FULL COMMITTEE HEARING ON CLOSING THE TAX GAP WITHOUT CREATING BURDENS FOR SMALL BUSINESSES

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FULL COMITTEE HEARING ON CLOSING THE TAX GAP WITHOUT CREATING BURDENS FOR SMALL BUSINESSES

THURSDAY, APRIL 26, 2007

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

The Committee met, pursuant to call, at 11:00 a.m., in Room 2360 Rayburn House Office Building, Hon. Nydia Velázquez [Chairwoman of the Committee] presiding.

Present: Representatives Velázquez, Jefferson, Shuler, Larsen, Cuellar, Braley, Clarke, Sestak, Chabot, Bartlett, Akin, Heller and Jordan.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

ChairwomanVELÁZQUEZ. Good morning. I call this hearing to order to address closing the tax gap without creating burdens for small businesses.

One of the focuses of this Committee is to ensure small businesses are given every tool to comply with regulations as well as reduced paperwork burdens. No place is this more true than when it comes to the taxes. Right now, it is estimated that small businesses spend 6 billion hours complying at a cost of $260 billion. While the vast majority of taxpayers comply with their obligations, the Internal Revenue Service has estimated that a significant percentage of tax due are not paid. This problem, known as the tax gap, is the subject of today's hearing.

The IRS estimated the tax gap to be $345 billion for 2001 alone. It seems the Administration is seeking for new ways to make up for the current deficit. As made clear in the Fiscal Year 2008 revenue plan, they have wrongly determined that the best course of action is to escalate IRS enforcement efforts on small businesses. I believe there are several proposals in the plan that will impose severe hardships on the small business community, yet only narrow the tax gap by a fraction of 1 percent.

Before imposing additional reporting requirements, the IRS needs to assess whether their internal procedures can achieve this without creating excessive burdens. Small businesses are facing a number of challenges which include an overly complex tax code. Now, they are being hit with a disproportionate share of IRS enforcement efforts.

Of the $100 million enforcement initiatives in the FY 2008 budget, nearly 75 percent is directed toward small businesses. It is that fact that in our present system of taxation many of our most profitable, large corporations avoid paying taxes by shifting income to off-shore tax savings. In fact, the IRS web site cites one of 30 that the annual loss to off-shore tax shelters to be at least $70 billion. Yet, enforcement efforts remain on small businesses.

I find it puzzling when the IRS projects it will generate 50 percent more revenue for each dollar spent in enforcement for large multi-nationals. It is also troubling to know that the figures estimating the tax gap do not include recent data on the compliance levels of large corporations. That information has not been updated since 1988. Before deciding on a course of action that may harm small businesses, it is necessary to have an accurate picture of the tax gap.

Congress also needs to work together to make it easier for small businesses to comply and harder for bad actors to evade their obligations by simplifying the tax code. A good first step will be made with passage of a measure to expand and extend 179 expending. The Commissioner is right when he says that it is unfair for honest, small business taxpayers to have to compete against these tax cheats.

My advice to the IRS in crafting a tax gap plan is to consider the private costs on burdens of your proposals and do not simply focus on the revenue figures. As this country celebrates Small Business Week, we need to ensure our government is not creating unnecessarily obstacles for the small business owners who are doing the right thing.

Closing the tax gap is critical, but we must not simply replace one problem with another by burdening our small businesses. I look forward to today's testimony and I thank the witnesses for their participation.

I yield to Mr. Chabot for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr.CHABOT.

Thank you, Madam Chairwoman, and thank you for holding this hearing on closing the so-called tax gap. This term "tax gap" is the Internal Revenue Service' estimate of the difference between taxes voluntarily paid and taxes that should have been collected. For example, a tax gap is created when individuals under-report income or improperly claim credits or deductions.

The IRS estimates that the United States collects 83.7 percent of the total taxes due and let me state for the record that I believe taxes are far too high and should be reduced, but as obviously important that businesses and everyone comply with the law.

After adjusting for delinquent taxes collected by existing compliance efforts, the IRS estimates that 86.3 percent of tax revenues are collected. The net tax gap is currently estimated by the IRS National Research Program, as the Chairman indicated, nearly $350 billion for the tax year 2001 which was the last year that data is available.

Even Washington, D.C., where the words "million" and "billion" are tossed around liberally throughout the course of each day, $350

billion is quite a significant amount of revenue that is not collected each year. Because of taxpayer non-compliance, the burden of funding our nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes and that's not fair.

And again, I want to make the point that the amount of taxes, the total amount of taxes that the Federal Government collects from the American public in my view is also not fair because I think taxes are just too high.

The question becomes what do we do about it? Many small business groups have serious concerns regarding the IRS plan to address the tax gap. Already struggling under the weight of massive paperwork burdens and high taxes, many of the ideas put forth by the IRS would only make it more difficult for small businesses to keep their head above water. While a few of the ideas put forth by the IRS has merit, the stated overall goal of increasing enforcement efforts is not the way to go.

I firmly believe that the first and best thing that we can do to address this problem is to simplify the tax code. The code has become a morass or incomprehensible rules and regulations that is growing increasingly complex. For small businesses that are just starting out, it can be exceptionally difficult to know exactly what to do and when to do it. Most small businesses pay their taxes in full and on time. However, doing so is never easy for them as the cost of complying and the difficulty in following the tax code can be overwhelming.

In 2001, the Small Business Administration's Office of Advocacy released a report on the regulatory costs faced by small firms that contained an estimate of the pay for compliance costs. The report showed that small businesses with fewer than 20 employees spend over $1200 per employee to comply with tax paperwork, record keeping and reporting requirements. This is twice the compliance cost faced by larger firms.

Another area that the IRS has not focused on enough is education and compliance assistance. The IRS itself estimates that roughly $148 billion of a gap comes from under-reported business and self-employment taxes. Expanding efforts to help businesses and the self-employed to prepare their returns accurately and on time would significantly reduce the gap without penalizing the honest people out there doing their best to comply.

Make no mistake, I do believe that enforcement must be a factor in the equation. Just like any segment of the population, there are always going to be bad actors out there trying to skirt the system. Finding them is not easy. We must continue to look for and penalize those who deliberately evade paying their taxes, but it must not be done at the expense of those citizens doing their best to comply with their share of the tax burden.

It's going to take a balanced approach of simplification of the tax code and again I want to emphasize that, greater education and outreach efforts to individuals and businesses in enforcement in order to make any real headway on this problem.

Madam Chairwoman, thank you again for holding this hearing. I look forward to hearing from our distinguished panels and to working with you and our colleagues in the House in a bipartisan

fashion, hopefully, as we've done on the Committee on most occasions and the Administration to address this issue.

And again I want to thank you for holding this hearing. I yield back my time.

ChairwomanVELÁZQUEZ. Thank you, Mr. Chabot. And now I welcome the Honorable Mark Everson, Commissioner of the Internal Revenue Service.

Commissioner Everson was confirmed by the U.S. Senate on May 1, 2003. Commissioner Everson is the forty-sixth Commissioner since the creation of the Agency in 1962. The American Red Cross last week announced that Commissioner Everson will be its President. We commend Commissioner Everson for his service at the IRS and wish him the best in this new position.

Thank you for coming before our Committee today.

STATEMENT OF THE HONORABLE MARK W. EVERSON, COMMISSIONER OF INTERNAL REVENUE SERVICE, U.S. DEPARTMENT OF THE TREASURY

Mr.EVERSON. Thank you, ma'am. It's a pleasure to be back here again, Chairman Velázquez, Ranking Member Chabot, Members of the Committee.

Before taking your questions, let me just say a few things about the filing season that we're just completing. At the IRS, we recognized some time ago that this would be a challenging filing season for us. Two of the reasons were Congress' late action on the extender legislation. It didn't take place until December. And the fact that we did not actually have an operating budget until the middle of February, as you know.

The one time refund of the telephone excise tax and initiation of the split refund were also of concern. Taken together, we anticipated the most difficult filing season in a number of years. Nevertheless, we have kept up with the work and the system is functioning well. The extenders were successfully implemented. Our software updates were taken care of by early February.

Electronic return filing continues to grow to almost 9 percent from a year ago at this time and our service indicators are healthy. Along with the increase in the e-file rate, we have see a 16 percent gain in our volunteer prepared returns which is a cornerstone of our outreach program.

As you may know, this effort helps eligible participants claim the earned income tax credit which lifts millions out of poverty every year.

We have, however, seen a lower than expected claim rate for the telephone excise tax refund, some 30 percent of the people haven't taken that and what I would characterize as quite minimal interest in the new split refund program.

Concerning services for the small business community, our small business, self-employed division has a vigorous outreach in education program for small businesses, including some 500 personnel who work in this area. Our office has relationships with over 1500 small business, industry and tax professional organizations. In Fiscal Year 2006 we concentrated or—pardon me, coordinated or participated in over 2000 events across the country with more than

120,000 direct participants sharing education and outreach messages and information about IRS policies and procedures.

We co-host small business fora along with the U.S. Chamber of Commerce, the NFIB, and the Small Business Legislative Council. In 2006, we began a new outreach to tax professionals through phone forums, eight national forums have been conducted by our offices across the country who have more than 1,000 participants each on various tax topics.

Let me turn to enforcement. We again enjoyed significant increases in our enforcement results in Fiscal Year 2006. And I am pleased to report we're making continued strides in Fiscal Year 2007. One of the things that I'm proudest of is that the IRS has restored the credibility of its enforcement programs without generating a significant amount of noise or increased allegations of infringement of taxpayer rights, very essential that we do it this way.

In addition, we have successfully launched the private debt collection initiative passed into law in 2004. With private companies, an estimated $1.4 billion of unpaid back taxes can be collected over 10 years. The IRS lacks the manpower to collect this money by itself. We are holding the companies to the highest standard of professionalism and integrity. The Inspector General for Tax Administration recently reported that the IRS has effectively developed and implemented the private collection program.

Concerning the President's 2008 budget, I am pleased that the President's request provides additional monies for IRS systems infrastructure and modernization as well as for enforcement and notably for increased research. There is also a modest increase for taxpayer services. This is the best budget that I have seen in my four years on the job. I ask the Members of the Committee to support the President's budget and to help enact an appropriation before Fiscal Year 2008 actually starts. That's really essential for a large operating agency like ours.

These requested monies will help us generate continued progress in attacking the tax gap, but they are not the only things we need to do. The Administration has made 16 legislative proposals. I would direct your attention to four that I think are particularly important. First, reporting of credit card gross receipts; second, making willful failure to file a tax return a felony, rather than a misdemeanor; third, requiring basis reporting for sales of securities; and fourth, lowering the threshold for mandatory electronic filing for large corporations and partnerships.

Thank you. I'd be happy to take your questions.

[The prepared statement of Mr. Everson may be found in the Appendix on page 49.]

ChairwomanVELÁZQUEZ. I will recognize Mr. Chabot.

Mr.CHABOT. Thank you very much, Madam Chair, and thank you for appearing before us this morning, Commissioner Everson.

Just a few questions. First of all, relative to the proposed reporting on payment cards from businesses, there's currently no line on the Schedule C for merchants to report their annual payment card reimbursement, so clearly these annual information reports couldn't presently be used for income matching purposes.

How exactly does the IRS intend to utilize that information?

Mr.EVERSON. Well, I think that we—what we've seen in our research, sir, is that the biggest portion of the tax gap is under reporting. A big piece of that is the income on Schedule Cs. What we believe is that if we get the information, let's take a simple example. You have a dry cleaning business, let's say. And we know that from our studies that typically half of the revenues in a business like that comes in cash and half comes in credit cards. I don't know if that's actually the case or not. But if the retailer were to be reporting to us a total receipts of $1 million, but we saw in the credit card information that would come in once a year, just once a year that the total revenues were $800,000 or $900,000 just on the credit card receipts, that would prompt us to perhaps make an inquiry. And maybe it would be a signal for audit.

What we believe is though that as soon as this reporting took place, there would be more honest reporting on the part of some who are under reporting. Let me just give the Committee the classic example of this. In '86, when the last time there was major tax reform issues, the Congress added in the ability for us to show the Social Security Numbers for dependents. Previously, that was not on the face of the form. And when that happened, the next year, 5 million dependents vanished. And that was—even though the IRS had no capability at that time to do matching at that stage, because it took a couple of years to get it all programmed. But people will just be more honest, though some people who aren't reporting honestly.

Mr.CHABOT. Let me ask you another question somewhat related. Are you concerned or is there a possibility that the proposal on additional reporting on the cards, you may run the risk of small merchants not accepting credit cards, for example?

Mr.EVERSON. I think that that—I guess, the Treasury Department has taken some comments to that effect. I think as commerce moves more and more into the credit card reporting, I don't see that as a significant issue. I had dinner last night at a restaurant. I asked the proprietor, I asked, what is your percentage of credit card receipts? He said 98.5 percent. That's his business. I think we'll get an awful lot from this if we do it.

Mr.CHABOT. Have you asked the GAO to evaluate the proposal from a cost-benefit perspective?

Mr.EVERSON. We have not, sir. What happens in these is that the Treasury Department and then the Joint Committee, they do revenue estimates and take a look at the proposals and they come up with dollar figures that they think will be generated and then those are used for scoring purposes. Typically, if you add money to our budget to hire more auditors or people doing the collection work, that cost is scored by the Congress in the budget but not the extra revenues we're going to get.

If you do a legislative proposal like these, on the other hand, that is scored and you do put an effect into the budget.

Mr.CHABOT. Madam Chair, if I have time I'll ask one additional question? Thank you.

I realize it might be more than a little difficult for IRS employees to do the education and outreach. But I think most Americans might be a little incredulous to having an IRS agent come to them and say I'm from the IRS and I want to help you. But what strate-

gies are you implementing to get the word out and get better education and those types of things out? When one considers, I think, 10 percent is going to the education effort and 90 percent going to the enforcement effort. So if you could respond?

Mr.EVERSON. Yes. If you recall the reforms that were taken by Congress in 1998, it changed the way the Service was organized to have it be organized around tax payer sort of segments. So we have one for the larger businesses and we have one that's for sort of individuals, one for tax-exempt entities. But the one that is of particular interest to this Committee is for small business and self-employed individuals.

So that unit is charged with looking at both the enforcement side and the services side. It does have a large group of dedicated people who do a lot of outreach with trade organizations and others as I have indicated. It is a cornerstone of our program. I think we've done much better. The other thing we have is we have an Office of Burden Reduction that is constantly looking at what we can do administratively.

I agree, sir, with everything you have said. Simplification is something that we have got to do, but that's—I mean, that's something that you have got to do. We're trying to do whatever we can though, and we have done some things like make it for smaller taxpayers, do their employment tax reporting annually instead of quarterly and things like that. We try to do whatever we can.

Mr.EVERSON. Madam Chair, I don't have any additional questions. Let me just comment on what the Commissioner just said. I agree. It's not the IRS' fault that the code is so complicated. It is Congress' and, whereas, in recent we have made some progress in reducing the level of taxes, whether it is capital gains or a number of other things, we've—I think Congress has failed miserably in simplifying the code, and I think that ought to be a major effort that hopefully could be worked on in a bipartisan fashion. Thank you, and I yield back.

ChairwomanVELÁZQUEZ. Mr. Cuellar?

Mr.CUELLAR. Thank you, Madam Chair, and following up on what the Ranking Member said, Commissioner, I agree with him. I think certainly there is a responsibility that we need to do in Congress when we talk about simplifications. But if I can just follow up a little bit. You talk about some of the trade groups, and I've just talked to one of the small business trade groups just a couple of days ago.

Their concern that IRS, and I appreciate the difficulty that you have to look at in your agency, but they are concerned that you're looking at, when you look at closing up the tax gap that you're looking more at the enforcement part instead of the assistance and the compliance and the customer service, and that type of assistance.

How do I respond to them in that particular area?

Mr.EVERSON. We're not going to audit our way out of this tax gap. What we have to have is a balanced program, and it includes some additional of this third-party reporting, which I know generates a lot of controversy, and you're certainly going to hear from the second panel on this. We have, as I've mentioned in my opening statement, asked for more monies our infrastructure.

We've been under funding this for years. It is very important because better systems will help us get things more accurately as we correspond back and forth with taxpayers and respond to their concerns. I think that the other thing I would indicate is that we just issued now something called the Taxpayer Assistance Blueprint, the second phase of this which is a big study that is going to help us. It's an outline, if you will, of a set of principles that will help us make decisions just in this area on service and on outreach. We've worked hard to do better here. It's not so much—I mentioned in a statement that our volunteer program, on our assistance for the elderly—this program has increased the total returns filed by over 16 percent year-on-year.

That's a phenomenal increase. That is all about outreach.

There are people who will deal with, be much more comfortable dealing with an association or dealing with a volunteer group to ask them a tax question. Not maybe as comfortable coming to the Service, particularly some of the immigrant communities and emerging areas. So we really work hard on that.

Mr.CUELLAR. Commissioner, could you on that blueprint, because I know my office has worked with your folks on there on the outreach and the taxpayer assistance. Is there anything else that you have specifically that you can provide to us in the Committee that we as Members of Congress, we work on the simplification on something else, that you can provide so we can work with you to provide some of that assistance to the small business community?

Mr.EVERSON. Yes, sir. Well, what I will do as the Chair has indicated, I'm not going to be in this job that much longer. But I will certainly make sure that our folks come see you and take you through the materials we have. One of the things we'd like, we've worked—Secretary Paulson was very strong on the EITC this filing season. And we reached out to all of your offices to try and do more outreach through your offices. I'd like to do whatever we can working with your office.

Mr.CUELLAR. If we can do that. Just one more question, Madame Chair.

As you know, when you look at the simplifications and how we can provide customer service, some of it is within the rule-making authority that you have. Could you give us an outline for the Small Business Committee following up what Mr. Chabot talked about? What is congressional—what needs congressional action and what is something that you can do within your rulemaking authority? I mean, you do have a little bit of flexibility, if I can say this. Could you give us some suggestions where we could improve customer service, improve compliance assistance for the small business and just say well, if we're going to take this action it needs congressional or statutory change, but this is something within the rulemaking authority that you might have?

Mr.EVERSON. I'm certainly happy to provide you a list of the things that we're looking at in terms of administration burden reduction. It's a changing list, obviously. But the problem is more on the other side where we feel we're following what the Congress has said.

Let me give you an example. People complained in this community about a very complicated, something like a 22 part test.

There's a manual this big about what's an employee versus an independent contractor. The Congress wrote into law in I think it was 1977—1978, pardon me—saying that you can't change this definition or issue any regs on it. That's an example of an area where there is a lot of ambiguity. It's very hard for people to comply.

Mr.CUELLAR. Well, give us at least an attempt. I know it's fluid, but at least so we can get a blueprint, to give us some suggestions. I still want to see what rulemaking authority you have because I know you have a little bit of flexibility on that, sir. If you could provide those two things, I would appreciate it.

ChairwomanVELÁZQUEZ. Time has expired. Thank you. I will recognize Mr. Bartlett, but let me just say that right after Mr. Bartlett we're going to recess and go to the House vote. We will reconvene within the next half hour right after the vote.

Mr.BARTLETT. Thank you very much. As a small business person in a former life, I'm particularly sensitive to the issues that we're talking about here. Thank you, Madam Chairman, for your comments. And Ranking Member, thank you for your comments.

I have a brief statement I would like to submit to the record if that is okay. The gist of the statement is—

ChairwomanVELÁZQUEZ. No objection.

Mr.BARTLETT. —Thank you—asking the question are we sure in this effort the juice is going to be worth the squeezing?

[Laughter.]

Mr.BARTLETT. I'm sure that there are some taxes out there that we haven't collected. But maybe the harm that we do by trying to collect those taxes will not justify the effort. There are occasions when the treatment is worse than the disease. We have to be careful that this is not going to be one of those.

And now to a specific question, if I might. According to the tax gap figures for tax year 2001 released in 2007, I would like to ask you to provide to this Committee for the record the methodology, you don't have to do that today, but just provide us for the record the methodology used to arrive at these estimates. How did the IRS arrive at the conclusion that the 2001 voluntary compliance rate was 83.7 percent? Could it in fact have been 95 percent? What are the solid raw data and the methodologies including assumptions that produce the tax gap estimates?

I understand that the initial research was done in 1988. I would like those raw data sources provided as well as any updated data that this most recent research has performed and on which the tax gap estimates are based. Can you do that for us?

Mr.EVERSON. We can certainly provide details on how this was all compiled. It has been looked at by GAO and by our Inspector General and we have had outside consultants working with us. It is a very significant effort involving 46,000 individual audits. So yes, we can tell you about that. I don't know how much we'll be able to provide from 1988, but we certainly can tell you how the difference between the two approaches.

