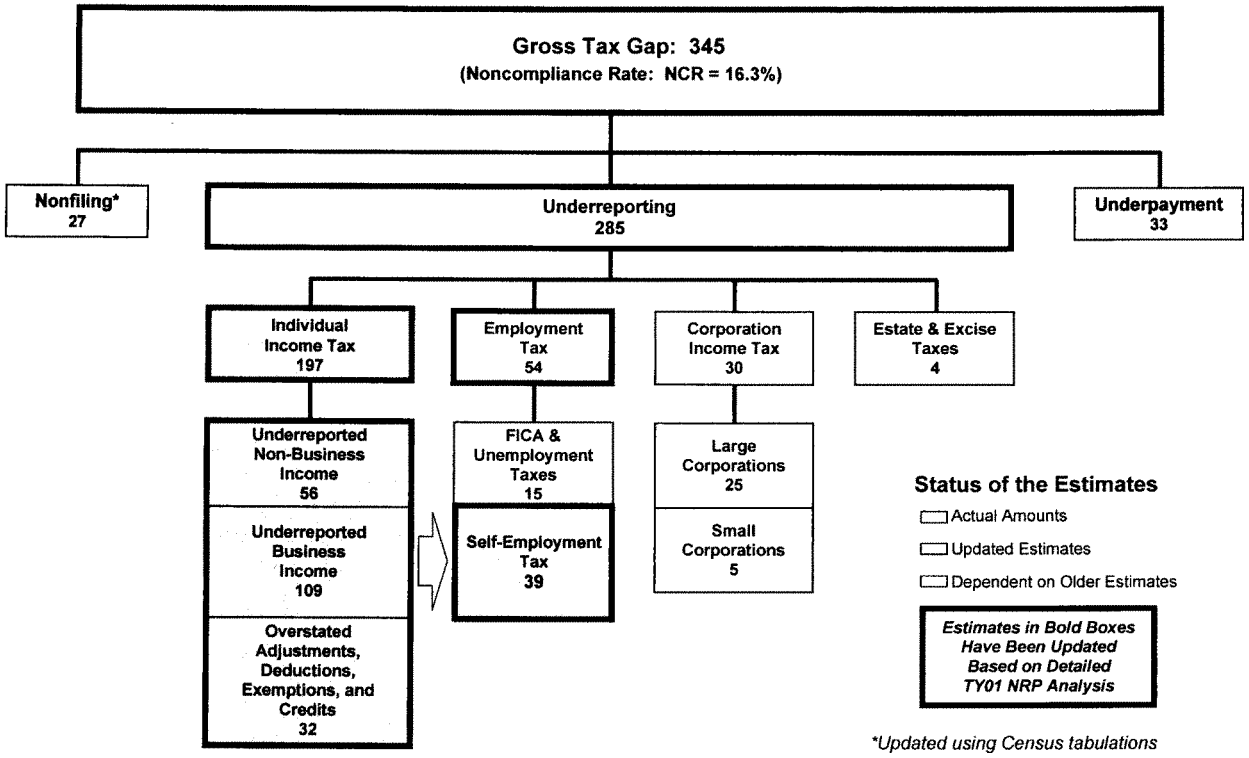
Reasons for Change
Employment taxes represent nearly one-fifth of the IRS total inventory of unpaid taxes. Frequently, an employer that fails to satisfy its Federal employment tax liabilities for one period will also fail to satisfy its liabilities for later periods, resulting in a "pyramiding" of unpaid taxes. Some employers who request a CDP hearing and judicial review for one tax period will continue to accrue, or pyramid, their employment tax liabilities during the CDP proceedings. Liabilities for these subsequent periods cannot be collected by levy until after the employer has been given notice and opportunity for hearing and judicial review for each period. The existing CDP framework compounds the pyramiding problem by allowing employers to continue to accrue Federal employment tax obligations without risk of collection action.

Proposal
The proposal would expand the exception to the requirement for pre-levy CDP proceedings to include levies issued to collect Federal employment taxes. As with the current procedures applicable to levies issued to collect a Federal tax liability from State tax refunds, the taxpayer would be provided an opportunity for a CDP hearing within a reasonable period of time after the levy. Collection by levy would be allowed to continue during the CDP proceedings. Taxpayers would retain their current right to seek managerial appeal of a proposed levy and to participate in the formal Collection Appeals Process before a levy is issued.

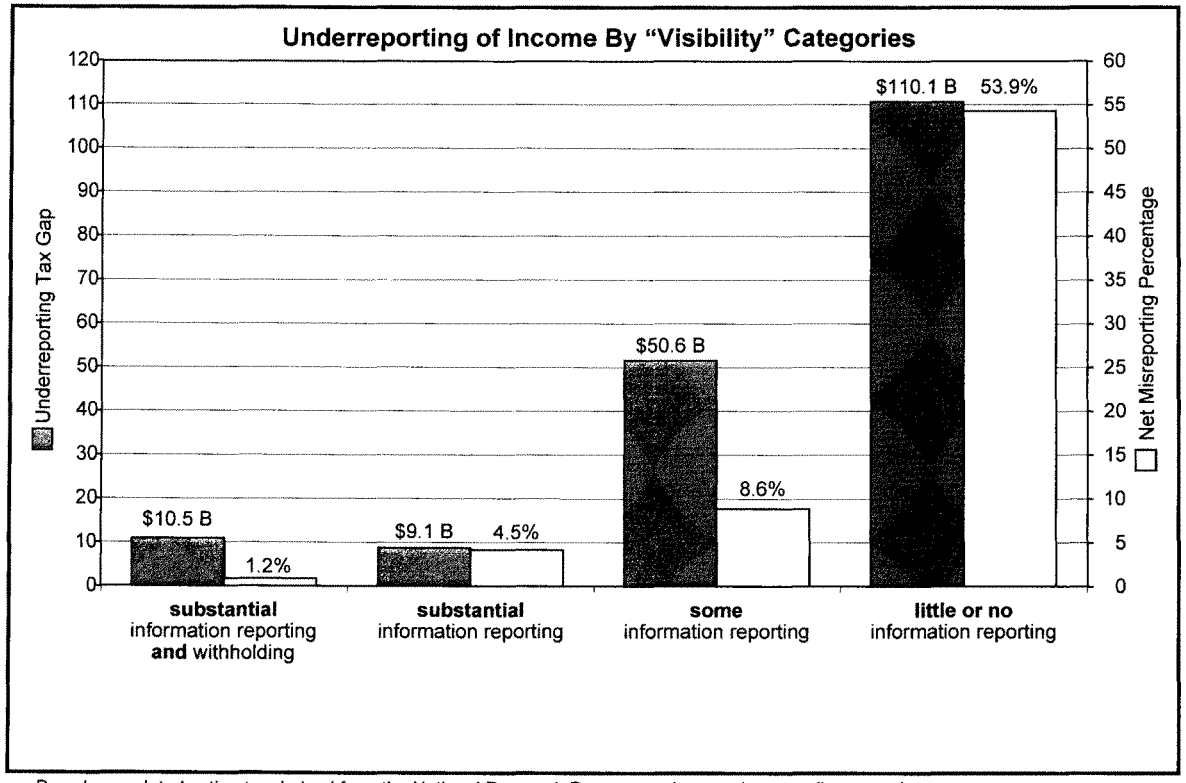
The proposal would be effective for levies issued on or after January 1, 2007.

Tax Year 2001 FEDERAL TAX GAP

(in Billions of Dollars)



Tax Year 2001 Individual Income Tax Underreporting Gap



Based on updated estimates derived from the National Research Program underreporting compliance study.