Mr.BARTLETT. For all of us who fairly pay our taxes, it is unfair that others aren't fairly paying their taxes. I think the desire for fair enforcement is everybody's goal. Our small businesses now are enormously burdened by a cumbersome code. I just want to make sure that we aren't going to make their life worse and that at the

end of the day we'll be happy that the results we get were worth the effort that we put into it.

Thank you very much and thank you Madame Chairman.

Mr.EVERSON. If I could just say one thing on that very important point. Both the Secretary and I have been very cognizant of this question. In fact, we have been criticized for not being more ambitious in some circles, Senator Baucus, Senator Conrad, in particular, saying you ought to be doing more, what you're proposing really is too modest. Because we do recognize this trade-off about burden versus the ability to get the revenues, and we think we have a good set of proposals. We're asking the Congress to work with us to enact those, but we're sensitive to going further than this. So I understand what you're saying, sir.

Mr.BARTLETT. Thank you, sir.

ChairwomanVELÁZQUEZ. Okay, so we're going to the House now and vote and come back in a half an hour.

[Recess.]

ChairwomanVELÁZQUEZ. The Committee is called to order.

Commissioner Everson, I just would like to again ask a question that was asked to you by Congressman Bartlett, but I don't feel that I didn't hear a complete answer to the question. Again, my concern is the impact that the new proposals are going to have on small businesses. I would like to ask you if either the IRS or Treasury Department conduct a cost-benefit analysis of tax cut proposals before they are offered in the Blue Book. And if so, what is the nature of this analysis?

Mr.EVERSON. We look at and estimate all of the revenues and we try to look at what we think the burden impact will be. Now it is difficult in some instances to know exactly what you're going to get, because after all a lot of this is directed at what is under reporting now. so you may not know how large the populations are. But we look at things like, I'll give you an example. We would say right now one of the proposals that I'm sure you know is generating commenting, concern is about the 1099s for corporations.

Right now, Madam Chair, we already get something like 82 million reports a year that are like that, the 1099 Miscellaneous for Independent Contractors. We anticipate that this would be another 60 million perhaps reports that we would get because of that. We don't necessarily put a cost figure on it, though, but we do estimate the revenue side.

We could develop some options there. What we tried to do is we went through the basket of proposals, ma'am, was we tried wherever we could to limit this like in the credit card reporting, so that we had the least burden for the small businesses. There were other things, as you know, that we could do. Some have advocated withholding. We're not suggesting that. Withholding gets you more compliance obviously, but is extra work. What we have tried to do is be as sensitive to the issue as possible.

ChairwomanVELÁZQUEZ. As I've mentioned in my opening statement, I am concerned by the fact that the data that the IRS is relying on in estimating the tax gap for C corporations is from the 1970s and 1980s. In fact, and in July 2005, the General Accounting Office report cited IRS official as stating that the IRS has not sys-

tematically measured large corporation tax compliance through statistically valid studies.

This despite the fact that officials acknowledge such information will be useful. I suspect that if that information was updated, the proportion of the tax gap attributed to small businesses will be significantly lower. Do you agree with that?

Mr.EVERSON. Can we look at the tax gap map, Lenny? Let me just sort of say what we did. We started with the individuals and we did the work that was 46,000 individual audits. It's very time-consuming because you're going through each line. As you say, we have no yet, the corporate piece here is sort of this train, maybe you can point to it, Lenny, right there, the under reporting. That is exactly what you said. It is using the old assumptions and updating it for certain changes. That is a relatively smaller portion. Let us go to the audit coverage now.

What I have said, ma'am, is that the way we use the data is to make audit selections and update our own internal procedures. No, no, the coverage. Right, that front one. We already have very high coverages for the large corporations. As you can see here, the percentage coverage in 2006 is one out of every three of those companies is being audited. So we have ongoing, very high coverage in contrast down here with the Schedule Cs, which is a 3 percent coverage rate.

What I have said we would not change our approach too much on the big companies based on more data in terms of total coverage. Nevertheless, we have in the budget asked for $41 million more for research. One of the things that we're going to do is get at this. I'm particularly concerned about, someone mentioned international. The international transactions, very great complexity. They are a real challenge for us in the off-shore areas. So we want to do more in that area. I assure you.

ChairwomanVELÁZQUEZ. But let me ask you. Do you have any plans to update the tax gap data for C corporations?

Mr.EVERSON. Yes, we do. We will start to work on that. We're doing some sort of macro studies on it now. But this is a tricky thing to do because if you're looking at individual you can go line by line and do it all, but a big corporation, like General Electric, are you going to audit every line? That's not the approach you take as you can imagine given the size of some of these.

ChairwomanVELÁZQUEZ. When do you plan a better picture of the tax gap regarding C schedules?

Mr.EVERSON. I would say it's going to take place over the next four of five years. If we get the money that we need—this takes several years. If you do an audit, the entity or the corporation or the individual files the return, then it takes us a lot to figure out which ones we want to look at. Right now you might be familiar, we're doing the 1120 Ss. We've already finished. We started that work a little over a year ago. We finished some of them, but those are the clearer ones. The more complex ones tend to take a little bit longer where there may be issues in sorting out. So it takes several years.

What we want to do now though, to get at one of the issues you may inferring, we don't want to just have a periodic study like in 2001 or way going back to 1988. We want to put enough money in

the base of the budget so that we can be constantly fine-tuning the research and updating it and looking across all of the different elements of the tax system.

ChairwomanVELÁZQUEZ. Let me ask you, shouldn't you wait, the Administration wait until you have a complete picture of the tax gap? And you just said that yes, you intend to do a—to try to update the tax gap data for C corporations. So my question is shouldn't the Administration have a complete picture of the tax gap before deciding on a plan, on a specific plan?

Mr.EVERSON. Let's go to the visibility chart. I think we know enough here that there are clear problems in terms of under reporting of income in the Schedule C area for the business income that—we can address that. We can address that through a combination of things. Outreach has been mentioned. Sure, that may have some impact, but the biggest issue here is just plain understatement of gross receipts. That's not so much a question of education, we believe.

What this chart does is it shows you that you have a one percent noncompliance rate on wages. That is our estimate. There are 146 million wage earners in the country and employees. There, we are getting the third-party reporting. There's actually withholding too. This says that when you get all the way out to the other end where there isn't any third party reporting, as in this instance, this credit card proposal that we're getting to, that there is a noncompliance rate of something like 50 percent.

I think we know enough to make these proposals. The trick though is what we got to before. It's this balance. How much do you do and how many proposals do you put in? That's the trick, I would say.

ChairwomanVELÁZQUEZ. Mr. Everson, I think that also we know enough, or maybe you should know enough about corporations and accounting firms that are becoming aggressively, increasingly aggressive in seeking ways to shift their profits on paper into offshore tax havens in order to avoid tax obligation. In fact, the General Accounting Office has stated that abusive tax shelters are costing the federal government tens of billions of dollars in revenues and that the IRS faces challenges in addressing the abusive shelter workload.

It seems to me that instead of skewing enforcement resources towards small businesses, you should be investing more to address the abusive shelter workload. Why isn't this the case?

Mr.EVERSON. Well, I think that if you look over what we have done over the last four years, we have made shelters in particular both for corporations and high-income individuals a centerpiece of our work. So we started there and we have increased audits generally, but we have not, I think, addressed that much additional focus I would say to you on small businesses in particular. We started with the high income individuals and the corporations.

Now the other piece that you're getting at which is so complicated is the international. Now a lot of the problem there, it's not only—it's not only things that we would consider in the tax gap. It would also be the manipulation through tax arbitrage and the establishment of sophisticated transactions which are actually, arguably legal but they're taking advantage of one thing is debt in

one country and treated as equity by another, and then you structure transactions to minimize taxes that way.

There's a lot of complexity here. It is the hardest thing for us to get after, but we devoted more resources to it. It is an area of focus. I have chaired something called the Forum on Tax Administration which works on it.

ChairwomanVELÁZQUEZ. What would you say is the biggest challenge in addressing the abusive shelter problem?

Mr.EVERSON. Well, the biggest problem in the abusive shelter had been I would say the practitioners. What happened, you've got Don Alexander here. Not everybody is as scrupulously adherent to the standards of the law as Commissioner Alexander. Things got quite—they got quite wild a few years ago with attorneys and accountants trying to outdo each other, setting up transactions that in many instances were inappropriate. Now I think some of that through efforts of the Service and the Justice Department, stepping in strongly we've turned a corner on that. But there still is a lot of problems out there.

ChairwomanVELÁZQUEZ. Okay, my last question on this round before I turned to Mr. Chabot. You're enforcement budget request, it doesn't make a lot of sense to me, basically because nearly three times as much money is being requested for enforcement against small businesses than for large multi-nationals. Meanwhile, the IRS says it generates 50 percent more revenue for each dollar spent on large, multi-national businesses. Why is it that this enforcement budget request is not more balanced?

Mr.EVERSON. Well, again I think that what we're trying to do here is address where this very large portion of the tax gap is, which is in under reporting by individuals. We are adding $26 million to the large corporate piece, which is about what we can take. The work force is much larger on the small business area, because that's a much bigger piece of the economy, as you would know so well.

What we do is we are adding an enforcement personnel, pretty much what we can in each of these areas, frankly.

ChairwomanVELÁZQUEZ. Mr. Chabot?

Mr.CHABOT. Thank you, Madam Chair. I just have a couple of questions and you've covered quite a bit in your questions, too, and I certainly won't repeat that. But Mr. Commissioner, let me ask you this, if I can. On average, how long would it take, I know this is going to vary extraordinarily depending on the size of the business and the complexity of the return, but what is your range on the typical audit for a small business, how much time that it would take, and again, I know you can't just say it's eight hours or ten hours or whatever.

Mr.EVERSON. I'd want to get back to you. It's something that we could certainly tell you how, what the norms are and then what the ranges will be, but it all depends on whether issues can be settled out, or whether documentation can be brought—it can take some time, but those are obviously much simpler than you get into the big companies. The big companies takes years. It's actually something I've been concerned about. It takes too long.

Mr.CHABOT. Thank you. In previous hearings on this topic, several witnesses brought up the idea that the IRS could help address

the issue by modernizing their systems to take advantage of the information that they already collect. Would you comment on this and are there any inefficiencies that you could address internally or need help from Congress to address internally?

Mr.EVERSON. Yes, sir. As I indicated before, I really do think this is the best budget request that I've seen in my four years on this job. And one of the reasons that's the case is because it provides adequate funding to improve our infrastructure. Your point is absolutely correct. Good infrastructure supports both the service side of the IRS and the enforcement side of the IRS, so we need to invest more on that. There are new monies in there that do that, both on terms of the core sort of infrastructure and also what we call modernization efforts within the IRS, so that is the good, the real good news on the budget.

Going to your point, I would tell you that my personnel, my managers tell me if you said, Mark, I'm going to give you an extra $30 million, you have to choose whether it's in better systems or additional people. They would take it in the systems is where they are now. So that really is job one and that's a good component of the new budget.

Mr.CHABOT. Thank you. Before I yield back, the charts you had there before, there was just one of the lines—

Mr.EVERSON. Percentage coverage?

Mr.CHABOT. Not that one. It had the list of—

Mr.EVERSON. Yes, sir.

Mr.CHABOT. That's it. The very bottom line, "employment tax returns", then it was .13 percent. What is that exactly?

Mr.EVERSON. That is an audit of whether the tax return that a business will be filing on what it's withholding for Social Security or Medicare, the employment taxes. Most of our work in that area is in the collections side where what happens is we get into problems where a business and it can often—it's typically a small business, the business will get a little behind, getting squeezed and then they don't make the current payments. They've been withholding the taxes for you as an employee, but then they get behind on making the quarterly payments. We try to step in very quickly there because what happens is it just compounds itself and they get in deeper and deeper. It's a lot of well-meaning folks who are trying to stay in business and we work with them. If they're a couple of quarters behind and they can demonstrate to us that they can get current for that quarter, and then start to work out the other piece, then we'll work with them, but otherwise, if they're just going to keep shorting the government and not sending on the money they have withheld from the employee, then we'll really step in.

We don't do that many audits there. We don't find that the employer has really—we don't see that as a problem area.

Mr.CHABOT. Thank you. One other thing, I apologize, one other thing comes to mind. I'd just like to maybe emphasize and reiterate what our colleague Roscoe Bartlett said much better than I am going to be able to repeat it now, but he said something about squeezing the orange and getting the juice out of something like that.

Mr.EVERSON. He said is the juice worth the squeeze.

Mr.CHABOT. That was it. Yes. And I have to say I agree with him and want to make sure that we kind of keep our eye on the ball here. We definitely, if you have businesses or individuals that are intentionally or even accidentally but are either evading or not paying their fair share, they certainly because it does put the burden on the rest of the folks that are doing what they're supposed to be doing, both individuals and small businesses especially. But we don't want to have one additional burden on the small business community where we're trying to squeeze out every last dollar and creating kind of a paperwork monster on these folks who are already struggling in a very competitive environment already.

I would just urge to the extent that you're able to commit to us to going after those tax dollars that are owed, but not making it any more burdensome on the small business community than necessary.

Mr.EVERSON. I think that's good counsel and both the Secretary and I really feel quite strongly that you've got to be careful about how far you do go and as I indicated before, we've both been criticized by a number of people in the Congress for not having more robust proposals going after the tax gap, but I think it reflects our appreciation of just this tricky question you're getting at.

Mr.CHABOT. Thank you very much.

ChairwomanVELÁZQUEZ. Mr. Sestak?

Mr.SESTAK. Thank you, ma'am. Sir, just a couple of specific questions just for my edification. One of the proposals in the Blue Book was to expeditiously verify TINs.

Mr.EVERSON. Yes.

Mr.SESTAK. If that were to come about, what would have to be done for IRS to be able to verify it expeditiously which has got to be one of the major challenges.

Mr.EVERSON. Yes, sir. This proposal gets at this question of whether there's some misrepresentations, someone saying you don't have to give me a 1099 under the existing standard because I'm not an independent contractor. I'm a corporation.

My understanding is we do have already enough automation to be able to handle this comfortably. It's not one of the proposals. Some of the proposals require additional investment. We provided for those monies in the budget. I don't believe that this is one of the cases where we feel we would have difficulty on it.

Mr.SESTAK. I've heard you speak about PCAs.

Mr.EVERSON. Yes.

Mr.SESTAK. But also the comment has been made that we're getting what we expected from them. What does that mean? What are the figures for it, the return on it?

Mr.EVERSON. Thus far, over the life of the program through the middle of April, we've received almost $20 million that has come in through the program and then you have to back off of that $3 or $3.5 million from the commissions that they earn. So for this fiscal year, it's about at a break even point considering the investments we've made.

We expect the program—

Mr.SESTAK. Break even after how many years, is it three?

Mr.EVERSON. No, no, not even. It was put into law in October of 2005, but after we had to develop it and go through the procure-

ments, we did not start it until September of this past year. So it is really still a very new program.

We expect to recoup the whole investment, the systems that we put in and everything else, by about a year from now. And then the comment, I freely acknowledge that we could do this work as well or better. We've got great employees who are trained. The constraint we have though, sir, is that right now as with many other agencies in the government, we have a lot of attrition. There's a lot of churning in the workforce, okay. Our churning is running at something like 8 or 10 percent, so then when you build on top of that the enforcement initiatives that we're talking about here today, with the $230, $240 million we're asking for, that adds more people. There's only so many people you can add in a given period without losing control of your training and everything else.

What I have said to the appropriators, your colleague, Congressman Serrano, particularly, we got into this at a hearing a few weeks ago, is that we would not be able to do this work for a number of years. You have to be giving us these increases of the magnitude that we've asked for several years before we'd be in a position to get after this money.

Mr.SESTAK. The third is you said in your testimony that you've increased the audit of those who earn over $1 million by 78 percent. What's the number change? How many to how many?

Mr.EVERSON. I'd have to get you that, but what we have now is about a—it's over—I think it's like 6.3 percent for the—over $1 million. If you take a look again, that's what it is.

Mr.SESTAK. The number of individuals?

Mr.EVERSON. Yes, the individuals with income over $1 million, we audit 6.3 percent last year. That was up from around 5.

Mr.SESTAK. I see.

Mr.EVERSON. If we go to that one you've got right there, individuals, it sort of gets me to another point I would like to make. The centerpiece of what I've tried to do over the last four years has been to do more for high income individuals and corporations. And if you see here this starts in '01 which was a transition year. Clinton-Bush, first part of that year was under President Clinton, the second part of that is under this President.

You can see the growth. The EITC is the green line. We have brought those up but then I took a decision in '05 to flat-line those because we were getting a lot more efficiency, but we rediverted. We diverted our resources into that blue line which is audits of individuals under $100,000. And the real growth, you can see, has been over $100,000. So we really have worked on this. A lot of it gets back into the shelter question and this has been very successful for us because a lot of the money is up there.

Mr.SESTAK. Last two. In your comment, when you say that you're going to put like $73 million in to get $144 million in more revenues from small businesses, does that include what you always talk about, that 3 percent of indirect revenue where people are deterred?

Mr.EVERSON. No, sir.

Mr.SESTAK. That's just what you expect from actually the enforcement? Is that correct?

Mr.EVERSON. That's right. What we have said in this, all the proposals that we've made in the legislative side, they would get about $3 billion in direct.

In the budget side, the money that we're asking for in the budget, we've said that would get I think it's $700 million of direct. We have conservatively and we think this is conservative, stated it 3 to 1 indirect.

Mr.SESTAK. I've got it. Last question is I honestly believe from my background you kind of expect what you inspect. And my take on it is some of your proposals that you have on the merchant payment card reimbursements or the verification of TIM or the payments to corporations, my question is even though the study says that a large proportion comes through small businesses and this may have already been asked, do you see a greater return for every dollar for enforcement on small businesses, X amount of dollars out for revenue enhancement, as compared to big business, even though the study says there's a smaller pool of revenue to be garnered? And if so, even though there's a bigger pool in the small businesses, if the return is better for bigger business, shouldn't more enhancement enforcement be there?

Mr.EVERSON. We are increasing what we're doing on bigger businesses. First of all—

Mr.SESTAK. $23 million compared to $73 million for small businesses.

Mr.EVERSON. The small businesses are a bigger piece.

Mr.SESTAK. But is there a better return?

Mr.EVERSON. The returns vary. Going after the complicated bigger businesses can take many, many years. The best returns we have—

Mr.SESTAK. The only reason I ask is your testimony shows that $73 million into small businesses will you give a 2 to 1 return, $144.

Mr.EVERSON. Right.

Mr.SESTAK. The other one, the 23, it's a 3 to 1 return.

Mr.EVERSON. Right.

Mr.SESTAK. When you add up all your seven proposals that you have, the last two you don't show what the returns are on the criminal investigation and—

Mr.EVERSON. We don't calculate it.

Mr.SESTAK. But if you did look at that, that's a 4 to 1 return. Is it right to go after the 2 to 1 return, if you're getting 4 to 1 in other areas or 3 to 1 in other areas? I'm not saying you shouldn't. I honestly think you should make sure you're fair across the board. But are you putting the marginal dollar in the best enforcement pot to get the best return, if you are a business?

Mr.EVERSON. We don't approach it that way. We try to run a balanced program.

Mr.SESTAK. Should we approach it that way? Because this is all about getting more dollars back.

Mr.EVERSON. I don't believe we should in terms of the easiest, the returns that you would do the most on, earned income tax credit. You've got a very high return on that. And in the middle class, some of the work you do in the middle class, you get a very easy return or some of the collection work you get a better return. We

don't get any return of significance in the short term on the work we do on charities, as an example, because there's a tax exemption there.

Mr.SESTAK. You show in your testimony you get about a $15 million return on charities by looking at them. So you do get a return.

Mr.EVERSON. I'm not sure which piece of that proposal you're talking about, but generally speaking, what I'm saying is a general rule, we have several thousand people working on what are tax-exempt areas.

Mr.SESTAK. Your $50 million to create tax-exempt entities compliance?

Mr.EVERSON. That's a budget increase that we're making, but I don't think we have anything revenue-associated with that. Over the long term, sir, if we don't draw the line between what is tax-exempt and what is not, you'll have an erosion of the revenue base. So we have to run a balanced program. This does represent our view of what is good, strong steps to take now.

Mr.SESTAK. I understand. And then just it seems though when you look, you have gone up $15 billion. You're now at $50 billion approximately a year now, at $45 billion gap which was studied five years ago, so what is it today? That's still just a 1 in 7 return. It just seems as though getting the dollar back in with close to $9 trillion deficit maybe—shouldn't we look at it a little bit more? Having a return across all the various channels, but isn't it almost becoming a business proposition now if we can get your best return?

Mr.EVERSON. I don't like to view it that way. I view it as trying to trying to run a balanced program across all of the responsibilities that the IRS has and I think what we've done is we've added to each of those areas and in my tenure, again, we've given great emphasis in the area of tax-exempt and governmental entities and they aren't viewed as generating that kind of return.

Mr.SESTAK. Thank you, sir.

ChairwomanVELÁZQUEZ. Mr. Jefferson.

Mr.JEFFERSON. Thank you, Madam Chair. Good afternoon, Mr. Everson.

Mr.EVERSON. Good afternoon, sir.

Mr.JEFFERSON. In your written testimony here, you say that in more than one place we cannot determine how much of the gap is attributable to willful noncompliance and how much is a result of a lack of understanding by the taxpayer, his or her full tax obligation. Why is that the case?

Mr.EVERSON. Well, I think that as you go through and you do these audits, you have penalties that would be associated with willful noncompliance that could be more onerous. And the individual would not obviously admit that they were willfully being non compliant is one factor that I would suggest to you. So you have to exercise a fair amount of judgment as the auditor as to whether you're going to assess that penalty or not.

Mr.JEFFERSON. There has to be a long history with the IRS collection system.

Mr.EVERSON. That's right. And part of it is research on service, if I can get to the other piece of this, has been lacking. One of the things we're asking for more money in here to try and get a little

bit of a better understanding on just what, if you provide better service and education, what will that do.

Mr.JEFFERSON. It just seems to me that if you don't know which it is, and you make decisions where you apply more resources to enforcement over compliance, but you don't know which is worse, I don't know how you come to a decision. Here's almost 3 to 1 on enforcement, I guess because you just—it seems to me you've got to find some way to figure which is a greater problem, so you can apply the resources accordingly.

Mr.EVERSON. Right.

Mr.JEFFERSON. And without that, then you simply seem to just opted for the enforcement angle as opposed to the compliance angle.

Now small businesses, you admit in here that complexity is a big issue and it obscures the understanding of the code. I would suspect that the complexity issues go more to the smaller concerns, it seems to me more difficult to understand it and have the advice you need from accountants and lawyers who clears these things up for people.

And so doesn't it seem to follow that we ought to do as much as we can to make sure that before we get to the issue of enforcement and audits and so on, this complexity issue is really, really addressed properly by your Agency and that you take all the time you need to invest, all the resources you need, and ask us for as much as you need to make that determination clearly so that we don't overburden small business people because of the complexity issues and lack of compliance as opposed to intentional under-reporting.

Mr.EVERSON. I would say to you, sir, it comes back to the earlier conversation. The complexity starts with the nature of the law itself and simplification of the code will do a lot for compliance.

Mr.JEFFERSON. We can't do that. We hear about that all the time, so that's not going to work.

Mr.EVERSON. You can do that, I can't do that.

Mr.JEFFERSON. It hasn't happened here. So we're talking about stuff that isn't going to happen on the complexity side. We've tried—everybody has a simplification proposal, but it never works. The world that we live in is one of a complex tax code. That being the case, we ought to deal with the issue of compliance, given the complexity that's obviously there and we aren't in any quick way get rid of. I know we have it within our power theoretically, but as a practical matter, just never happens.

Now—I'm sorry.

Mr.EVERSON. No. That's a direct response. I won't—I'm not going to agree totally with that.

(Laughter.)

Get myself in trouble with others. We are, as I indicated earlier, we have this taxpayer assistance blueprint where we're looking at all these issues about how we better educate and how we serve the taxpayer, but I do have to say on this one area which is so large, the understatement of receipts, I don't think that's a question of education. That's why this credit card proposal we think is such a good one. We think we'll get better reporting on that.

Mr.JEFFERSON. You have a lot of elements of the under reporting over here. Let's see if I can find it. Well, I don't seem to see it here.

All the way from having deduction exemption reported incorrectly to simply failing to report—overstated reductions of income, under reporting of nonbusiness income, all that sort of business.

Mr.EVERSON. Yes.

Mr.JEFFERSON. Some of these require determinations as to how it ought to be categorized and how you—what you essentially have to make of it and some of them, of course, you know, it's a lot less complicated.

But in any event, my point is that we ought to really, given that we're dealing with this issue complexity, we've spent a lot of time on the issue of compliance through education. Now the last little thing I want to say here, you talk about high-risk tax returns. What do you mean when you refer to that? Under the funding or increased audits of high-risk tax returns. What does that mean?

Mr.EVERSON. Well, we see high-income individuals where they're working at a level of complexity, they might have lots of K-1s or different investments and things that we have seen historically some problems with. You can get into this international area that we were talking about a little bit before. There are certain categories which would fall into the higher risk. The Schedule C where we would see certain relationships. What we've done with our research is we've updated our audit selection models and we go through and we look at each return and we see how it relates to other comparable returns. And if we see a problem, it's outside the norm, that would make it higher risk.

Mr.JEFFERSON. Does it have anything to do with the kind of how small the concern is or where the concern is located, the part of town it's from, any of those things have anything to do with higher risk?

Mr.EVERSON. I wouldn't say that they generally would. I mean you're looking—again, we have to have a balance. We try to do across a range of size of organizations and both individuals and incorporated businesses.

Mr.JEFFERSON. This really is the last thing, Madam Chair. The EITC, these are really small people here. These are people who are working poor folks who don't make enough to meet the poverty wage that are working and therefore we give them a refundable tax credit.

This has to be an area in many cases where people just don't understand what's going on with this whole area of taxation. This cries out for some sort of assistance to taxpayers to make this work right. In your experience, how much assistance are we giving to folks in the EITC area and before we condemn them as not meeting their responsibilities of the system?

Mr.EVERSON. One of the things we've really worked on over the last several years is increasing the outreach in this area. I mentioned earlier the fact that this year there's been a 16 percent increase in volunteer-prepared returns. We work—there are 12,000 sites around the country that are mostly community-based where organizations work with individuals. And it's all based on—it's typically based on income and a large part of it is geared towards EITC. I've done events with Congressman Lewis, Congressman Emmanuel and others to try to champion just these sorts of coalitions because they're highly effective because in many instances

people in that population, they'll feel more comfortable coming in and working with a community-based organization than they will coming directly to the IRS.

The EITC is terribly important, both the Secretary and I believe it needs to be increased. As you may know, something like our calculation is about 75 or 80 percent of eligible claimants take the credit. That means there are still millions more who could and are not.

ChairwomanVELÁZQUEZ. I will ask if the gentleman doesn't have any more questions, a last question, Commissioner. It has been widely reported in the media that IRS auditors are being forced to close larger corporate cases prematurely, allowing billions in tax dollars to go unpaid. Agents have said that unless they were free to pursue what their instincts told them, their focus will end up being only on non-abuses. New tax shelters crated by the tax advice industry will go undetected.

What are your comments on that?

Mr.EVERSON. Yes. I'm happy to address that. It's come up almost every year. Like with the audits of individuals, the audits of corporations, large corporations, we're talking about over $10 million, they had decreased. Do they have this chart? I think you have this chart in your packet.

And you can see the number of returns audited—it was going down from before this, but this is starting 2001. We brought that back up significantly from 2003 where it bottomed out. And what we wanted to do is get more coverage in this area between $10 and $250 million of assets because those are growing businesses that are going to become bigger. We were doing very little there. Now we've started adding back there.

In terms of the dollars that we've set up, if you look at this line of dollars recommended, you can see it went from $13 billion all the way up to $32 and then $27 billion in the last two years. So it's gone up very much. Now I have pushed to try and reduce the length of time it takes to do these audits. I think it's unconscionable that it takes 7, 8, 10 years to do these audits because we don't get after problems. The IRS missed the tax shelter eruption in the year like 2000, 2001 because we were looking at audits from 1992 and 1993. So I do think it's important to do our work more quickly to help to resolve that uncertainty.

Now an individual auditor though who has a problem with a decision that's being taken should take it up line, but the complaints I'm hearing is there may be more in those individual returns. That conceivably is true, but I'm not hearing complaints that we're taking them off line and sending them home to watch TV or get trained. They're going off to do other work as indicated there and to touch more corporations.

I think that's a better answer.

One final point on this, do you have the chart on the growth? Yes. This shows the growth in the last several years of corporate tax receipts as the green line is the growth in just overall dollars and they've come up sharply in the last several years and also as a percentage of GDP.

When I got on this job, I was getting a lot of tough questions about how come they're so low? You've got to get in there. I would

be concerned about what I'm hearing from a macro point of view if this wasn't recovering or we weren't setting up more dollars, but it's a tough issue. I know it's tough, particularly if you think you can do more on an individual case, but we're just saying we want you to go work somewhere else and get some money there.

ChairwomanVELÁZQUEZ. Okay. I have one final question as this will be the last time you come before this Committee. When are you leaving for your vacation? And where are you going?

Mr.EVERSON. Soon, soon. We lived in France for three years and we had a joy in 1996 of going on a boat, you know where you rent a boat, our family, and you cruise down a river for a few hours and you stop and wander around a village. My wife and I are going to do that and we're in the Cognac region and hopefully we'll get good weather. We're taking a bit of a chance here. We've got an 18-year-old, a 20-year-old and they're in school, so they're going to be home alone.

(Laughter.)

As my mother said, this is a vote of confidence in them and we think it's going to go well, but we'll see.

ChairwomanVELÁZQUEZ. I guess it's going to be a vacation for you and for them.

Mr.EVERSON. That's it. That's it.

ChairwomanVELÁZQUEZ. Well deserved. Thank you for your service, sir, and I just would like to ask you, we are going to have a second panel and for you to identify the person, your staff person that will remain here?

Mr.EVERSON. Yes, okay, in case there are follow-up questions. I think that would be Cathy. Kathy Petronchak is here and also Beth Tucker and Mark Mazer is the head of our research group if you want Mark to stay. He can certainly stay as well, because this gets into the question of the tax gap methodology.

ChairwomanVELÁZQUEZ. Thank you and you're excused.

Mr.EVERSON. Thank you, and I just want to say it's always a pleasure to be here with Don Alexander. He's a real sort of icon of the tax community.

ChairwomanVELÁZQUEZ. I would ask the second panel to take their seats. We have to put some chairs there. Thank you very much.

Well, I want to welcome all the witnesses, and I want to thank you for your participation in this important hearing. You will be given five minutes to make your presentation, and your complete testimony could be entered into the record.

So we are going to start with Mr. Keith Hall. He is the primary consultant available to the self-employed and micro business owners through the National Association of the Self-Employed Tax Talk Service. He has been involved in providing consulting and tax services to small businesses for the last 10 years through the accounting firm of Hall and Hughes in Dallas/Fort Worth. He is testifying on behalf of NASE.

Welcome.

STATEMENT OF MR. KEITH HALL, NATIONAL TAX ADVISOR, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

Mr.HALL. Thank you. Madam Chair, members of the Committee, thank you so much for the opportunity to be here today representing micro business owners. From a professional standpoint, I am first and foremost a small business owner. I have a small tax and accounting practice in Dallas, Texas. We have an administrative person, three staff accountants, and me. That is it—pretty small, but we have created five jobs where none existed before. To me, that is what small business is all about.

Outside of my kids, I am more proud of those five jobs than anything else I can think of. There are over 20 million men and women just like me out there creating jobs every day one job at a time.

Through the National Association for the Self-Employed, I get a chance to visit with thousands of those small business owners every year. Most don't ask a lot from the IRS, maybe because they don't have time, but mostly they just want a fair shake. The problems that you face every day are more complicated than those that we face, and certainly the decisions that you make affect a lot more people. But today we share the same problem in the form of the tax gap.

There is no doubt that the tax gap is a significant issue. There is no doubt that something needs to be done, and there is no doubt that you are the ones that can do something about it. But after that, I have some doubts.

The proposals that the administration and Congress are considering include increased reporting on credit card transactions, requiring ID number verification, TIN verification, implementing voluntary withholding on independent contractors, and several others affecting micro business owners. There is more detail in my written testimony, including some new ideas on how to increase compliance with minimum burden on small business, but I didn't want to put everybody to sleep this close to lunch.

In general, each of those ideas will provide more data, more information, which always seems like a good idea, but at what cost? One issue is that we can't tell what any of these ideas will really cost. All of the ideas expand current reporting systems or create new regulations, which will require additional manpower, technology, and infrastructure, both for the IRS and for small business owners trying to comply with those new rules.

The only thing we know for sure about the cost is who is going to pay for it, and that is us. Worse, we don't know the true benefit, and we don't know for sure how any of the new information will be used. There is a reasonable chance that none of the ideas will help the problem at all.

About two months ago my sister noticed a burning smell inside her new car. After several trips to the shop, several different diagnostic tests, nothing worked. They checked heating coils, oil gaskets, and even the seat warmers. But it turned out to be a plastic bag stuck to the muffler underneath her car.

That is not a great example, but the point is, no matter what they are going to do to the heating coil, it is not going to affect the smell of that burning plastic bag. I am afraid that credit card re-

porting, TIN verification, 1099 withholding, are all heating coil tests that have no chance of fixing the problem.

The plastic bag here that is causing things to smell funny is the complexity of the Tax Code itself, as we have heard before. Most small business owners are scared to death of the IRS. Most are scared to death of their own tax return. They just want to do what they are supposed to do when they are supposed to do it.

But let me be more specific. Several weeks ago, Commissioner Everson and Assistant Treasury Secretary Solomon held a roundtable discussion about the tax gap. After opening comments from everyone, Secretary Solomon proposed a question before a group for conversation. His first scenario was let us assume a small business guy who provides services and gets paid in cash but doesn't report that on their tax return. What do we do? That was his emphasis for the discussion.

I think it is interesting that he chose that example, because that is what most—most people think the tax gap is caused by. The question I have is, I mean, obviously that guy is contributing to the tax gap, but which of the proposals that we are talking about is going to catch that guy? And I think the answer is none of them, and that is my real fear.

I hope it doesn't sound like I am against any and everything, because I want that guy caught also. Every dollar that he doesn't pay is a dollar that I have to pay. But adding more reporting, more paperwork, and more costs to taxpayers, as outlined in the current proposals, won't target those who are underreporting, and will only make it more difficult for those who are currently complying to continue to comply.

I am afraid that we are shooting a bunch of arrows that really have no chance of hitting the target. My request of this Committee, as a micro business owner, is that no matter which arrows we choose to shoot, please make sure that they have a reasonable chance of hitting the target. And, more critical, please make sure that compliant taxpayers don't pay for the arrow with less support and less education.

The Commissioner has often stated that enforcement plus education equals compliance. So please don't—please keep both of those components important. Don't sacrifice education for the sake of enforcement. Current assistance from the IRS helps compliance and reduced the tax gap through education. Again, my belief is that most people want to do the right thing, so please don't take away support from the people who are trying to do the right thing solely because of those who aren't doing the right thing.

And, again, I appreciate the opportunity to be here. Thank you very much.

[The prepared statement of Mr. Hall may be found in the Appendix on page 68.]

ChairwomanVELÁZQUEZ. Thank you, Mr. Hall.

Our next witness is Mr. Paul Hense. He owns his private accounting practice in Grand Rapids, Michigan, which focuses on small business, personal tax, and financial advising. He is on the Board of Trustees for the National Small Business Association. He is speaking on behalf of the National Small Business Association.

Welcome.

STATEMENT OF MR. PAUL HENSE, CPA, PAUL HENSE, CPA, P.C., OWNER, ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr.HENSE. Thank you, Chairman Velázquez, and Ranking Member Chabot. I want to thank Todd McCracken from MSB for inviting me here, because I am a CPA from a small midwestern town. And to have an opportunity to come here and speak for my clients in the small business community is a real honor.

I do want to mention, if I am a little grouchy, I just finished tax season. My suit is tight, because I haven't lost my tax season fat yet, so I am—may be a little temperamental.

It is kind of interesting when this—when this came up, I ought to have mixed feelings. It is a little bit—I guess in pictures—put pictures in people's mind. I look at the additional paperwork. I am a little bit like an undertaker taking—being told there is a plague coming. Your first reaction is, oh, those poor people. But inside you are thinking, think of the money I am going to make.

If you add another level of complexity to the tax law, as a CPA, with a—I guess it is a small practice, there is three CPAs and five or six staff people, depending on the time of the year. But that is how we make our business.

I bought a new boat a year ago, and I think I was here testifying in another committee, and I made the comment that I was going to name the boat the Alternative Minimum Tax, because that is what paid for it. Whenever things get more complicated, as though—even though us accountants come here and complain, we make more money, but the problem is that is short-sighted on our part, because if we kill the source of our income in the long run we are going to suffer. So in the short run, over the next two or three or four or five years, I might make more money with these proposals, because I will set up the services to prepare these forums.

On the other hand, I believe that these types of proposals are the type of thing I am—part of my reputation in Grand Rapids has to do with startup. We are good at getting people off the ground. It is getting harder and harder to get businesses off the ground, because there is more and more paperwork.

And I guess a lot of older people—I am 64, a lot of people my age have always said this, "The people coming up don't know what we knew when we were their age." On the other hand, I don't think that the more complexity we add to the tax law and to running a small business, the more we close the door.

The expansion of information reporting is—I can see where the Treasury, the IRS would think that was a good idea. On the other hand, I am not sure the small business community can handle the burden.

One comment—and I am not real good with names, but the Commissioner mentioned—I am always afraid I am going to mispronounce it or—but the Commissioner mentioned the credit card issue. That they looked at dry cleaners, that this would give them an idea—and this is the difference where I am a hands-on, up-to-my-elbows-in-it accountant working with small businesses all day every day. That is what I do.

I don't deal a lot in statistics, but I do know this. If you checked a cleaners in—East Grand Rapids is our trendy, upper class part of town—you are probably going to see a lot of credit cards. Go downtown, you are probably going to see a lot of cash.

So you have got to be real careful how you use statistics, because if you are in the guts of this thing, and you are working with it every day, and you work with the real people in the real situations, you sometimes see that statistics—figures don't lie, but liars figure. Well, it is not a lie, it is just that the thing doesn't really tell you what you think it told you.

Another question that came up in my mind was this idea of providing the ID numbers for people you do business with. It seems that you are asking the small business community to do your work for you. We are going to collect more numbers, do more paperwork, ask people for more information. It just becomes overwhelming.

So now not only do we have to keep track of how much we paid them, and their address, we now have to get their federal ID number. I see some problems with that.

Blaming small business for the tax gap—I am going to tell you a couple of things—human nature. You can pass all these laws, and you can tighten the screws, and you can go all the way back to the Revolutionary times to see that the tighter you turn the screws, the smarter the real crooks get.

As you do this and put all of this paper—this squeezing juice idea was a nice idea, because you go to everybody and make this push, but the real cheaters will figure out a way to get around the paperwork. That is just the nature of the way things go.

One of the things that disturbs me in this is there is more burden going to be placed on small business, whereas the tax law is also inordinately unfair to us. We don't get the pension plans, we don't get the health care benefits, we don't get a lot of the tax breaks that normal everyday employees and government and big business get, yet when there is a problem you turn on us.

You know, I can't go have my 401(k) plan double just because, well, I have got a little extra money. I have to go—because I am the owner, I have to go through a lot of paperwork to get that benefit. The simplification is a big issue. It leads to some problems with some small businesses feeling set upon.

Improved services—I think the IRS is doing a good job—am I out of time?

ChairwomanVELÁZQUEZ. Your time is expired.

Mr.HENSE. I am done. Thank you.

ChairwomanVELÁZQUEZ. But you could wrap up if you want.

Mr.HENSE. I am very concerned that this is like throwing we blanket on a hot fire. Small business, the engine that drives the economy, we don't want to put that fire out.

Thank you.

[The prepared statement of Mr. Hense may be found in the Appendix on page 75.]

ChairwomanVELÁZQUEZ. Thank you, Mr. Hense.

Our next witness is Mr. James Brennan. He is a partner with Ernst & Young in New York City, practicing in their tax controversy and risk management services group. Prior to joining Ernst & Young in 1983, he was with the IRS Appeals Division. Jim

is testifying on behalf of the American Institute of Certified Public Accountants.

Welcome.

STATEMENT OF MR. JAMES E. BRENNAN, CPA, ERNST & YOUNG, LLP, ON BEHALF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr.BRENNAN. Thank you. Myself and the AICPA want to thank the House Small Business Committee for this opportunity, for this hearing on the tax gap, the impact on small business, where small business, you know, plays in this whole tax gap debate. And I find this a very wonderful debate, and not very simple, by the way.