Individual Income Tax Underreporting Gap
Items Subject to Little or No Information Reporting

Category	Tax Gap* ($ Billions)	Net Misreporting Percentage
All Items	**110.1**	**53.9%**
Form 4797 Income	3.3	64.4%
Other Income	22.6	63.5%
Schedule C Income	68.0	57.1%
Farm Income	5.8	72.0%
Rents & Royalties	13.4	51.3%
Total Adjustments	-3.0	-21.1%

*Tax Year 2001 (Source – NRP)

Tax Year 2001 Individual Income Tax Underreporting Gap
Selected Schedule C Income & Expense Line Items

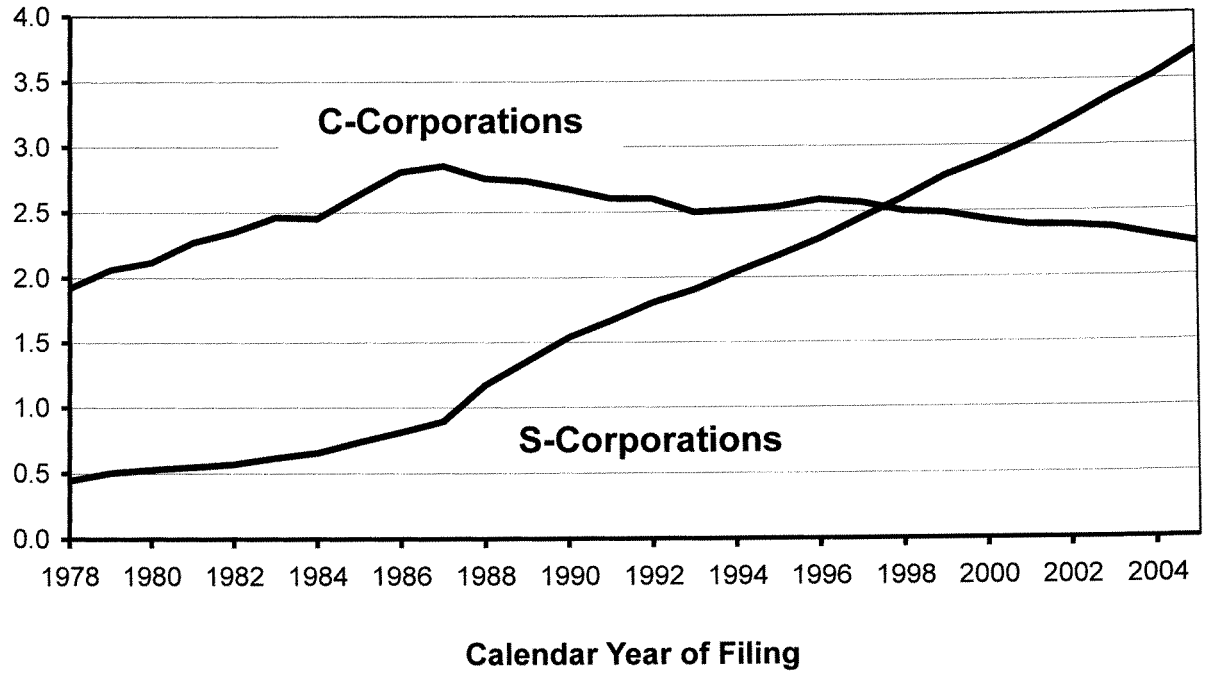
Schedule C Category	Net Misreported Amount with Undetected Income ($Billions)	Tax Gap ($Billions)
Net Profit or Loss	327.3	68.0
Gross Income	186.2	38.6
Gross Receipts	187.6	38.5
Cost of Goods Sold, Other Income and Returns and Allowances	(1.4)	0.1
Total Expenses	141.1	29.4
Part V Expenses (Telephone, Postage, Bank Fees, Dues, Contract Labor, etc.)	31.4	6.6
Car and Truck Expenses	28.0	5.4
Depreciation	10.4	2.3
Supplies	10.2	2.1
Travel, Meals, and Entertainment	9.4	2.1
Rent or Lease	8.8	1.8
Other Schedule C Expenses and Home Business Use	42.9	9.1