We support the Congress' efforts and the administration to identify ways to close the gap. We have heard a lot about enhanced information reporting, increased IRS audit activity, and we think there is a spot in the tax administration for those measures, but the overriding feature is to minimize burden. And we have heard that from everyone today.

Make sure that—again, the juices work the squeeze. Cost-benefit analyses, and looking at the data—the research data is so important, and one of your colleagues, or maybe it was yourself, talking about getting the data from the large business. It is not there.

I am sure there are assumptions made from the data that is 15 years old, but I can—we can see that the data that is more current, which impacts individuals and small business, if there are problems there, they should be addressed. But keep the burden reasonable, practical, and don't hurt the honest person unduly.

Customer service is vital. Recently, the IRS has just issued Phase II of its tax assistance blueprint. The AICPA looks forward to working with the IRS as they implement the various facets of this blueprint. There should be a greater emphasis on research, continual research.

We reiterate our call to the IRS to maintain a high level of outreach and dialogue with its stakeholders, and for the Service to continuously refine its tax gap data, including further analysis of the components of the tax gap, before any hasty legislation is enacted. I wonder if anyone would be surprised if two years from now we look at the tax gap, and we guess that it is double what we say it is today, and that maybe it is from an area that is not the areas that have been identified heretofore.

We would also like to commend Chairperson Velázquez for including the small business—including in the Small Business Tax Flexibility Act, which could give certain S corporations and certain partnerships that are starting up the flexibility to adopt a tax year-end that makes sense for that business, rather than a mandated year-end. Another area that has been tossed around recently in the press are increased tax penalties and how that might put a dent into the tax gap.

We are concerned that many of the civil penalty proposals are being raised by the Congress in a narrow rifle-shot perspective. You might use the word "haphazard." Instead, we, as an organization, believe greater levels of tax compliance could be achieved if Congress established a broad legislative oversight process similar to that which was used in the drafting of the Improved Penalty Ad-

ministration and Compliance Tax Act of 1989. We believe that by using a broad process not only would you have higher levels of tax compliance, but there would be a much better view of fairness in the system.

Lastly, a comment on some recent proposals that came out of the Joint Committee on trying to neutralize—trying to eliminate self-employment tax or FICA—Social Security tax—as being a determinant in picking the choice of an entity, be it an S corp or a partnership.

Currently, the way self-employment tax or FICA is paid by the owners of those different entities—S corp and partnership—are distinct. They are quite different. And one could pick the choice of an S corporation if they wanted to minimize somehow payment of that tax.

But from our research and from the studies that we have done, we believe that the choice of entity, while one factor might be the payment of self-employment tax, we do not believe it is a driving factor. So to conclude, what we—as the AICPA believes, it is premature to enact either of the Joint Committee tax proposals that deal with this without first identifying whether a self-employment tax avoidance problem truly exists, and, if a problem exists, the IRS should first utilize its existing enforcement capabilities.

Thank you.

[The prepared statement of Mr. Brennan may be found in the Appendix on page 84.]

ChairwomanVELÁZQUEZ. Thank you, Mr. Brennan.

And I will recognize Mr. Chabot for the introduction of our next witness.

Mr.CHABOT. Thank you, Madam Chair, for permitting me to make this introduction. It is a great honor to introduce our next witness. Although we have had a very distinguished panel, I want to recognize this particular gentleman, The Honorable Donald C. Alexander, who was the IRS Commissioner from 1973 to 1977.

His expertise includes corporate taxation, the taxation of partnerships, insurance companies and their products, and employee benefits matters. He is now a partner at Akin Gump, and I just want to say that he literally is an institution in this town. We have had an opportunity to talk with him many times over the years about a whole range of issues.

And he is—not only that, you know, there is a group of people that has been called the greatest generation, Don Alexander was also one of our World War II veterans. We are losing them at about the rate of 1,000 a day in this country, and he fought for his country and was in combat. And it is just—I can't say enough about this gentleman who is our next witness.

Mr. Alexander?

STATEMENT OF THE HONORABLE DONALD C. ALEXANDER, FORMER IRS COMMISSIONER, PARTNER, AKIN GUM STRAUSS HAUER & FELD LLP

Mr.ALEXANDER. Thank you very much, Mr. Ranking Member, Congressman Chabot, whom I have known—had the privilege of knowing for many years, and the equal privilege of living in Cincinnati, which you have represented extremely well all those years.

Thank you, Madam Chairwoman, for having this hearing on this very important subject. By the way, thank you for your earlier hearing, on March 22 I think it was, where you discussed what we are discussing today, where you saw a proposal which would have an enormous squeeze yielding little juice, and that was withholding on government contract revenues.

Now, the Treasury has proposed certain measures—and others have, too—to try to deal with the tax gap, to try to be able to assure the honest taxpayer that those who would cheat their fellow taxpayers are going to be called to account more than they have been in the past, more than they are in the present.

All of us have a duty, unfortunate as it is, to pay our taxes, and most of us—and that includes small business of course—meet that duty well. The duty is a very difficult one to meet, because our tax law, as has been pointed out by the members of this Committee, is so unbelievably complicated. However, when one says, "Hey, simplify the law and that will solve the problem," great. When is the law going to be simplified, if ever?

We call on the Internal Revenue Service to try to administer at least half our discretionary expenditures in our entire budget. Internal Revenue has to try to determine, for example—taking a new one—whether a car is environmentally friendly enough to deserve a subsidy. Why on earth doesn't the Department of Transportation do its job and make that determination?

Well, there are some very good reasons. There are some very good reasons that turn not so much on policy as on the necessity of having a Congress continue to be concerned about national issues. And to be concerned about national issues and do something about it, you have to be reelected. And being reelected is tough if you were to undertake a genuine deep-seated simplification of the Code as we tried to do in 1987.

So we have a tax gap. We have got an enormously complex code. You have an excellent Commissioner of Internal Revenue in office right now. I wish he were going to stay 10 more years, but he is not, and he needs support. We need to recognize that there is a gap. We need to recognize that we do need to have some more juice in the reduction of a gap measured at $345 billion gross. I think it is probably closer to $500 billion for the reasons stated very briefly in the statement that you are willing to put in the record.

Should we do something about it, or forget about it? I don't think we can forget about it. I don't think that's unfair to the many people who cope with their tax responsibilities. But having in mind, again, the need to get the maximum amount of juice from the minimum amount of squeeze what you need to do is to avoid withholding as a remedy. Withholding deprives small business of the essential working capital that they must have to survive.

You need, then, to turn to the least obtrusive, the least expensive, the least difficult remedies. A selection out of some of those in the Treasury's proposals and other proposals would be useful, and joint staff is reviewing, I understand, the burden, and indeed the burden is something of great interest to all of us, including even former tax collectors.

Thank you.

[The prepared statement of Commissioner Alexander may be found in the Appendix on page 93.]

ChairwomanVELÁZQUEZ. Thank you very much.

Our next witness is Mr. Joe Samuel. He is Senior Vice President of Public Policy of First Data Corporation, where he leads the company's federal and state government advocacy initiatives, as well as their community outreach program.

In addition, Mr. Samuel serves as Chairman of the board of the First Data Foundation, which is First Data Corporation's philanthropic organization.

Welcome, sir.

STATEMENT OF MR. JOE SAMUEL, SENIOR VICE PRESIDENT, PUBLIC POLICY, FIRST DATA CORPORATION

Mr.SAMUEL. Thank you. Good afternoon, Chairwoman Velázquez, Ranking Member Chabot, members of the Committee. I am pleased to be here today to talk about First Data's role in the payments industry and, frankly—and talk about merchant processing and really the costly impact that the IRS's proposed credit card plan would have on small businesses and payment processors such as First Data. Frankly, we believe that the consequence of this proposal will have an extremely highly negative impact on small businesses as well as payment processors such as First Data.

Now, not long ago, the Committee heard from the IRS Commissioner about many of their tax gap proposals, and there was some talk about—high-level talk about this credit card plan. And while I think the plan has been portrayed as being very simple and very easy to implement, I am here to tell you in fact that it is a very difficult plan.

At best, it is flawed and challenging, and, at worst, it is flawed and unworkable. And here is why, frankly. And there is a lot of detail in my written testimony, so I am just going to take a few minutes just really to highly summarize some of the question marks that we think should be raised about this particular IRS proposal.

First, again, the data as we see it would be highly inaccurate. Second, it is going to be very costly. And unless the government is willing to help pay for the considerable resources and costs that would be expanded to pay for this, I think it is fairly unworkable.

Third, we believe that this proposal could encourage merchants, particularly smaller merchants, to steer customers away from certain payment methods and to steer them more into particularly cash payments, because of the costs. And, fourth, I think a good question the Committee should pose to the IRS is, you know, does the Treasury and the IRS—do they have the tools necessary to read this kind of information that they are talking about?

Essentially, it is akin to me to opening up the spigot on a fire hydrant and putting your face in front of it. Do they have the tools necessary to read this information and understand it? Even if they did, this accurate—this data would be inaccurate.

So I am going to take just a minute to talk about—to give you some examples of why this information is going to be inaccurate. First and foremost, there was some talk earlier about how a merchant here in Washington, D.C., a restauranteur took 95 percent of his or her payments by credit card transactions.

Well, I am here to tell you that data varies. It varies by merchant, it varies by location, it varies in a number of different methodologies, and I think Mr. Hense talked about this just a few minutes ago. I can tell you that a merchant who is a plumber, an electrician, a carpenter, does not have to take 95 percent of their transactions via credit cards.

So to extrapolate the data that was initially talked about earlier to all small business merchants, frankly, is doing a disservice to them, and it is going to be very costly for them.

Second of all, I think it is important to note—I have got a quick example of another reason why this would be inaccurate, why the data would be inaccurate. Many of you—many of us here in this room use our debit cards every day to make purchases, and we have a feature on our debit cards called a PIN. Use your personal identification number to sign electronically for a transaction.

So, for example, I may go to Safeway, and I decide to buy $60 worth of groceries for the week. And then, I said, ah, you know what, I forgot that I need to get some cash. I need some cash; I am going somewhere. So I decided to get $40 in cash, and using my PIN with my debit card allows me to get cash back. It is called cash back at the point of sale.

Well, I do that. That is a $100 transaction. That is what the IRS wants payment processors like First Data to present to them to show, okay, this business had $100 in transactions. Well, I can tell you right now that is incorrect. $60 of that transaction was actual business transaction, it was, you know, me buying something from the store, from the little bodega down the street. $40 of it was cash back.

So, in other words, what I am saying is we would be over reporting numbers on small businesses to the IRS. That puts them at a significant disadvantage, because then they are going to be facing—they are in the burden—now they have the burden of proving themselves innocent when they didn't do anything wrong.

And I think that is a significant issue that we wanted to bring up to you. There are a lot of other issues, but in the interest of time why don't I stop there.

But ultimately what I would like to say is this. We urge—we strongly urge, I think all of us on this panel do, members of this Committee and members of this Congress to slow down this particular IRS process. No one here is against encouraging and going after those who don't pay their taxes, but it is how the IRS goes after—this plan that they have in place, how they go after and solve this tax gap issue, frankly, is a real issue.

So, again, we urge you to slow this process down, because the last thing I think would be helpful is to put significant burdens on either the payments industry or financial or small businesses where you are hurting this backbone of our nation's economy.

So with that, I will conclude my statement. Thank you.

[The prepared statement of Mr. Samuel may be found in the Appendix on page 95.]

ChairwomanVELÁZQUEZ. Yes, Mr. Chabot.

Mr.CHABOT. Thank you very much, Chairwoman. And before I ask questions, just one comment that I would make, and I think this—personally, it has been very helpful having this hearing, and

I want to, again, commend you for holding the hearing on this tax gap issue.

I want to just make this comment, that I think that we need to be careful that we don't let kind of this concept of this sort of pot of gold at the end of the rainbow, that there is this $350 billion a year, maybe as much as Mr. Alexander indicated, maybe $500 billion a year that is there, and all we have to do is find a way to collect it. And it allows—because it pretty much matches up fairly closely with what the deficit has been on an annual year, and perhaps Congress doesn't need to be restrained in its spending. We just need to get those resources that are out there.

And so I think it is incumbent upon Congress not to have that attitude, that it is just a matter of collecting it, and we can continue to spend with reckless abandon, as I am concerned that Congress has done under Republican control, and, unfortunately, may well do in the future. I hope not, but that is just a point that I wanted to get out there.

Secondly, Mr. Hall, if I could go to you first. Relative to the groups that you represent, and it is self-employed people, you are a tax advisor to them, is that—

Mr.HALL. That is correct.

Mr.CHABOT. Have you seen an increase as more and more people, for example, are falling into the AMT now that weren't involved in it perhaps over the years, and since it wasn't indexed and more people find that they have to figure it out—are fewer people perhaps figuring out their own taxes and going to an advisor now because they—it is too complicated for them to figure it out? Is that an issue with some of your people at this point or—

Mr.HALL. I think it is an issue. I think over the years technologically always is going to pull more people from a manual method to an automated method, whether there is some software package that they actually use, whether they use an online filing option. I think there are more people moving towards that.

But that may be one key difference between small business in general and micro business owners is access to resources, whether that is a 30-person company who has one of those people allocated to maintaining compliance with these issues versus the micro business owner which may only have two people, and so one of those individuals now is having to stop one of their other jobs because they all wear multiple hats.

So the cost to that micro business owner, even if they do have that automated software package, it is still taking them away from managing their business. I think they had talked about the average cost for keeping up with just employee reporting was $1,200 per employee.

Well, I would contend for the micro business owner it is even more exaggerated than that, because the owner is not making a sales call, or he is not providing services because he is having to take away from the growth side of his business to meet the needs of compliance with the Tax Code.

So I think automated process still is an assistance point there, but a big piece of micro business owners still fill out the return forms at their kitchen table on April 14.

Mr.CHABOT. Okay. Thank you.

Mr. Hense, if I could go to you next. I think it was Mr. Hall that mentioned that small business folks, and individuals for that matter, are, you know, currently scared to death of the IRS. And not to offend any of the IRS folks here, but I think that is just kind of a fact, that most individuals are, no matter who they are. I am sure the President probably is as well, quite frankly.

But do you think that the additional things that we have heard discussed here relative to tying to go after this so-called tax gap there—let me put it this way. Are there any realistic things that you think we ought to be looking at that would make it—people more compliant without just attempting to frighten them more, for example?

Mr.HENSE. Well, I don't think there is anything wrong with frightening the real cheaters. Just scare them. I mean, I don't think anybody here—I don't and the National Small Business Association doesn't—I don't think anybody here wants to defend people who are truly cheating on their taxes. And if you catch them, in normal, if you do the crime, you will do the time. Well, if you do the cheating, you are going to pay the penalties, the interest, and maybe worse than that.

The fear in an audit sometimes doesn't come from the fear of getting caught cheating, it is the fear of being asked a lot of questions about a lot of technical things that may or may not be correct—dealing with Section 125 plans, dealing with simple plans, dealing with accounting's contractors, with inventory issues, dealing with cash versus accrual.

I asked an auditor one time, "What is your favorite situation to walk into?" He said, "QuickBooks and non-licensed accountant." He said they are just—you have an accounting system that anybody can pick up and put any amount of numbers in they want, and they may print an accrual, they may print a cash, and then you have a lot of tax practitioners out there now.

My office spends a lot of money on training, and we—but there's a lot of people out there who aren't spending money on training. They are just doing this work, no training, no background. They just QuickBooks, they get a tax program, and they are a professional.

So the fear in the audit isn't so much, God, they are going to find out I hid $100,00; it is that they are going to find out my Section 125 program is flawed, I didn't do something right on my pension plan, they are going to take that away from me.

I don't have any problem with scaring cheaters, and I don't have any problem with prosecuting cheaters. But my concern is the fear of the IRS isn't in that area of really cheating, I don't think. A lot of it is just, oh, my God, what little thing are they going to find?

Payroll—people on the payroll versus subcontract labor. Some companies use a lot of subcontract labor legitimately and under the right rules and doing it right. They are still scared to death they will get a zealot auditor who will come in and say, "Those people are employees; they are not subcontract." And you can destroy a small business with that.

So scare them—scare the bad ones, yes, and go get them. But the good people, treat them right and let them be.

Mr.CHABOT. Thank you. I am going to—I have questions for each one. I am going to—try to keep the answers, if you could, relatively brief.

Mr.HENSE. I am sorry, yes.

Mr.CHABOT. Just so we—that is okay. So we can get it done.

Mr. Brennan, is there—could you discuss briefly how much time folks in your profession have to devote to retraining or continuing to keep up with the laws as Congress is changing them, or whatever the IRS interprets them, so that you are able to continue to provide service to the folks that you represent?

Mr.BRENNAN. It is actually a very significant amount of time. Various states mandate, you know, various numbers of hours. I am with a large firm. I probably spend 150 hours a year on education. That is not mandated by the state, but that is what our firm requires. And then, there is always incidental absorption of education.

Mr.CHABOT. Okay. Thank you.

Mr. Alexander—and, again, it is a real honor to have you here today. And you had mentioned that we have sort of been throwing out the figure that we think that the tax gap could be, say, $345-, $350 billion a year. And in your testimony you thought that it could be up to $500 billion a year perhaps. Is there any particular reason that you think that might be the case, or anything you would like to add to that comment that you made, which I thought was kind of interesting?

Mr.ALEXANDER. A good question, and there are several reasons. The first reason is that the tax gap does not measure all of the non-compliance with all of the taxes that we impose. We impose excise taxes. The biggest excise tax is, of course, the gasoline tax. The tax gap of $345- assumes 100 percent compliance with all excise taxes.

It also ignores the illegal sector, because it is very hard to measure the illegal sector. If you can measure it, that means you have found it. If you have found it, you ought to do something about it. So the tax gap is—$345- is I think clearly lower than what the number is. I don't know what the number is.

I would like to add one tiny comment to my distinguished colleague's mention of scare the bad guys. One of the problems the IRS has is that it doesn't know who the bad guys are. It knows that there is some cheating out there. Let us face it, there is some. But if it is going to scare only the bad guys, it has got to figure out who the bad guys are, like figuring out what the illegal sector is.

So, regrettably, it scares some people that shouldn't be scared. But if didn't scare anybody at all, it would fail to scare some people that I think all of us at this table believe should be scared.

Mr.CHABOT. Thank you very much.

And, finally, Mr. Samuel, you were in your discussion talking about the increased burdens that there might be on businesses if you had to report various transactions that aren't necessarily reported now. Are there any ways that you think it might make more sense than what they are talking about doing that? Or, a different question, if you—how burdensome would that be to some of these small businesses that might have this imposed on them?

Mr.SAMUEL. Considerable. I mean, I am going to be very honest here. I mean, just for us, First Data is the largest payment processor in the world. It is a U.S.-based company here in Denver, Colorado. And so for us, we are talking millions of dollars, not even knowing the full scope of what the IRS wants to do.

Those costs—we don't just absorb those costs, whether it is us or anybody else who is in this industry. We don't just absorb those costs, so it is going to flow down. Someone has got to pay for this. And if the government is not going to pay for this, who is left?

And, frankly, it is going to hit the small business folks the hardest, and ultimately consumers, right? You and I are going to pay higher costs, right, for goods and services. But, frankly, it is the small businesses, the micro businesses, those who can least afford to pay these costs. And I think that is one of our biggest issues.

And also, even at that, even if we could do this, because the payments infrastructure, how you make a payment—credit cards, debit cards, electronic checks, stored value cards—that infrastructure is completely different than a tax reporting infrastructure.

And the IRS would make you believe that you can just flip a switch and, you know, combine these two. That is absolutely not the case. We don't have the same information, and so the concern is, again, the compliance costs of trying to match these two issues to provide the IRS what they are looking for. Those costs, building these systems, would be exorbitant, passing those on to businesses, particularly small businesses, and then, at the same time, Congressman, the data is still inaccurate. You are still going to get inaccurate data.

Mr.CHABOT. Thank you very much, Mr. Samuel.

I yield back.

ChairwomanVELÁZQUEZ. Mr. Sestak.

Mr.SESTAK. Thank you. I just have one question to ask, if I might, I think of Mr. Paul Hense and Mr. Hall. And my question really does come from a concern for small businesses, since my district has lost 607 in the past three years. But at the end of the day—you know, I am trying to study this issue a bit. You know, at the end of the day, as much as I love the image of the juice, policy has to be made on facts.

And the Commissioner stated that—and it appears as though, you know, out of the NRP study—and I know there is questions about that, but one fact that he brought forward is that it appears as though misreporting or, you know, compliance, that if you have a group that has to do reporting and withholding there is a non-compliance of 1 percent. And then, he walks through the facts that if it is just reporting it is 4 percent. And as partial reporting, it is 12 or 16 percent. But if it is neither, it is 64 percent non-compliance.

If you accept that as somewhere in the ball of possibility—understand every study is off—what does that say to us about, as I also struggle on another committee, No Child Left Behind, where the challenge of gathering the data, which I think is correct—I think President Bush is right—has permitted people to then use that data in a certain way, what are these facts that I just said between withholding and reporting 1 percent—99 percent compliance to

only 36 percent compliance if you don't have to report anything? And there is stuff in between. Sir?

Mr.HALL. I think it is a good point, and I think at the bottom of the entire discussion is the validity of that data. And from a standpoint of micro business owners, I think the Commissioner had talked about his little formula. And I don't want to give anybody flashbacks to algebra, so don't have any nightmares, but he talks about compliance plus education—or, I am sorry, enforcement plus education equals compliance.

There is only two variables in that formula that equals compliance. He indicated that a lot of that non-reporting, whether it is any of those percentages that you mentioned, were not a matter of education. His indication was people are not reporting by choice. It is not a matter of education.

Well, consider the example of the guy who is—the plumber or the guy mowing the yard who gets $300 in cash for the services he provides. There is a requirement out there that 1099 reporting, if that was provided to a business, is not required because it is under $600. Does that guy who is actually mowing the yards for that company know that the $300 is still taxable income for him, or does he think it is not taxable income because it is not reportable on the 1099?

At the end of the year, does he just add up all of the 1099s he gets and that is his income, or does he have to add up all the cash? Clearly, he has to add up all of the cash. That is the requirement. But does he know that or not?

Mr.SESTAK. They always ask me in cash, not check.

Mr.HALL. Well, the thing about the check, at least with the check—

Mr.SESTAK. They seem pretty educated out there.

Mr.HALL. At least with the check he has to take that check somewhere to cash it. With the cash, he just puts it in his pocket and goes and spends that at Safeway for his groceries. That is never going to be traceable.

The point I am making is I believe that the biggest impact in that algebra formula is on education, whether it is women's business centers or small business development centers.

Mr.SESTAK. Do you have any facts to show that? I mean, I have heard a lot of stories, very compelling stories—again, another man mowing a lawn—but I am searching for facts of what it is. For instance, the Commissioner—and, again, you know, I quizzed him on the other side why he was here, but he mentions the motor fuel excise tax example where there was the businessman who came forward and said, "Look, we really do want more compliance. It makes our competition more fair."

And then, he also gave the example—and I don't remember it—of the five million dependents that all of a sudden were erased when something—with more compliance there. And so what I would be interested in is, in addition to the very compelling stories, is—and, you know, the examples of the lemon and all of that, what are the facts on this? Because this is a hard one. It is hard to believe, again, with such a deficit, but I do believe it is half a billion dollars, just based on inflation alone since 2001, you know, half a trillion dollars out there.

And if we have a U.S. Government where people have claimed that we are accountable for our national treasure, and we are only getting $1 out of every $10 back, you know, in compliance or education, it seems we have to go another step. And the facts attendant to which is the best method—obviously, we have to redo the NRP study and all and go back and get the big business one, which hasn't been done since '98, but I would be interested on—if there were facts to show, you know, this. And I think that is what we probably lack here of making the story—I mean, making a wise decision.

Mr.HALL. I will make a quick comment and then pass to Paul. But I think that is one of the issues we have is that we don't have the underlying facts. We are working on tax gap data from several years ago. The Commissioner even mentioned on several occasions, well, it will be several years before we know how that plays out. From the time somebody audits a return, it is two years after they file that return, and maybe another year by the time it is resolved.

So I am not sure that those facts exist, but from my chair I have overwhelming fact, and that is every day I get questions from small business people who don't know what they are supposed to do with that $300. Now, that doesn't show up in the IRS statistics, but to me that is a fact that is undeniable. And I think that is where education always outweighs the opportunities for enforcement.

Mr.HENSE. I am a very strong backer of small business, and I believe in integrity, on and on and on and on, but I am not stupid. I know if somebody gets cash and there is no way to track it that there is a fairly good chance it is not going to get reported.

The thing I am wrestling with, you are asking for statistics, we are not those kind of people. I mean, I am a businessman. I don't have access to that, couldn't generate it, don't have all that much interest in it. I am in the—I do things more on here it is in front of me as opposed to looking at a national statistic.

Sometimes the cure is worse than the disease. If you had a cancer on your finger, would you cut off the finger, hand, arm? You can cure it, but how much are you going to take to do it? We have a problem, and none of us at this table know there is not a problem. If anybody here says there is not a problem, then they are not just not in touch with reality. I understand the problem. What we are talking about is methodology.

If you say, "There is this cheating going on, and here is what we are going to do. We are going to lay this whole thing on you where you are all going to file these forms. The government is going to take withholding, and you are going to be responsible for getting the ID number for that person. You make me responsible for his taxes." I have got enough problems. I don't need to be responsible for his taxes.

So I absolutely understand that if the fear of punishment is not there we will have this problem. I believe the solution is smarter auditors, better trained auditors, more experienced auditors, who instead of over fooling around on the Section 125 plan looking for some little mistake where they can snatch $4,000 from the owner or $2,000 from the owner, you go in, you look at the whole thing, get a feel for it, and if you are experienced and you have been

trained right, you can get in and out pretty quick and know whether you have got a decent operation.

If you have got somebody showing $25,000 a year in income, and they are living in a $400,000 house, then something is wrong. I mean, there is—I believe that rather than burden everybody with a greater problem, increased auditing—obviously, I am not going to be particularly happy with that. But if you are going to increase the auditing, be smarter in the audits.

And I may be getting off the subject. If I am, just tell me that I am going the wrong direction. 1120-S corporations, where the owner is showing dividends and wages and they are not paying Social Security on the dividends, and they are paying Social Security on the wages, how hard is it to look at the front page of an 1120-S and go—we have got to say a dentist making $400,000 a year, and that is an exaggeration by the way, and he has got $400,000 in dividends or distributions and nothing in wages, well, that is—probably you have got some non-compliance there.

If he has got—if you pick up an 1120-S and they have got $80,000 in wages and $10,000 in distributions, they are probably doing it right. Some of this stuff is so simple and plain to find that I think that would be your first—the first thing to do would be smarter, better, more targeted audits, looking for underpayment—I am sorry, underreporting of income. And the second was take the information you have already got and use it better.

Mr.SESTAK. No, I appreciate—my time—I would just make one final comment, if I might, to you, sir. I honestly think your—some of your comments are spot on. I step back here, and even after looking at the three major proposals that have been mentioned, you know, the information reporting, payments to corporations, the merchant payment cards, and the certified TIN, even with those three that is only $1.6 billion a year against a half a trillion dollars of non-compliance.

It comes back, obviously, to the Tax Code, as you say. Congress isn't going to address that. So somehow it has to be better at compliance than $1.6 billion out of half a trillion. That is peanuts.

And I hear about education, but I doubt it is going to do much more. There has got—and it comes back to what you say, I mean, we are really dancing around a little bit of money here with all this effort.

Yes, sir, I am sorry.

Mr.ALEXANDER. It is frustrating, because if you take all of the Treasury proposals, they add up to a very little bite in the tax gap that, as you point out, may well be understated for a whole host of reasons, one of which is simply time value of money. But it beats nothing.

It would be wonderful to have smarter agents. It would save IRS, as well as taxpayers, a heavy burden that not infrequently results in a no change audit. No change audits are pleasant things at the end of the audit for the taxpayer, but it is a waste of the taxpayer's time and a waste of the agent's time, and sometimes the agents maybe miss things. The agents are going to continue to miss things, even under the direction of somebody as able as Commissioner Everson, who was with you earlier.

Would that it were possible to simplify the law, a sensible law—and the last time we tried was in 1986, make the law more sensible than it had been the prior year, and we were halfway successful, only halfway because we left the alternative minimum tax in there unindexed to grow into the monster that it is today.

And we did lose not just five million dependents, but actually seven million dependents by requiring—by imposing a burden on the taxpayer. The burden on the taxpayer—well, gee, you have got to get a taxpayer identification number for your dependent. Is the world going to come to an end if the taxpayer is required to do that? Some would so suggest, I believe, the world didn't come to an end. The seven million dependents that never existed came to an end, because they weren't claimed in following years on tax returns.

Mr.SESTAK. Thank you, ma'am.

ChairwomanVELÁZQUEZ. Mr. Alexander, you made reference to the 3 percent withholding for payment for government contracts. And in your testimony you said that it could have adverse impact on small businesses. As a former IRS Commissioner, I would like to ask you, can you speak to why this enforcement measure goes too far, and if you believe that this provision should be repealed?

Mr.ALEXANDER. Taking the last question first, I certainly believe that it should be repealed and should be replaced by information returns, not by nothing but by information return reporting. Information return reporting does, according to GAO, produce 96 percent of the revenue that should be reported, and withholding produces only an additional 3 percent.

That is hardly worth it when you are depriving, by this provision—you didn't do it, but it was—Congress did it, and the President signed the law—when the taxpayers are being deprived by this provision of 3 percent of those gross revenues. Now, that is working capital, and that is really meaningful. That is not the burden of filing—of making an additional filing. That I think may be a little overstated here.

But that is meaningful. That is highly adverse, and that does have or will have, in 2011, a very serious adverse impact upon small business that has any dealing, any contractual dealing with the government of the United States or the government of a state for that matter.

ChairwomanVELÁZQUEZ. Mr. Hall, I suspect that if these new withholding requirements are implemented that the self-employed, particularly your members, will be impacted. Can you talk to us about the burden and costs of this requirement?

Mr.HALL. Sure. Twofold—first, the cost is strictly cash flow. Withholding money up front, number one, treats all businesses, all taxpayers, the same. If there is a 3 percent requirement, or a 5 percent requirement, two small businesses could be totally different but their withholding requirement is going to be the same.

And that particularly is cumbersome for a small business owner who is trying to grow, so they may have a number of employees out there doing the paint jobs for them—this is a painter. So their margin on a particular job may be low, because they are paying other independent contractors and/or other employees to do some of the work.

And if their margins are low in that particular job, a 3 percent withholding may be their entire margin. It could be half their margin. So if you talk about their personal cash flow, if they have got a 6 percent margin, just for an example, that is half of their personal money withheld up front.

Compare that with an individual who does all the painting themselves, which I think may be the profile that initiated the plan to begin with, 3 percent may not be that much, because virtually all of the money is his personal money other than his supplies. But the big inequity there is that those two profiles of a business are treated exactly the same under that withholding concept.

The second piece, of course, is they have to keep up with the activity. I think the National Association for the Self-Employed has done surveys of its membership, and it still has about a fourth—about 24 percent of all its members still maintain some type of manual ledger, still keep track of their stuff with pencil and a piece of paper. And so now if they have got withholding on their contracts, that is going to be an additional burden for them to keep track of what exactly is their total revenue.

And, again, that is just another hurdle and another allocation of resources they are going to have to keep up with.

ChairwomanVELÁZQUEZ. Thank you.

Mr. Alexander, having served as the Commissioner of the IRS in the mid-'70s, do you believe that abusive tax shelters are a bigger problem today than it was back then?

Mr.ALEXANDER. No, they are a smaller problem today than they were back then. They were a bigger problem a few years ago before Commissioner Everson's activities brought an end, I believe, to the really abusive tax shelters and to the enormous leakage that we had from tax payments by the wealthiest individuals and by our largest corporations.

We had tax shelters back when I was around IRS in those antediluvian days. They were simple shelters, dealing largely with fictitious cattle, like the 7,000 dependents that never existed but were being marketed heavily to people who were more interested in keeping their funds to themselves than they were in sharing their income with the country.

ChairwomanVELÁZQUEZ. Mr. Brennan, included in H.R. 46, a bill I introduced on the first day of Congress, is language giving most S corporations and partnership startups the flexibility to adopt any fiscal year end, from April through November. Do you believe this measure can in some way help to narrow the tax gap?

Mr.BRENNAN. Well, we believe that having that flexibility—having that flexibility would enable small businesses, such as S corps and partnerships, to get better service from their outside service providers. I think the small businesses work hand in hand with your accountants, and this is as much of a benefit for the accountants as it is for the small businesses.

I think in an obscure sense, when you have more time and the better time to work on something, you will get a better byproduct or a better result, and I think that would indirectly impact the tax gap.

ChairwomanVELÁZQUEZ. Mr. Hense, as I mentioned in my opening statement when the Commissioner was here, I am concerned

that the administration proposal to require information reporting on payments to corporations, that it will have—impose a tremendous new paperwork burden on small businesses, while it is projected to narrow the tax gap by only a fraction of 1 percent.

Could you please describe how this proposal will burden NSBA members?

Mr.HENSE. There is two parts to this. One, I am not sure I have totally got my arms around it. I understood originally that there would be a requirement for 1099s to be issued for services and for product. I am not sure now on that. I was told just before we got together here that it does not include a 1099 for product.

If it is for products and services, it is overwhelming. It is a you-can't-do-it kind of thing. So if it is just for services, that eliminates probably 80 percent of the filing. It is still a burden—one burden for products and services, it is overwhelming, and I don't believe it can be done. The other is if the requirement for issuing 1099s to corporations, when you keep the withholding issue out of it, that is a big thing to me. The withholding creates a whole other thing like payroll.

We will have whole new companies blooming just to do or starting just to do the processing services for the withholding and the payment to the government. I am not happy with 1099s for corporations, but it wouldn't be as bad if it is just for services. More additional paperwork, more of a burden. I don't like it, but it wouldn't be the killer that the product would be.

ChairwomanVELÁZQUEZ. Thank you. Mr. Brennan, in a report issued last March, the General Accounting Office stated that the current IRS modernization effort, the business system modernization, did not have adequate policies and procedures in place to be consistent with proper management practices.

In fact, as I understand it, the IRS still uses the master file system, which was designed during the Kennedy administration. You mentioned that modernization is a positive avenue for easing taxpayer burdens. What is your assessment of how the IRS modernization effort is going? And I would invite Mr. Alexander to make any comments, if he has any knowledge as to how the modernization process is going at the IRS.

Mr.BRENNAN. Yes. I can't personally speak to how the modernization system is progressing. But I can attest to the fact that when a practitioner approaches the IRS, or a taxpayer approaches the IRS to get data, sometimes one might have to wait a month to get the data. You may make a payment to the IRS, and you want to see how it was posted to the IRS system, and if you made that deposit to your bank you could go on the next day and see that it is proper and it has been recorded.

To do that with the IRS, you could be told by IRS, because of their system being so outdated, that they do things batch, they don't do it real-time, and you have to wait three weeks. So things of that nature need to be corrected, but I can't talk to how, you know, the progress is being made.

Mr.ALEXANDER. Nor can I, really, because I have been out of the tax collecting business now for 20 years. But I am sure that distinguished folks from IRS who are here will give you a response to that question shortly. Is that right?

ChairwomanVELÁZQUEZ. If there is anyone from the IRS? Would you identify yourself, ma'am?

Ms.PETRONCHEK. I am Kathy Petronchek. I am the Commissioner of Small Business Self-Employed. In terms of our modernization, we have had some stops and starts, but things are improving. I am a little bothered that it takes a month to get data, because we do have batch processing that is normally done each week. So there should be updates.

And that was part of our modernization—to ensure that we could get information more timely, and that it was available to all of our employees across the country, because the old systems, they couldn't get information wherever they were located.

So we have—I think the Commissioner has talked in some of his other venues about CADE, and that has come up, and how we processed more returns this year, not as many as we would have liked, but we are making improvements. So I think there are improvements, and we realize we have other things that we need to be doing as well.

ChairwomanVELÁZQUEZ. Thank you. Mr. Samuel, a report recently released by the Inspector General of the IRS raised concerns about the security of taxpayers' data at the agency. Could you please discuss First Data's concern with sharing this information with the government?

Mr.SAMUEL. Yes, absolutely, Madam Chairwoman. What the IRS—as we see it, the IRS plan is really vague. But as we see it, the IRS plan would have us match taxpayer identification number, or, if you are small business you may not have a taxpayer identification number. If you are a sole proprietor, you may use your Social Security Number.

Match that information with transaction data, and we think, you know, that could just be ripe for bad things to happen. So in order to help protect privacy, you know, on the one hand, for example, here in Congress, in this House of Congress, there will be a committee that will work here pretty soon to pass legislation restricting the use and access to Social Security Numbers.

On the other hand, we have got a government agency that is saying, "No, we want you to use more, take more." That is a concern to us, because what happens if there is a breach? Who is liable? This is not something that we do normally, but the IRS is asking us to do something like this. And so, you know, who would take on that liability and those responsibilities? I think that is a major concern, Madam Chairwoman.

ChairwomanVELÁZQUEZ. Thank you. Mr. Chabot, do you have any other questions?

Mr.CHABOT. Thank you, Madam Chair. Just let me conclude by saying I think this has been a very informative, very helpful hearing. I think we have had an excellent panel here today, and I just want to again reiterate things that I have said during the course of this and in the questioning.

That I think what Congress can do, number one, is to simplify the Tax Code. I think we heard Mr. Jefferson indicate before that that's just not going to happen. I am not as pessimistic as perhaps Mr. Jefferson is about that. I think we should never give up on

that effort, although thus far I haven't seen realistic evidence that it is going to happen in the near term. But I certainly—

ChairwomanVELÁZQUEZ. Maybe it will happen now under a Democratic-controlled Congress.

[Laughter.]

Mr.CHABOT. Well, I hope so. If you can, I may switch parties and become a Democrat.

[Laughter.]

Not much chance of that happening, by the way.

[Laughter.]

ChairwomanVELÁZQUEZ. Trying to convince yourself.

[Laughter.]

Mr.CHABOT. We get along, but not that well. And I also would just encourage us not to use this quest for the so-called tax gap as a—you know, it is almost like going after the Holy Grail or this pot of gold at the end of the rainbow—we not use that as an excuse for the fiscal discipline that Congress should show under either Republican control or Democratic control. And, unfortunately, it too often fails to exercise that fiscal discipline, whichever party is in the majority.

And, finally, I would just again reiterate that we not do what Mr. Bartlett had talked about before, and that is, you know, squeezing and squeezing and squeezing to try to get that juice. And, unfortunately, the people squeezed oftentimes is the small business folks who can least afford to be squeezed, because they are already burdened with and live in a very competitive environment.

But, again, this has been an excellent hearing, and I commend you for holding it, and yield back the balance of my time.

ChairwomanVELÁZQUEZ. Thank you. I want to take this opportunity to thank all the witnesses. As Mr. Chabot expressed, it has been an excellent, excellent panel. It really helped us a lot.

And let me just say that before, in previous Congresses, the Small Business Committee was limited in terms of jurisdiction. But since under the new Democratic leadership, our Committee's jurisdiction has been expanded, and it was included in the rules package that we passed. We intend to use this jurisdiction to make sure that we watch what Ways and Means and other committees are doing or will continue to do in terms of legislation that will have impact on small businesses.

And I am proud to the fact that in my first day during this Congress I introduced legislation to simplify the Tax Code. So we are serious, and we want to make sure that we provide the tools for small businesses to continue to do what you do best, and that is creating meaningful jobs for our economy. So thank you all.

And I ask unanimous consent that members have five legislative days to enter statements into the record. Without objection, so ordered.

And this hearing is adjourned. Thank you.

[Whereupon, at 2:33 p.m., the Committee was adjourned.]

STATEMENT
of the
Honorable Nydia M. Velázquez, Chairwoman
House Committee on Small Business
Hearing on Closing the Tax Gap Without Creating Burdens for Small Businesses
April 26, 2007

One of the focuses of this committee is to ensure small businesses are given every tool to comply with regulations and reduce paperwork burdens. No place is this more true than when it comes to their taxes. Right now, it is estimated that small businesses spend 6 billion hours complying, at a cost of $260 billion.

While the vast majority of taxpayers comply with their obligations, the Internal Revenue Service has estimated that a significant percentage of taxes due are not paid. This problem, known as the tax gap, is the subject of today's hearing. The IRS estimated the tax gap to be $345 billion for 2001 alone.

It seems the administration is seeking for new ways to make up for the current deficit. As made clear in the fiscal year 2008 revenue plan, they have wrongly determined that the best course of action is to escalate IRS enforcement efforts on small businesses.

I believe there are several proposals in the plan that will impose severe hardships on the small business community, yet only narrow the tax gap by **a fraction of one percent**.

Before imposing additional reporting requirements, the IRS needs to assess whether their internal procedures can achieve this without creating excessive burdens. Small businesses are facing a number of challenges, including an overly complex tax code. Now, they are being hit with a disproportionate share of IRS enforcement efforts. Of the $100 million in enforcement initiatives in the FY 2008 budget, nearly 75 percent is directed towards small businesses.