Source: NRP

Selected IRS Coverage Rates – FY 2005

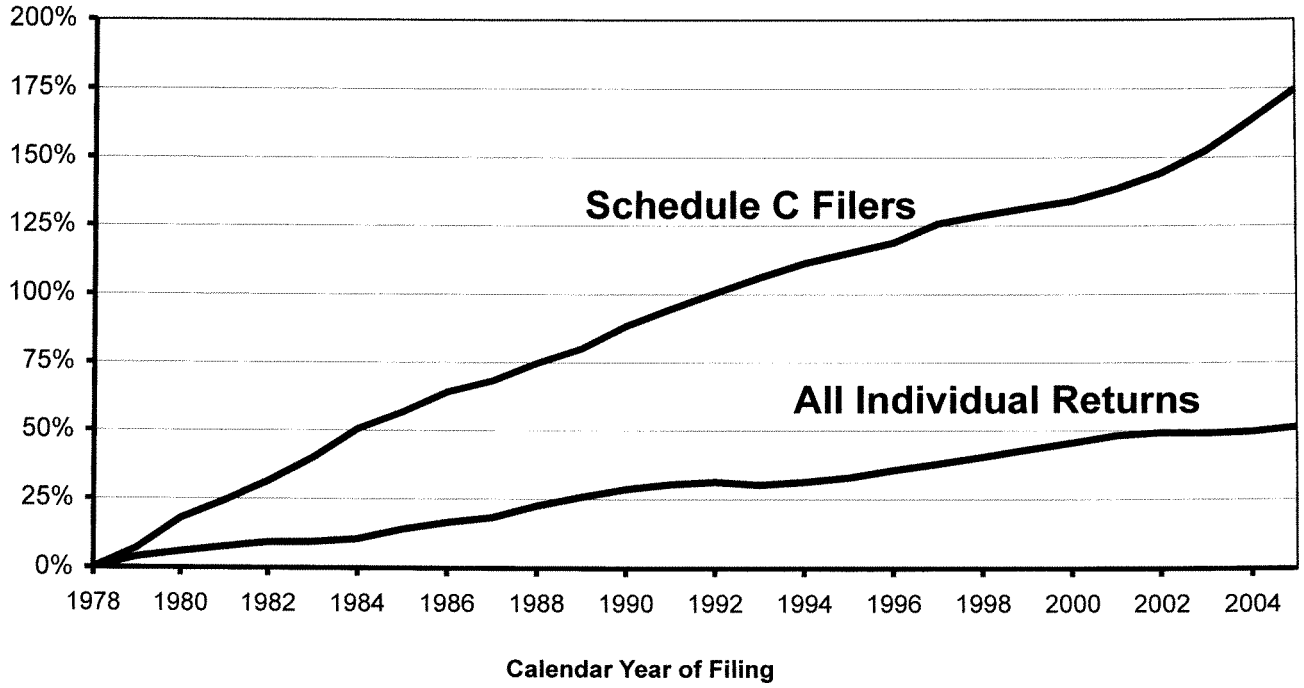
Corporate with Assets > $250M	44.06%
Estate Tax with Gross Estate > $5M	28.12%
Corporate with Assets $10M - $250M	13.86%
Individual with Income > $1M	5.23%
Individual Business with Schedule C	3.07%
Individual with EITC	2.39%
All Individuals	0.93%
1120S Corporations	0.30%
Employment Tax Returns	0.11%

Millions of Forms 1120 Filed



* Form 1120 "C" is a summation of the following corporate form types: Forms 1120/1120A/1120L/SF/FSC/REIT/RIC

Percent Growth in Individual Income Tax Returns Filed



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May 2, 2006

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

Dear Chairman Manzullo:

The American Bankers Association ("ABA") is pleased to provide comments for the record of the House Committee on Small Business's April 5, 2006 hearing to examine the Internal Revenue Service's ("IRS") latest enforcement actions. Our comments are focused specifically on the proposal in the Administration's Fiscal Year 2007 budget to require payment card issuers to annually report to the IRS the aggregate reimbursement payments made to merchants and to impose backup withholding on certain payment card transactions.