It is a sad fact that in our present system of taxation, many of our most profitable large corporations avoid paying taxes by shifting income to offshore tax havens. In fact, the IRS website cites one authority that the annual loss to offshore tax shelters to be at least $70 billion. Yet, enforcement efforts remain on small businesses. I find it puzzling when the IRS projects it will generate 50 percent more revenue for each dollar spent on enforcement for large multinationals.

It is also troubling to know that the figures estimating the tax gap do not include recent data on the compliance levels of large corporations. That information has not been updated since 1988. Before deciding on a course of action that may harm small businesses, it is necessary to have an accurate picture of the tax gap.

Congress also needs to work together to make it easier for small businesses to comply and harder for bad actors to evade their obligations by simplifying the tax code. A good first step will be made with passage of a measure to expand and extend Section 179 expensing.

The commissioner is right when he says that it is unfair for honest small business taxpayers to have to compete against these tax cheats. My advice to the IRS in crafting a tax gap plan is to consider the private costs and burdens of your proposals and to not simply focus on the revenue figures.

As this country celebrates Small Business Week, we need to ensure our government is not creating unnecessary obstacles for the small business owners who are doing the right thing. Closing the tax gap is critical, but we must not simply replace one problem with another by burdening our small businesses.

U.S. House of Representatives
Small Business Committee
Rep. Steve Chabot (R-OH), Republican Leader

NEWS RELEASE

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Opening Statement of Ranking Member Steve Chabot

Hearing on the Tax Gap

"Thank you, Madam Chairwoman, and thank you for holding this hearing on a very important topic for small businesses around the country – closing the so-called 'tax gap'.

"The tax gap is the Internal Revenue Service's estimate of the difference between taxes voluntarily paid and taxes that should have been collected. For example, a tax gap is created when individuals underreport income or improperly claim credits or deductions. The IRS estimates that the United States collects 83.7 percent of the total taxes due (and let me state for the record that I believe taxes are far too high and should be reduced, but it is obviously important to comply with the law). After adjusting for delinquent taxes collected by existing compliance efforts, the IRS estimates that 86.3 percent of tax revenues are collected. The net tax gap is currently estimated by the IRS' National Research Program at nearly $350 billion for the tax year 2001—the last year data is available.

"Even in Washington D.C., where the words 'million' and 'billion' are tossed around liberally throughout the course of each day, $350 billion is quite a significant amount of revenue that is lost each year. Because of taxpayer noncompliance, the burden of funding our nation's commitments falls more heavily on taxpayers who willingly and accurately pay their taxes. And that's not fair. The question becomes, what do we do about it?

"Many small business groups have serious concerns regarding the IRS' plan to address the tax gap. Already struggling under the weight of massive paperwork burdens and high taxes, many of the ideas put forth by the IRS would only make it more difficult for small businesses to keep their head above water.

"While a few of the ideas put forth by the IRS have merit, the stated overall goal of increasing enforcement efforts is not the way to go. I firmly believe that the first and best thing we can do to address this problem is to simplify the tax code. The code has become a morass of niche laws and regulations that is growing increasingly complex. For small businesses that are just starting out, it can be exceptionally difficult to know exactly what to do and when to do it.

"Most small businesses pay their taxes in full and on time. However, doing so is never easy for them, as the costs of complying and the difficulty in following the tax code can be overwhelming. In 2001, the Small Business Administrations Office of Advocacy released a report on the regulatory costs faced by small firms that contained an estimate of the paperwork compliance costs. The report showed that small businesses with fewer than 20 employees spend over $1200 per employee to comply with tax

paperwork, recordkeeping, and reporting requirements. This over two times the compliance costs faced by larger firms.

"Another area that the IRS has not focused on enough in their efforts is education and compliance assistance. The IRS itself estimates that roughly $148 billion of the gap comes from underreported business and self-employment taxes. Expanding efforts to help businesses and the self-employed to prepare their returns accurately and on time would significantly reduce the gap without penalizing the honest people out there doing their best to comply.

"Make no mistake; I do believe that enforcement must be a factor in this equation. Just like any segment of the population, there will always be bad actors out there trying to skirt the system. Finding them is not easy, and we must continue to look for and penalize those who deliberately evade paying their taxes – but it must not be done at the expense of those citizens doing their best to comply with their share of the tax burden. It is going to take a balanced approach of simplification of the code, greater education and outreach efforts to individuals and businesses, and enforcement in order to make any real headway on this problem.

"Madam Chairwoman, thank you again for holding this hearing. I look forward to hearing from our distinguished panels, and to working with you, our colleagues in the House and the Administration to address this important issue."

# # #

Statement of Rep. Jason Altmire
Committee on Small Business Hearing: "Closing the Tax Gap Without Creating Burdens for Small Businesses"
April 26, 2007

Thank you, Chairwoman Velazquez, for holding this hearing today on the efforts to close the tax gap and those efforts' impacts on small businesses. It is important to have a thorough discussion on enforcement efforts and to understand the full impact those efforts will have on taxpayers. I look forward to hearing our witnesses' thoughts on the tax gap and proposals to address it.

The tax gap represents a significant problem. It is estimated that a staggering $350 billion in taxes goes unpaid each year. In narrowing this gap, we must work to ensure that the solutions do not create more problems. Enforcement must be evenhanded and not overly burdensome for businesses and individuals. Education should be coupled with enforcement to ensure that taxpayers are fully able to decipher the tax code. Efforts that single out small businesses may result in fewer small businesses, fewer jobs, and even less tax revenue for the treasury.

Thank you, Madam Chair. I yield back the balance of my time.

# # #

WRITTEN TESTIMONY OF
COMMISSIONER OF INTERNAL REVENUE SERVICE
MARK EVERSON
BEFORE
HOUSE COMMITTEE ON SMALL BUSINESS
ON
THE TAX GAP
APRIL 26, 2007

Good morning Chairman Velazquez, ranking Member Chabot, and Members of the Committee on Small Business. It is good to be back with you this morning to update you on the tax gap and our efforts to improve voluntary compliance.

Let me begin 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 grow small businesses into larger ones. Having said that, I would be disingenuous if I did not concede that one of the major challenges facing all small businesses is the inherent complexity of the tax code. Complexity obscures understanding and facilitates noncompliance.

In my testimony last year, I reported on the results of the National Research Program (NRP) study of 46,000 individual tax returns from tax year 2001. The results of that study tell us quite a bit about the tax gap. But, there is one critical piece of information that we still do not know. We cannot determine how much of the gap is attributable to willful noncompliance 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.

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 or she willfully decides to underreport his income, overstate his deductions, or fails to properly remit payroll taxes.

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.

The Senate Permanent Subcommittee on Investigations has held a number of hearings on the issue of federal contractors that are delinquent on their taxes. This includes both income and payroll taxes. At a hearing a year ago, 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 and we have made progress.

But, perhaps the most troubling information in the context of that 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-Next Generation (FPDS–NG), small businesses received more than $79 billion in prime Federal contracts in FY 2005. While I believe that most of the small businesses acting as Federal contractors are making every effort to be fully compliant with the tax laws, some contractors are willfully noncompliant 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. Noncompliant 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 in 2006, 86 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 8 percent said that is was acceptable to cheat on their taxes "a little here and a little there."

Making Progress

IRS has made significant progress in reducing the tax gap through its compliance efforts. It has:

- Increased annual enforcement revenues by nearly $15 billion since FY 2001, with enforcement totaling $48.7 billion in FY 2006.
- Increased examinations of individual returns by 75 percent between FY 2001 and FY 2006, when the IRS conducted nearly 1.3 million examinations.
- Focused resources on examinations of individuals with income over $1 million. The number of examinations in this category rose by almost 78 percent as compared to FY 2004, the first year the IRS began tracking them separately.
- Examined over 52,000 business returns in FY 2006, an increase of nearly 12,000 over FY 2001. Increased audits of corporations with assets over $10 million from 8,718 in FY 2001 to 10,578 in FY 2006.
- Increased examinations of the very largest corporations, those with assets over $250 million, by nearly 30 percent growing from 3,305 in FY 2001 to 4,276 in FY 2006.
- Improved how often audits occurred by reducing cycle times from 23 months in FY 2001 to 17.8 months in FY 2006 - a 22.6% reduction - for corporations with assets greater than $10 million. This allows IRS to maximize the efficient use of resources "touching" more corporations as part of its enforcement program.
- Expanded the emphasis given to tax-exempt organizations by increasing the number of examinations by nearly 33 percent from 5,342 in FY 2001 to 7,079 in FY 2006.
- Achieved a 91.4 percent conviction rate on criminal investigation cases from FY 2001 through 2006, including investigations involving abusive schemes, high-income nonfilers, employment-tax evasion, unscrupulous return-preparer fraud, and general tax fraud.

These enforcement efforts reflect the direct impact of IRS enforcement initiatives. Though difficult to quantify, there is also an indirect effect of IRS enforcement, which some research suggests is at least three times the direct effect of enforcement efforts. This indirect effect is seen when individuals thinks twice about overstating deductions or failing to report income if they know a neighbor or friend has been audited. Similarly, if the small business community in general is aware that IRS is being more aggressive, voluntary compliance increases, which as noted above help compliant small businesses remain competitive.

Enforcement Gains Not at the Expense of Taxpayer Service

I am particularly proud of the fact that our improvement in enforcement has not been accomplished at the expense of taxpayer service. According to a survey commissioned by the IRS Oversight Board in 2006, taxpayers increasingly recognize that the IRS provides quality service through a variety of channels, such as its Web site, toll-free telephone lines, and Taxpayer Assistance Centers (TACs). This is supported by the

metrics that we use to determine the effectiveness of our taxpayer service efforts. In category after category, we continue to see improvement in the numbers in our telephone services, electronic filing, and IRS.gov access. This is demonstrated by the following FY 2006 business results:

- Electronic filing by individuals continued to increase. It rose three percentage points from FY 2005, to 54 percent of all individual returns.

- The level of service for toll-free assistance was 82 percent, about the same level as FY 2005 and up substantially from FY 2001. The level of customer satisfaction with the toll-free line remains 94 percent.

- The tax-law accuracy of toll-free responses improved to 91 percent and account accuracy increased to over 93 percent.

- Visits to the IRS Web site jumped nearly 10 percent in FY 2006 to more than 197 million visits.

- More taxpayers used the online refund status tool "Where's My Refund." In FY 2006, there were 24.7 million status checks, up nearly 12 percent from FY 2005.

At the IRS, we continue to work to improve services. Clearly, we are making progress, and these numbers underscore that point.

Another development in our taxpayer service program is the Taxpayer Assistance Blueprint (TAB). This collaborative effort of the IRS, the IRS Oversight Board, and the National Taxpayer Advocate began in July, 2005 in response to a Congressional mandate to develop a five-year plan for taxpayer service delivery. We sent Phase 1 of the Blueprint to Congress in April, 2006. Phase 1 identified and reported the following five strategic service improvement themes for increasing taxpayer (including small businesses), partner, and government value:

- *Improve and expand education and awareness activities*: This theme addresses the critical need for making taxpayers and practitioners aware of the most effective and efficient IRS service options and delivery channels for meeting their tax obligations and receiving benefits they are due.

- *Optimize the use of partner services*: This theme emphasizes the critical role of third parties in the delivery of taxpayer services, and calls for improving the level of support and direction provided to partners to ensure consistent and accurate administration of the tax law.

- *Enhance self-service options to meet taxpayer expectations*: This theme focuses on providing clear, standard, and easily customized automated content to deliver

accurate, consistent, and understandable self-assistance service options—particularly for transactional tasks.

- *Improve and expand training and support tools to enhance assisted services*: This theme highlights the need for ensuring accurate information across all channels by improving and expanding training, technology infrastructure, and support for employees, partners, and taxpayers.

- *Develop short-term performance and long-term outcome goals and metrics*: This theme provides for the development of a comprehensive set of performance goals and metrics to evaluate how effectively the IRS is meeting taxpayer expectations, and how efficiently it is delivering services.

Phase 2 of the Blueprint was delivered to Congress two weeks ago. Throughout this project, extensive research has allowed us to refine our understanding of taxpayer and partner needs, preferences, and behaviors and to identify current planning documents, decision processes, and existing commitments affecting IRS service delivery. Certain recurring findings emerged from the wealth of data analyzed. These findings, combined with agency-wide considerations and priorities, led to the development of the five-year TAB Strategic Plan for taxpayer service. This plan will benefit small businesses as IRS learns more about taxpayer preferences.

The TAB Strategic Plan includes a suite of service improvement initiatives across all delivery channels, a portfolio of performance metrics, and an implementation strategy, which recommends numerous future research studies. The TAB Strategic Plan outlines a decision-making process for prioritizing service improvement initiatives based on taxpayer, partner, and government value and ensuring continued stakeholder engagement. This process is designed to help the IRS to balance quality service with effective enforcement to maximize compliance

As a first step in incorporating Blueprint results into the IRS budgeting process, the FY 2008 budget request includes the funding necessary to implement some of the telephone service and Web site enhancements recommended by the TAB Strategic Plan. Enhancing telephone service will contribute to the goal of increasing taxpayer, partner, and government value. Improving IRS.gov will help us to make the Web site the first choice of individual taxpayers, small businesses, and their preparers when they need to contact the IRS for help.

The TAB Strategic Plan also recommends a suite of multi-year research studies to continue to refine and improve our understanding of optimal service delivery. In addition to funding for research regarding noncompliance, the FY 2008 budget includes funding for research to understand better the effect of service on compliance. This research will also benefit small businesses.

Outreach to Small Business

Our Small Business/Self-Employed (SB/SE) division has a vigorous outreach and education program for small businesses carried out by our Stakeholder Liaison (SL). SL has relationships with over 1,500 small business industry and tax professional organizations. In FY 2006, we coordinated or participated in 2,069 events across the country with more than 122,000 direct participants, sharing education and outreach messages and information about IRS policies and procedures. In the first quarter of FY07, we have already coordinated or participated in over 1,100 events with approximately 81,000 direct participants.

One of SL's most successful ongoing events with small business industries are 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 the two-way communication during these forums, small business organizations alert the IRS about issues that are a burden to their members, provide feedback to IRS on policies, practices and procedures, and receive information to assist small businesses meet their tax obligations and navigate the IRS. The forums – held in both Washington, DC and in field locations across the country – are attended by multiple small business industry organizations including Small Business Administration representatives.

We know that many small businesses rely on practitioners, and our stakeholder liaison office engages practitioners and payroll providers through national and local chapters of prominent organizations such as the American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), the National Association of Enrolled Agents (NAEA), the National Payroll Consortium (NPRC), and the Independent Payroll Provider Association (IPPA). Through these channels we deliver key messages relating to small business tax obligations, as well as provide information on IRS policies and procedures. Communication is two way giving an opportunity for open dialogue about pertinent issues.

SL began a new outreach to tax professionals in 2006 through Phone Forums. Eight national forums have been conducted, with more than 1,000 participants each, on topics such as navigating IRS.gov, the Automated Underreporter Program, Offers in Compromise, On-line Payment Agreements, and the Telephone Excise Tax Refund (TETR). Future topics will include Individual Taxpayer Identification Numbers (ITINs) and how businesses can better use IRS.gov. Over 100 local phone forums have also been conducted by field offices.

Another avenue of outreach is through leveraged partnerships with the Small Business Administration and their local Small Business Development Centers to deliver Small Business Workshops to small business owners. The Service Core of Retired Executives (SCORE) works with us through SBA to assist in delivering these workshops.

SL also maintains a close working relationship with the Internal Revenue Service Advisory Council (IRSAC) and the Information Returns Program Advisory Committee

(IRPAC) to address small business issues through their Small Business/Self-Employed Sub-Working Group. Currently, both groups are working to address issues to improve voluntary compliance.

Issue resolution is a major element in our relationship with small business and practitioner stakeholders. To have a true partnership with these groups, we must be willing to listen to feedback and concerns. A vital element is the Issue Resolution Management System, which we use to collect, catalogue and resolve issues elevated to us by stakeholders. Through this system, we have made improvements in operations to benefit small businesses, practitioners, and the Service.

We also offer specific products for small business persons and tax professionals. These include:

- Virtual Small Business Tax Workshop DVD, a 10-lesson interactive video. It is also available on IRS.gov through streaming video.
- Small Business Resource Guide CD-ROM. This CD-ROM was ordered by over 400,000 small business owners last year.
- Tax Calendar for Small Businesses and Self-Employed. This is a wall calendar filled with items to help a business owner manage a successful operation.
- SB/SE Web content on IRS.gov. This was viewed by almost 15 million people in FY 2005.
- Tax Talk Today – A monthly webcast for tax professionals. We currently have approximately 75,000 registered viewers.
- E-News for Small Businesses and E-News for Tax Professionals – Weekly electronic newsletters with approximately 200,000 combined subscribers.

Reducing Taxpayer Burden

We are committed to imposing the least amount of burden necessary for taxpayers to meet their tax responsibilities. The IRS Strategic Plan is very clear in articulating this goal and making its achievement the responsibility of each and every IRS employee.

In 2002, we established the Office of Taxpayer Burden Reduction (TBR) to lead Service-wide burden reduction efforts. Since its inception, that Office has aggressively pursued reduction initiatives and enabled the IRS to reduce burden on taxpayers by more than 200 million hours since 2002. TBR has reduced burden by focusing on simplifying forms, publications, and notices; streamlining internal policies, processes, and procedures; promoting less burdensome rulings, regulations, and law; assisting in the development of a burden-reduction methodology and model; and partnering with internal and external

stakeholders to identify and address more effectively and efficiently burden-reduction initiatives.

Some recently implemented improvements in IRS forms, processes, and procedures coordinated through TBR include:

- *Redesigned Form 940, Employer's Annual Federal Unemployment Tax Return, and Associated Processes*: The new Form 940 incorporates the advantages of Form 940-EZ (discontinued for tax year 2006) into a simplified form for all filers. Highlights include arrangement in a logical sequence from the taxpayer's point of view; organization into eight separate parts with visual cues, breaking up the task into smaller steps; a new Schedule A for multi-state employers or credit reduction situations; check boxes instead of "A, B, C" questions; and no more need for hand-written explanations of exempt payments. We estimate this redesign will result in a 7.6 million hour burden reduction for 940 filers.

- *Simplified Tax Filing Requirements for Small Employers with Form 944:* Beginning January 1, 2006, certain employment-tax filers are able to file the new Form 944 (Employer's Annual Federal Tax Return) once a year rather than filing Form 941 (Employer's Quarterly Federal Tax Return) four times a year. The first Form 944 was due January 31, 2007. This program is for small employers who owe $1000 or less in total employment tax. All other employers are still required to file a Form 941, Employer's Quarterly Federal Tax Return, on a quarterly basis. The Form 944 is used to report wages paid, federal income tax and Social Security/Medicare taxes withheld from the employees' compensation, and the employer's matching Social Security tax amount.

- *Revised Schedule K-1 for Partnerships, S-corporations and Trusts:* Form 1041 Schedule K-1 was revised for filing season 2006. The Schedule K-1 has been simplified to reduce common errors and the burden associated with the preparation and filing requirements. Schedule K-1 for Forms 1065 and 1120S was revised in 2005.

- *Simplified Extension of Time to File:* We eliminated the need for filing Form 2688, Application for Additional Extension of Time to File U.S. Individual Income Tax Return, by allowing the taxpayer to get a 6-month extension to file initially. This change eliminated over 3.7 million forms and 2.2 million hours of taxpayer burden.

- *Developed Alternative Minimum Tax (AMT) Assistor for IRS.gov:* This assists taxpayers in determining whether or not they may be subject to the Alternative Minimum Tax and whether they need to complete Form 6251.

Projects under development include:

- *Simplifying the S-election process:* We are looking at ways to minimize the impact of problems with Form 2553, *Election by Small Business Corporation,* on the processing of 1120-S returns.

- *Simplifying Office in Home Deduction, Form 8829:* TBR, along with Counsel, Examination, SBSE Research, and our Office of Program Evaluation and Risk Assessment (OPERA), is examining the potential burden-reduction strategies for reducing the burden associated with the Office in the Home Deduction (Form 8829).

- *Amending Employment Tax Returns:* A team is exploring the creation of stand-alone form(s) to be used when amending a series of 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. The new forms should expedite amended return processing and reduce the need for additional correspondence with taxpayers.