The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

As a general matter, the ABA is deeply concerned about the IRS's policy direction that is geared toward significantly expanding the burdens on the banking sector to financially "eavesdrop" on its customers. We are also concerned about the proposed backup withholding requirements that would make it mandatory for a payor to withhold from payments processed for a payee. The entire proposal – reporting and backup withholding requirements – seems to presume that the small business community is guilty until proven innocent when it comes to paying their share of Federal taxes.

While the banking industry is a willing partner with the Federal government in such important tasks as fighting money laundering and terrorist financing initiatives, we believe it is wholly inappropriate for the IRS to transfer part of its responsibility for enforcement of the income tax code onto thousands of financial institutions. In addition to our general policy concerns with the proposal, we are troubled by the fact that it would impose numerous regulatory burdens and added costs on the industry which are, effectively, unfunded mandates, not to mention the establishment of penalty provisions intended to ensure compliance. These increased burdens would be a drain on corporate resources that are needed to serve our customers.

ABA representatives met with officials from the Department of the Treasury and the IRS on April 6th to discuss the Administration's payment card information reporting proposal. The meeting was scheduled to try to gain a better understanding of the elements of the proposal, since the description in the Treasury Department's "General Explanation of the Administration's Fiscal Year 2007 Revenue Proposals" (the "Blue Book") is quite vague. There is no clear definition of which financial institutions would be required to report and no clear definition of the term "merchant." Further, the Blue Book would appear to require "payment card issuers" to provide information reports on merchants with whom they lack privity (i.e., have no financial contractual relationship).

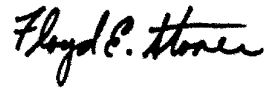
At the meeting, ABA representatives asked the Treasury and IRS officials present to provide a specific explanation of how the proposal was intended to operate. It quickly became clear that there was not a full understanding of the credit card industry and the complicated sequence of events that take place in the processing of credit card transactions. When they recognized that the proposal as described in the Blue Book would be extremely difficult to institute, they essentially requested that the ABA design the most efficient payment card reimbursement information reporting regime. We believe it is wholly inappropriate: (1) to require this reporting and (2) to expect the ABA to be responsible for developing a structure with which it disagrees. Our membership would not support such efforts, as the result will be significantly increased burdens and costs with no added benefit to our members.

Our greatest concern is that by requiring financial institutions to report annual payment card amounts processed on behalf of their customers (and to impose withholding on such amounts when requested to do so by the IRS), the proposal would place financial institutions in an adversarial position vis-à-vis their customers. While we recognize that the banking industry aids the Federal government already in certain other tax reporting efforts, we believe that this proposal moves us much further down a dangerous slippery slope that increasingly forces our industry to serve as de facto government enforcement entities. Forcing the banking industry into this role does not serve our shareholders, our employees and most importantly, our customers.

The ABA recognizes that the growing size of the annual tax gap is a serious concern for the Federal government. As IRS Commissioner Mark Everson's testimony to the Committee indicates, data gathered by the IRS in its National Research Program suggests that the largest source of the tax gap, approximately $197 billion annually, comes from under-reporting of income by individual taxpayers. Over half ($109 billion) of that amount comes from understated net business income (unreported receipts and overstated expenses). The proposed payment card information reporting regime is estimated by the Treasury to raise only $20 million annually in additional tax receipts — a miniscule percentage of the annual $109 billion tax gap due to understated net business income. We do not believe that the benefits to be derived from collecting this relatively small amount of additional revenue each year come even close to justifying the costs (both economic and non-economic) that would be imposed on the banking industry under the proposal.

Again, we appreciate this opportunity to provide you with further comments on issues raised at the Committee's hearing. If you or your staff have any questions, please contact Larry Seyfried at (202) 663-5322 or me.

Sincerely,



Floyd E. Stoner

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