- *Clarifying Capital Gains Tax Reporting, Form 1040, Schedule D-Capital Gains and Losses and Form 1099-B, Proceeds From Broker and Barter Exchange Transactions:* An IRS cross-functional team led by the Office of Taxpayer Burden Reduction has been established to recommend short-term and long-term solutions to reduce burden and increase voluntary compliance relative to computing adjusted cost basis and reporting gain or loss on the sale of securities on Form 1040, Schedule D - Capital Gains and Losses. The Government Accountability Office (GAO) and Taxpayer Advocate Service (TAS) have characterized capital-gains tax reporting as confusing and burdensome to taxpayers, estimating that noncompliance in this area contributes $17 billion to the tax gap.. The short-term goal is to educate taxpayers on existing recordkeeping and reporting requirements. The long-term goal is to develop recommendations to establish third-party (financial institutions) reporting of adjusted cost basis and gain or loss on the sale of securities transactions. This improvement will reduce the filing complexity and recordkeeping burden for taxpayers and enhance the IRS' ability to identify noncompliance.

The Tax Gap

The tax gap is the difference between the amount of tax that taxpayers are required to pay under current law for a given tax year and the amount that is paid voluntarily and timely. The tax gap represents, in dollar terms, the annual amount of noncompliance with our tax laws. We now estimate that the overall gross tax gap for all types of tax was approximately $345 billion for Tax Year 2001, leading to a noncompliance rate of 16.3 percent. The net tax gap, or what will remain after enforcement and other late payments, is estimated to be $290 billion. This means we have a net compliance rate of 86.3 percent.

At this same hearing last year, I discussed the NRP study from which these numbers are derived. That information has not changed. So rather than repeat them in this statement, I will simply offer a brief summary for the Committee. The NRP study of TY 2001 individual returns represented the first such comprehensive study done since 1988.

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. Underreporting constitutes nearly 83 percent of the gross tax gap. While individual income tax accounts for 46 percent of all tax receipts, individual income tax underreporting constitutes about 57 percent of the overall tax gap, or about $197 billion.

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.

We can see from these results that a significant portion of the tax gap results from underreporting on the part of small businesses and self-employed individuals. However, as I indicated earlier, it does not tell us the extent to which this underreporting is the result of unintentional errors or willful noncompliance. That is why it is important to address the issue with a comprehensive approach that includes improvements in taxpayer service, compliance, research, technology and outreach.

A Strategic Plan to Improve Voluntary Compliance and Reduce the Tax Gap

Last September the Office of Tax Policy at the Department of the Treasury submitted to Congress a strategic plan to improve voluntary compliance and reduce the tax gap. When President Bush submitted his FY 2008 Budget for the IRS it supported key elements of that strategic plan. Key components of that plan and how they relate to the FY 2008 IRS Budget are discussed below.

Enhancing Taxpayer Service

Taxpayer service is especially important to help taxpayers avoid making unintentional errors. The IRS provides year-round assistance to millions of taxpayers through many sources, including outreach and education programs, tax forms and publications, rulings and regulations, toll-free call centers, the IRS.gov web site, Taxpayer Assistance Centers, Volunteer Income Tax Assistance (VITA) sites, and Tax Counseling for the Elderly (TCE) sites.

Assisting taxpayers with their tax questions before they file their returns reduces burdensome post-filing notices and other correspondence from the IRS, and proactively addresses inadvertent noncompliance.

The FY 2008 Budget contains several significant taxpayer service initiatives. First, the budget requests $5 million for additional resources to enhance our understanding of the role of the taxpayer service on compliance. This research will focus on understanding taxpayer burden, opportunities for enhanced service to help reduce errors made on returns, and the impact of service on overall levels of voluntary compliance.

In addition, the budget requests $10 million for four of the initiatives recommended by the Taxpayer Assistance Blueprint (TAB) Strategic Plan for taxpayer service. As part of the Blueprint effort, we conducted a comprehensive review of our current portfolio of services to individual taxpayers to determine which services should be provided and improved.

Both of these initiatives should benefit small business. The more we know about the link between service and compliance the better we can direct the appropriate services to the right group of taxpayers.

Improving Enforcement Activities

The IRS is continuing to improve efficiency and productivity through process changes, investments in technology, and streamlined business practices. We will continue to reengineer our examination and collection procedures to reduce cycle time, increase yield, and expand coverage. As part of our regular examination program, we are expanding the use of cost-efficient audit techniques first pioneered in the National Research Program (NRP).

We are also expanding our efforts to shift to agency-wide strategies, which maximize efficiency by better aligning problems (such as nonfilers and other areas of noncompliance) and their solutions within the organization. The IRS is committed to improving the efficiency of its audit process, measured by audit change rates and other appropriate benchmarks.

There are seven specific initiatives proposed in the FY 2008 Budget aimed at improving compliance. These initiatives provide:

- **$73.2 million to improve compliance among small business and self-employed taxpayers in the elements of reporting, filing, and payment compliance.** This funding will be allocated for increasing audits of high-risk tax returns, collecting unpaid taxes from filed and unfiled tax returns, and investigating persons who have evaded taxes for possible criminal referral. It is estimated that this request will produce $144 million in additional annual enforcement revenue per year, once new hires reach full potential in FY 2010.

- **$26.2 million for increasing compliance for large, multinational businesses.** This enforcement initiative will increase examination coverage for large, complex business returns; foreign residents; and smaller corporations with significant international activity. It addresses risks arising from the rapid increase in globalization, and the related increase in foreign business activity and multi-national transactions where the potential for noncompliance is significant in the reporting of transactions that occur across differing tax jurisdictions. With this funding, we estimate that coverage for large corporate and flow-through returns will increase from 7.9 percent to 8.2 percent in FY 2008, and produce over $74 million in additional annual enforcement revenue, once the new hires reach full potential in FY 2010.

- **$28 million for expanded document matching in existing sites.** This enforcement initiative will increase coverage within the Automated Underreporter (AUR) program by minimizing revenue loss through increased document matching of individual taxpayer account information. We believe the additional resources will result in an increase in AUR closures from 2.05 million in FY 2007 to 2.64 million in FY 2010. We expect $208 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010. In addition, the budget requests $23.5 million to establish a new document matching program

at our Kansas City campus. This enforcement initiative will fund a new AUR site within the existing IRS space in Kansas City to address the misreporting of income by individual taxpayers. Establishing this new AUR site should result in over $183 million in additional enforcement revenue per year once the new hires reach full potential in FY 2010.

- **$6.5 million to increase individual filing compliance.** This enforcement initiative will help address voluntary compliance. The Automated Substitute for Return Refund Hold Program minimizes revenue loss by holding the current-year refunds of taxpayers who are delinquent in filing individual income tax returns and are expected to owe additional taxes. We estimate that this initiative will result in securing more than 90,000 delinquent returns in FY 2008 and produce $82 million of additional enforcement revenue per year, once the new hires reach full potential in FY 2010.

- **$15 million to increase tax-exempt entity compliance.** This enforcement initiative will deter abuse by entities under the purview of the Tax-Exempt and Governmental Entities Division (TEGE) and misuse of such entities by third parties for tax avoidance or other unintended purposes. The funding will aid in increasing the number of TEGE compliance contacts by 1,700 (six percent) and employee plan/exempt organization determinations closures by over 9,000 (eight percent) by FY 2010.

- **$10 million for increased criminal tax investigations.** This will help us to aggressively attack abusive tax schemes, corporate fraud, nonfilers, and employment tax fraud. It will also address other tax and financial crimes identified through Bank Secrecy Act related examinations and case development efforts, which include an emphasis on the fraud referral program. Our robust pursuit of tax violators and the resulting publicity is aimed to foster deterrence and enhance voluntary compliance.

- **$41 million for conducting research studies of compliance data for new segments of taxpayers needed to update existing estimates of reporting compliance.** The data collected from these studies will enable the IRS to develop strategies to combat specific areas of noncompliance.

Reducing Opportunities for Evasion

The IRS is already aggressively pursuing enforcement initiatives designed to improve compliance and reduce opportunities for evasion. As I pointed out earlier, these efforts have produced a steady climb in enforcement revenues since 2001, as well as an increase in both the number of examinations and the coverage rate in virtually every major category.

In the budget request, the Administration proposes to expand information reporting, improve compliance by businesses, strengthen tax administration, and expand penalties in the following ways:

Expand information reporting – Specific information reporting proposals would:

1) Require information reporting on payments to corporations;
2) Require basis reporting on sales of securities;
3) Expand broker/auctioneer information reporting;
4) Require information reporting on merchant payment card reimbursements;
5) Require a certified taxpayer identification number (TIN) from non-employee service providers;
6) Require increased information reporting for certain government payments for property and services; and
7) Increase information return penalties.

Improve compliance by businesses – Improving compliance by businesses of all sizes is important. Specific proposals to improve compliance by businesses would:

1) Require electronic filing by certain large businesses;
2) Implement standards clarifying when employee leasing companies can be held liable for their clients' Federal employment taxes; and
3) Amend collection due process procedures applicable to employment tax liabilities.

Strengthen tax administration – The IRS has taken a number of steps under existing law to improve compliance. These efforts would be enhanced by specific tax administration proposals that would:

1) Expand IRS access to information in the National Directory of New Hires database;
2) Permit the IRS to disclose to prison officials return information about tax violations; and
3) Make repeated failure to file a tax return a felony.

Expand penalties – Penalties play an important role in discouraging intentional noncompliance. Specific proposals to expand penalties would:

1) Expand preparer penalties;
2) Impose a penalty on failure to comply with electronic filing requirements; and
3) Create an erroneous refund claim penalty.

The Administration also has four proposals relating to IRS administrative reforms.

The first proposal modifies IRS employee infractions subject to mandatory termination and permits a broader range of available penalties. It strengthens taxpayer privacy while reducing employee anxiety resulting from unduly harsh discipline or unfounded allegations.

The second proposal allows the IRS to terminate installment agreements when taxpayers fail to make timely tax deposits and file tax returns on current liabilities.

The third proposal eliminates the requirement that the IRS Chief Counsel provide an opinion for any accepted offer-in-compromise of unpaid tax (including interest and penalties) equal to or exceeding $50,000. This proposal requires that the Commissioner establish standards to determine when an opinion is appropriate.

The fourth proposal modifies the way that the Financial Management Service (FMS) recovers its transaction fees for processing IRS levies by permitting FMS to add the fee to the liability being recovered, thereby shifting the cost of collection to the delinquent taxpayer. The offset amount would be included as part of the 15-percent limit on continuous levies against income.

Collectively, these proposals should generate $29.5 billion in revenue over 10 years. The proposed budget provides $23 million to implement these initiatives. This will fund the purchase of software and the modifications to IRS information technology systems necessary to implement these legislative proposals.

Enhancing Research

Research enables the IRS to develop strategies to combat specific areas of noncompliance, improve voluntary compliance, and allocate resources more effectively. The NRP, which we have used to estimate our most recent tax gap updates, provides us with a better focus on critical tax compliance issues in a manner that is far less intrusive than previous means of measuring tax compliance. Like the compliance studies of the past, the NRP was designed to allow us to estimate the overall extent of reporting compliance among individual income tax filers, and to update our audit selection formulas.

In addition to providing updated estimates for determining the sources of noncompliance, the NRP also assists us in better targeting examinations and other compliance activities, thus increasing the dollar-per-case yield and reducing "no change" audits of compliant taxpayers. Innovations in audit techniques to reduce taxpayer burden, pioneered during the 2001 NRP, have been adopted in regular operational audits.

Recurring and timely compliance research is needed to ensure that the IRS can efficiently target resources, effectively provide the best service possible, and respond to new sources of noncompliance as they emerge. Compliant taxpayers benefit when the IRS uses the most up-to-date research to improve workload selection formulas, as this reduces the burden of unnecessary taxpayer contacts.

The FY 2008 Budget requests funds for two significant research initiatives. First, the budget requests $41 million to improve compliance estimates, measures, and detection of noncompliance. This will fund research studies of compliance data for new segments of

taxpayers, which is needed to update existing estimates of reporting compliance. Unlike in the past, the IRS will conduct an annual study of compliance among 1040 filers based on a smaller sample size than the 2001 NRP study. This will provide fresh compliance estimates each year, and by combining samples over several years, will provide a regular update to the larger sample size needed to keep our targeting systems and compliance estimates up to date.

The second initiative funded by the request is to research the effect of service on taxpayer compliance. The budget requests $5 million for this project, which will undertake new research on the needs, preferences, and behaviors of taxpayers. The research will focus on four areas:

- Meeting taxpayer needs by providing the right channel of communication;
- Better understanding taxpayer burden;
- Understanding taxpayer needs through the errors they make; and
- Researching the impact of service on overall levels of voluntary compliance.

I should also mention that we are currently working on an NRP study of reporting compliance involving S corporations. By 1997, S corporations had become 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.

We are looking at approximately 5,000 Form 1120S returns from a nationwide random sample, and we expect to have the results of our research in 2008.

Continuing Improvements in Information Technology

Tax administration in the 21st century requires improved IRS information technology (IT). We are committed to continuing to make improvements in technology, and the FY 2008 Budget reflects that commitment. The FY 2008 Budget requests $81 million to improve the IRS' information-technology infrastructure. Sixty million dollars of this amount is requested to upgrade critical IT infrastructure. This infrastructure initiative will provide funding to upgrade the backlog of IRS equipment that has exceeded its life cycle. Failure to replace the IT infrastructure will lead to increased maintenance costs and will increase the risk of disrupting business operations. Planned expenditures in FY 2008 include procuring and replacing desktop computers; automated call distributor hardware; mission critical servers; and Wide Area Network/Local Area Network routers and switches.

This will allow us to continue to provide a high level of service to all taxpayers, including small businesses.

The other $21 million will be used to enhance the Computer Security Incident Response Center (CSIRC) and the network infrastructure security. CSIRC is a critical component

of protecting taxpayer data and responding if such data is ever compromised. This infrastructure initiative will provide $13.1 million to fund enhancements to the CSIRC necessary to keep pace with the ever-changing security-threat environment through enhanced detection and analysis capability, improved forensics, and the capacity to identify and respond to potential intrusions before they occur. The remaining $7.9 million will fund enhancements to the IRS' network-infrastructure security. It will provide the capability to perform continuous monitoring of the security of operational systems using security tools, tactics, techniques, and procedures to perform network security compliance monitoring of all IT assets on the network.

Finally, the FY 2008 Budget requests a total of $282.1 million to continue the development and deployment of the IRS Business Systems Modernization (BSM) program in line with the recommendations identified in the IRS Modernization, Vision, and Strategy. This funding will allow the IRS to continue progress on modernization projects, such as the Customer Account Data Engine (CADE), Account Management Services (AMS), Modernized e-File (MeF), and Common Services Projects (CSP).

The development of the CADE and AMS systems is the heart of the IT modernization of the IRS. The combination of these two systems working together will enable the IRS to process tax returns and deal with taxpayer and small business issues in a near real-time manner. In fact, our objective is that the IRS operate similarly to what one expects from one's bank; account transactions occurring during the business day will be posted and available by the next business day. In addition, AMS will enable the IRS representatives who work with taxpayers and small businesses to have access to all the information regarding that taxpayer or small business, including electronic access to tax-return data, and electronic copies of correspondence. Equipped with such comprehensive and up-to-date information, our representatives will be in a much better position to help taxpayers and small businesses resolve their issues.

MeF is the future of electronic filing. It provides a standard data format for all electronic tax returns, which will reduce the cost and time to add and maintain additional tax form types. MeF is a flexible real-time system that streamlines the processing of e-filed tax returns, resulting in a quicker acknowledgement of the filing to the taxpayer or their representative. In FY 2007, the IRS will start development and implementation of the 1040 on the MeF platform.

CSP will provide funding for new portals, which are technology platforms that meet many IRS business needs through Web-based front-ends, and provide secure access to data, applications, and services. The portals are mission-critical components of the enterprise infrastructure required to support key business processes and compliance initiatives.

The benefits accruing from the delivery and implementation of BSM projects not only provide value to taxpayers, small businesses, and government, but also contribute to operational improvements and efficiencies within the IRS.

Additional Observations on the Tax Gap

In the context of the President's Budget request, I would like to make several additional observations about the tax gap.

First, I think it is well understood that we will never be able to audit our way out of the tax gap. And, while simplification of our tax laws will surely help the vast majority of Americans who already voluntarily comply with those laws, we will actually have to complicate the tax laws to go after the non-compliant taxpayers (e.g., by requiring more information reporting), which impose burdens on small businesses that we are working to minimize.

Second, we understand that to reduce the tax gap dramatically would take some draconian steps – ones that would fundamentally change the relationship between taxpayers and the IRS, require an unacceptably high commitment of enforcement resources, and risk imposing unacceptable burdens on compliant taxpayers, including small businesses and entrepreneurs.

This is an important point. I talked earlier about leveling the playing field and the advantage to compliant small businesses of enforcing the law against those in noncompliance. We understand that if we place unreasonable additional burdens on compliant businesses, they will resist and may become noncompliant themselves with the new requirements. Nevertheless, there are reasonable steps – first and foremost the funding request and legislative proposals in the FY 2008 Budget – which I have outlined in this statement that can be taken to improve compliance.

Third, we are committed to applying our resources where they are of the most value in reducing noncompliance while ensuring fairness, observing taxpayer rights, and reducing the burden on taxpayers who comply. We are using the NRP results to manage our enforcement programs more effectively and design pre-filing activities that help taxpayers comply with the law.

Summary

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.

We also believe that dollars spent on taxpayer service have a positive impact on voluntary compliance. The complexity of complying with the nation's current tax system is a significant contributor to the tax gap, and even sophisticated taxpayers make honest mistakes on their tax returns. Accordingly, helping taxpayers understand their obligations under the tax law is a critical part of improving voluntary compliance. To this end, the IRS remains committed to a balanced program assisting taxpayers in both understanding the tax law and remitting the proper amount of tax.

Full funding of the FY 2008 Budget will enable the IRS to improve its research with respect to the tax gap. Despite all of our progress, there is still much we do not know about the sources and causes of the tax gap. Although the updated estimates provided by the NRP study are more accurate than our previous estimates, and more accurate than the estimates made at various times by others using more indirect methods, they have many limitations.

I appreciate the opportunity to testify this morning, and I will be happy to respond to any questions that Members of the Committee may have.

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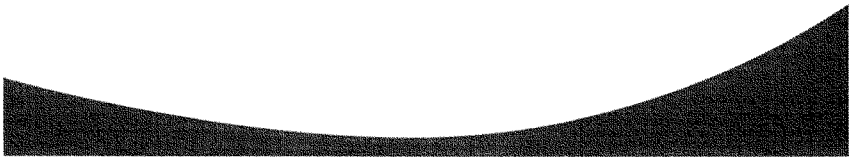
"Closing the Tax Gap without Creating Burdens for Small Business"

House Committee on Small Business

April 26, 2007



Introduction

The goal of increased tax compliance is one that is shared by citizens, legislators and businesses big and small. No taxpayer wants to pay for another's free ride. This goal becomes increasingly important as we begin to take a hard look at our nation's fiscal state. As we take the necessary steps to readjust our financial priorities, we must make certain the path we choose is balanced and effective, rather than detrimental to those sectors contributing most significantly to our economic stability and growth. The micro-business community is one of these important sectors, rich in job opportunities and the capacity for revenue growth.

The Internal Revenue Service and the micro-business community are well acquainted with each other. A chief complaint of the self-employed and micro-businesses is the lack of a fair and level playing field, which would allow them to compete equitably with other businesses. Equity in the tax code, clear and simple regulations, and accurate tax reporting and compliance is extremely important to micro-business. They cannot compete with those receiving additional benefits or deductions via the tax code, those able to afford accountants or a whole team of tax specialists, or those willfully disregarding their tax liability. Thus, our community also has an interest in addressing the issue of the tax gap and increased tax compliance.

Currently, the self-employed and micro-business communities face an unfair tax code which gives preference to larger businesses and specific industries. Additionally, the cost and overwhelming regulatory burden in complying with complex IRS regulations negatively affects their business. According to the General Accounting Office, a small business owner faces more than 200 IRS forms and schedules that could apply in a given year. Vague and complex rules and forms can mean the demise of their business. According to a study by the Tax Foundation, in 2005 individuals, businesses and nonprofits spent an estimated 6 billion hours complying with the federal income tax code, with an estimated compliance cost of over $265.1 billion. Businesses bear the majority of tax compliance costs, totaling nearly $148 billion or 56 percent of total compliance costs.

Despite the time and cost spent on compliance, a tax gap still exits and there have been numerous proposals by the Administration and in Congress regarding how to effectively increase compliance and minimize the tax gap. In review of current tax gap recommendations, we note two key deficiencies. First, current proposals presented in the Administration's FY2008 budget are frameworks or ideas which lack specifics as to how these ideas will be implemented and how the information obtained will be used in coordination with enforcement activities. In order to determine their potential effectiveness and impact on small business, we need to find out the details of these proposals presented to Congress. Secondly, a significant component overlooked is the cost to government to implement these proposals. All expand current systems or create new regulations which will require additional manpower, infrastructure and technology.

Without data on cost, we are unable to determine whether the reported return on investment of these recommendations would be worth the cost to implement them.

Based on the information we have access to, the National Association for the Self-Employed would like to highlight some pros and cons of a few of these proposals and include alternate recommendations to increasing compliance.

Increasing Information Reporting on Payment Card Transactions

The Administration has proposed in their FY2008 budget an increase in information reporting by requiring credit and debit card issuers to report to the IRS annually on aggregate reimbursement payments made to businesses. Capturing information can have a positive impact particularly in light of those taxpayers who consciously choose to avoid reporting income. However, based on the information at hand on this recommendation, the NASE believes 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.

The IRS has indicated that this information could be utilized to create industry profiles, taking the total credit card receipts reported for a particular business and then extrapolating total income based on industry averages. If these profiles stemming from credit card receipts were then used to make judgments regarding other items on the tax return such as estimations on cash payments, problems will arise. The averages will only provide additional discrimination against those businesses that have higher than 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 taken by the IRS based on these profiles such as examinations, requests for additional information or even tax assessments would be both burdensome to micro-business and most especially, could be irrelevant and frivolous.

Another concern regarding 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 well documented and would be revealed upon review and therefore it is unlikely that those amounts would be the key source for intentional underreporting. Additionally, this new level of regulatory burden place on credit card issuers will likely lead to increased fees being passed on to businesses which conduct credit card transactions. Increased fees will have a negative impact on revenues and sales of micro-business owners.

Therefore, the NASE is concerned that this approach may not be targeting the source of underreporting and could serve to increase the costs associated with credit card usage

without identifying any additional taxable income that would not have already been reported.

Requirement on Businesses to Obtain and Verify a Certified Taxpayer Identification Number for Contractors

Under the current system, businesses that pay contractors (non-employee providers) $600 or more for services in a calendar year are required to file an information return (Form 1099) to the IRS and contractor at the end of the year. The information on that return is not verified by the IRS.

In the FY2008 Budget, the Administration recommends that a contractor be required to furnish to the business (on Form W-9) the contractor's certified Taxpayer Identification Number (TIN). The business would then be required to verify the contractor's TIN with the IRS, which would be authorized to disclose for this purpose only, whether the certified TIN-name combination matches the IRS records. If the contractor fails to furnish an accurate certified TIN, the business would be required to withhold a flat rate percentage of gross payments to that contractor.

The NASE supports the requirement of a TIN number to be furnished by the contractor to the business on Form W-9. However, we have trepidation regarding the requirement on businesses to verify a contractor's TIN and withhold if it is inaccurate. Our concern lies in the lack of specifics as to what type of system the IRS plans to set up for businesses to fulfill this requirement. A system with substantial paperwork for requests and long wait times to receive needed approvals would impair businesses and self-employed contractors. If the IRS produces a user friendly, quick response TIN-name match system via online or phone, then the NASE would have minimal objections to this proposal. However, the NASE feels that there is still the potential for increased compliance issues due with this system. The Department of Treasury is asking business owners to be in part IRS compliance officers, a role for which they are not trained for. The additional regulatory burden could cause an increase in unintentional errors if Taxpayer Identification Numbers or names are accidentally reported inaccurately by business owners, contractors and the IRS.

Voluntary Withholding at the Request of Contractors

Included in the above proposal, is the creation of a voluntary withholding system. Contractors receiving payments of $600 or more in a calendar year from a business could require the business to withhold a flat rate percentage of their gross payments, with the flat rate of 15, 25, 30, or 35 percent being selected by the contractor.

The extensive regulatory burden and compliance hurdles this provision would create would significantly hurt the micro-business community and create a disincentive to utilize contractors. Additionally, this voluntary withholding system would undermine the quarterly estimated tax payments system currently in place for independent contractors and transfers the compliance burden from the contractor to another business owner. The NASE opposes implementation of this provision or any provision instituting additional

withholding regulations and believes this would further hurt rather than enhance compliance amongst the micro-business and self-employed communities.

Less Burdensome Approaches to Compliance

The overall goal of the Administration and Congress is to increase tax compliance and minimize the tax gap. It is not possible to completely close the tax gap. There will always be those who employ tax shelters, willfully do not comply, or inaccurately report their income. The goal should be to find ways to increase compliance without negatively affecting businesses to the extent that they are unable to manage cost and regulatory burden and must close their doors.

Key elements of the tax gap are the underreporting of income and concern of the accuracy of cash payments reported on tax returns, particularly amongst sole proprietors. Under current practices, checks made out to corporations must be deposited and cannot be cashed. The NASE recommends extending that practice to sole proprietor requiring that payments they receive for goods and services in the form of a check must be deposited and cannot be cashed at financial institutions. The expansion of this practice would increase the documentation of revenues and lessen potential underreporting.

Additionally, the NASE recommends modifying the Form 1040 Schedule C form in a manner that may encourage further compliance. First, in Part 1 of the form, alter line item 1 for gross receipts/sales to request two separate line items: one gross receipts/sales for credit/debit card transactions and the other gross receipts/sales for check and cash transactions. Visibly requiring the taxpayer to list separately their cash/check transactions may trigger the necessity for them to accurately track these payments and incorporate them into their tax return. Additionally, it offers to the IRS additional data on the types of transactions being conducted by businesses.

Second, in Part 2 of Form 1040 Schedule C, line 11 allows sole proprietors to include and deduct the payments they made to contractors over the year. We recommend the inclusion of a check box accompanied by a statement indicating that they have complied with the 1099 filing reporting requirement (i.e. "Check the box if you have filed Form 1099's for all contractors which have provided $600 or more in services to your business this year.") If business taxpayers do not check the box, they are not allowed the deduction for contract labor.

These two minor adjustments to the Form 1040 Schedule C would encourage additional compliance, increase pertinent data for the IRS and minimally burden micro-business owners.

Service vs. Enforcement

The IRS has made positive changes over the past years through taxpayer education and outreach efforts. The NASE supports increased funding for the IRS to allow to properly enforce current tax regulations and provide taxpayer compliance assistance. Our concern is with the large scale shifting of resources from taxpayer education and services to enforcement. In the FY2008 budget proposed by the Administration, the IRS will receive additional funding for enforcement services. We have already seen in the previous two years an adjustment of financial resources and manpower by the IRS from education to enforcement. IRS Commissioner Mark Everson has indicated that the IRS model is education plus enforcement equals compliance. However, we feel that the balance between education and enforcement is clearly changing to focus more heavily on enforcement.

The NASE feels that any recommendations seeking to increase compliance and lessen the tax gap should also seek to refrain from increasing the regulatory burden on taxpayers. We believe that ensuring comprehensive, effective taxpayer services is essential to accomplish taxpayer compliance. The more taxpayer education 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.

The NASE supports the utilization of federal programs such as the Small Business Development Center program, the Women Business Center program and SCORE to assist in taxpayer education services. These programs provide direct assistance to current business owners and future entrepreneurs and could play an invaluable role in efforts to increase tax compliance.

Conclusion

The NASE supports proposals that are fair and reasonable to address the issues of the tax gap and to increase tax compliance. 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 and compliance must focus on overall simplification, eliminating issues of inequity within the tax code, and enhancing taxpayer education and outreach. The majority of small business taxpayers want to comply with existing tax laws, thus making tax regulations easier to understand is the most effective and equitable way to improve compliance and to reduce the tax gap.

Additionally, as we review current proposals to address the tax gap, we see that they solely focus on business to business transactions. Business to business transactions are already highly regulated and have substantial reporting requirements. A large area of potential non compliance and underreporting stems from business to consumer transactions. These dealings are currently not subject to reporting requirements and the

creation of those requirements would likely be prohibitive to consumers and politically unappealing to legislators. However, we feel that it is not possible to have a striking change in the tax gap without addressing business to consumer transactions.

In our efforts to increase tax compliance and minimize the tax gap, it is essential we work together to ensure that our actions do not have a lasting, negative impact on our nation's economy. The NASE believes that our collective focus should be on supporting efforts for survival, growth and innovation of micro-businesses and the self-employed as a foundation for long-term economic vitality.

Testimony of Paul Hense

Hense and Associates

On Behalf of
The National Small Business Association

House Small Business Committee

Hearing:

"Closing the Tax Gap Without Creating Burdens for Small Businesses"

April 26, 2007

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Chairwoman Velazquez, Ranking Member Chabot and members of the committee, thank you for the opportunity to testify about several of the Treasury Department's legislative proposals to reduce the "tax gap" and the implications they will have on the small-business community. My name is Paul Hense and I am the president of Hense and Associates, a CPA firm located in Grand Rapids, Michigan. I also serve as the Immediate Past Chairman of the National Small Business Association.

Before I give my thoughts on the implications of the so-called "tax gap" and how Congress and the IRS are seeking to address it, let me outline the "tax gap," how it is being defined and interpreted, and what it may mean for small-business owners like myself.

To begin, the "tax gap" is certainly not a new issue. It has been a persistent problem over the last 20 to 30 years despite myriad congressional and IRS efforts to reduce it. The rate at which taxpayers comply with tax laws has barely changed since 1984, when approximately 87 percent were compliant. Yet, in recent years Congress has brought a new focus on closing the "tax gap."

IRS develops its "tax gap" estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely comply with their tax obligations. That rate is then used, along with numerous other assumptions, to estimate the dollar amount of taxes not timely or accurately paid. For tax year 2001, the IRS estimates nearly 17 percent of owed taxes were late or not paid at all, which translates into an estimated gross "tax gap" of $345 billion. The IRS recovered about $55 billion of this sum, leaving a net "tax gap" of $290 billion.

Thus, the "tax gap" includes both deliberate and illegal tax evasion but also non-payment that occurs for more innocent reasons; taxpayer error or simple inability to pay. Even Nina Olson, the IRSs taxpayer advocate, told Congress that IRS auditors have found that an estimated 94 percent of noncompliance is the result of honest mistakes by tax filers who simply don't understand the 17,000-page beast of a tax code.

The millions of honest small-business taxpayers are at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few "bad apples" that do not fulfill their tax obligations.

Earlier this year, the administration's FY 2008 budget called for a number of steps to close the "tax gap." Of the 16 different proposals outlined, many of them would impose new regulatory, reporting and withholding burdens on small business—all in an effort to try to "catch" other businesses that might not be reporting all of their income. Given the extraordinary burden that compliance with the tax code already imposes on small businesses, it strikes me as unfair at best to ask honest small businesses to do even more in order to catch a few potential cheats.

The most burdensome proposals would expand information reporting on payments to corporations, require a certified taxpayer identification number from contractors, and mandate information reporting on merchant payment card reimbursements.

A recent nationwide poll conducted by the NSBA shows that 61 percent of small-business owners do not even know about the "tax gap." However, once informed of the IRS proposals, the majority of respondents believed the proposals would increase burdens on their businesses.

As the nation's oldest nonpartisan small-business advocacy group, NSBA has thoroughly reviewed these recommendations and found most would not effectively increase compliance and minimize the "tax gap." Instead, they add additional and unnecessary burdens on already over-burdened small-business owners.

Information Reporting Requirements on Payments to Corporations

Under current law, corporations are exempt from our current Form 1099 information reporting system which requires all other taxpayers making payments of $600 or more for

services to send a Form 1099 to the IRS. The FY2008 budget proposal recommends an expansion to the Form 1099 filing system by requiring a business to file an information return on payments to corporations aggregating to $600 or more in a calendar year.

In practicality, this means that every time a small-business owner ships a package with Federal Express or uses some other service, and the expenses total more than $600 by year-end, they would need to keep the receipts, prepare a Form 1099 and file them not only with the IRS, but with Federal Express and any other companies as well. If enacted, every small-business owner will face an increased paperwork and administrative burden for each additional 1099 Form prepared. Increased costs are incurred for mailing additional forms and for hiring outside assistance to ensure that businesses are correctly complying with the law. Furthermore, if a business previously has not been required to utilize the Form 1099 filing system, greater difficulties with compliance is likely to ensue.

NSBA is concerned what the IRS will do with this amount of data. We do not believe that the IRS even has the capacity to utilize this data.

Requiring a Business to Obtain a Certified Taxpayer Identification Number from Contractors

Another administration proposal recommends that a contractor be required to supply to the business the contractors certified Taxpayer Identification Number (TIN). The business would be required to verify the contractors TIN with the IRS, who would determine whether the certified TIN-name combination matches the IRS records. If the contractor fails to furnish an accurate TIN, the business would be required to withhold a flat-rate percentage of gross payments to that contractor.

This will result in delays in performing and paying for contractors services. A system with substantial requests for paperwork and long wait times to receive needed approvals would harm daily operations of the business and disrupt the contractor's cash flow.

Included in this proposal is the creation of a voluntary withholding system. Contractors receiving payments of $600 or more in a calendar year from a business can require a business to withhold a flat-rate percentage of their gross payments, with the flat rate of 15, 25, 30 or 35 percent being selected by the contractor.

This is especially burdensome and complex to small-businesses if each contractor requests a different rate. Then business owners may have to withhold from some contractors and report information returns on others—resulting in increased administrative nightmares for the small-business. Plus allowing the contractors the option transfers the compliance burden from the contractor to the business owner creating further disincentives to utilize contractor services.

Information Reporting Requirements on Merchant Payment Card Transactions

Currently, taxpayers are subject to some level of information reporting and withholding requirements. Employers must report wages and withhold applicable payroll taxes and federal income taxes for their employees. Businesses are required to report payments made for services in connection with their trade and business of more than $600 per year. However, the administration has proposed an increase in information reporting by annually requiring credit and debit card issuers to inform the IRS about aggregate reimbursement payments made to businesses.

Such requests for information or possible tax assessments would be burdensome and raises questions of privacy for small businesses. Also, this new level of regulatory burden on credit card issuers likely will lead to increased fees being passed on to businesses which conduct credit card transactions. These increased fees will have a negative impact on business revenue and sales, and in turn tax revenue. Further, there is no data available to distinguish between payment card transactions and cash transactions as a contributor of the "tax gap."

Inaccurately Blaming Small-Businesses for 'Tax Gap'

As defined by the IRS, the "tax gap" consists of three components: non-filing (failure to file a return), underreporting (understating income or overstating deductions), and underpayment (failure to pay reported tax owed.) Of these, IRS argues underreporting is the largest, comprising 80 percent or $166 billion of the total gap. Of the $166 billion, IRS claims that small businesses are responsible for $109 billion.

However, most of the current data on the "tax gap" is derived from extrapolations and limited information, some of which is more than 20 years old. The IRS has misinterpreted its data and has reached erroneous conclusions about where the "tax gap" lays. None of the numbers examine the effects of external factors on tax compliance. The IRS failed to consider what percentage of "tax gap" is attributed to the complexity of the tax code. It also did not study what other external factors affect taxpayers behavior. NSBA asserts that better data is needed in order to craft more targeted solutions aimed at those who are in fact non-compliant in their tax obligations.

To the extent there is underreporting of income in the small-business community, the IRS does not seem to know what types of businesses are most likely to underreport. This is crucial information for crafting a potential solution. The IRS has proposed more collection and withholding for business-to-business transactions, but what if most of the underreporting occurs in businesses that sell to individual consumers and households? We have added a new burden for little benefit.

Now that the IRS is calling for stricter filing rules, more stringent audits and penalizing smaller businesses for unintentional transgressions, they are unfairly targeting most of the businesses who report accurately on their tax returns. The IRS is hiring more auditors and is petitioning Congress for increased funding to audit more small businesses. In the last two years alone, audits of small corporations have increased 150 percent and there is every reason to believe that number will continue to increase. NSBA fully supports

efforts to collect legally owed tax revenues, but not at the undue expense of the privacy and integrity of honest, hard-working entrepreneurs.

Tax Reform

The complexity of our existing tax system is a significant reason for the "tax gap." Fundamental reform and simplification of the tax law is necessary in order to reverse this situation. Perplexed, bothered and bewildered American taxpayers spent $265 billion last year just trying to comply with the tax laws and regulations. Yet, even with this vast expenditure of money, no one—including small-business owners—is sure they successfully complied with the law. In fact, the Treasury's own Inspector General for Tax Administration found an 84-percent error rate in spot audit visits to 26 different IRS Assistance Centers across the country in 2004.

Congress should stop trying to impose more burdens on taxpayers and replace the current tax code altogether with something that makes more economic sense, such as the Fair Tax.

NSBA Recommendations

The number one NSBA priority for the 110th Congress is working to address the root causes of these unpaid taxes and find a solution without placing excessive and intrusive burdens on honest small-business owners. We believe efforts to close the "tax gap" must focus on overall simplification, eliminating inequities within the tax code, and enhancing taxpayer education and outreach.

NSBA believes that the IRS should conduct more research to better identify noncompliant taxpayers, enhance taxpayer services to inform taxpayers of correct tax obligations and adjust its enforcement tools to target those who intentionally evade paying taxes. Adding new burdens and requirements on small business already struggling to do the right thing is simply the wrong answer.

Addressing the "tax gap" must entail balancing the desire to collect taxes that are duly owed with the importance of minimizing intrusive and complicated reporting requirements and additional audits of small businesses. Potential steps include:

1) **Improve Services**: Though the IRS has made strides in improving customer service, there needs to be a concerted effort to improve compliance assistance rather than enforcement. Additional improvements to customer service should facilitate tax paying while ensuring that unintentional errors are minimized, and not penalized.
2) **Crack down on Tax Scams**: A report by the Senate Permanent Investigations Subcommittee found that cheating on taxes now equals about four cents to seven cents on each dollar paid by honest taxpayers, or about $40 billion to $70 billion a year. NSBA supports efforts to curb tax-cheats, but the IRS and Congress must take a certain level of responsibility for creating a complex, out-of-control tax code that enables the very kind of cheating they're trying to stop.
3) **Simplify Taxes:** Considering the legal ramifications of filing incorrect returns, much less the "tax gap," the tax code desperately needs to be simplified. Reforms can include consolidating the number of tax breaks in the code, rationalizing and harmonizing definitions, and in general reducing the number of forms taxpayers are required to fill out each year. These changes could easily reduce the non-compliance rate and potentially raise tax revenues without an increase in tax rates.

NSBA Campaign

In order to reach these goals, NSBA has launched a campaign with three main objectives: inform small businesses about the potential threat that is posed by the "tax gap," give small-business owners an avenue to communicate their concerns back to elected officials, and provide an information repository to answer key questions about tax compliance, in order to cut back on honest mistakes.

You can view the NSBA Web site at www.preventirsabuse.org.

The majority of small-business taxpayers want to comply with existing tax laws, thus tax simplification and education is the most effective and equitable way to improve compliance and to reduce the "tax gap."

Now is the time for Congress to support proposals that are fair and reasonable, and that do not hinder the survival, growth and innovation of our nation's entrepreneurs. Thank you for your consideration of these recommendations.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TESTIMONY BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

PUBLIC HEARING:
CLOSING THE TAX GAP WITHOUT
CREATING BURDENS FOR SMALL BUSINESS

APRIL 26, 2007

The American Institute of Certified Public Accountants thanks the House Small Business Committee for the opportunity to appear at today's hearing on "Closing the Tax Gap Without Creating Burdens for Small Business." I am James E. Brennan, Chair of the AICPA's IRS Practice and Procedures Committee. The AICPA is the national, professional organization of certified public accountants comprised of approximately 330,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, large and medium-sized businesses, as well as America's small businesses. It is from this broad base of experience that we offer our comments today.

Today's hearing addresses a very critical issue for small business and federal tax administration; that is, the need to respond to the significant problems emanating from the nation's tax gap and at the same time, ensure that the compliance burden is not unnecessarily increased for the super-majority of American taxpayers who consistently: (1) file their tax returns on time and (2) pay their fair share of taxes.

GENERAL COMMENTS

The AICPA commends the House Small Business Committee for holding this hearing today on the tax gap and small business. We support efforts by Congress and the Administration to identify ways to close the tax gap, while taking into account taxpayer burden as well. The IRS Oversight Board has also provided significant input on this very important issue through the January 2007 release of the Board's 2006 Annual Report. This report aptly describes the Service's successes in implementing the IRS 2005-2009 Strategic Plan which calls for: (1) improving taxpayer service; (2) enhanced enforcement of the tax law; and (3) modernizing the IRS through its people, processes, and technology.[1] Accomplishing these goals will empower the IRS to make meaningful contributions to closing the tax gap.

We support the Board's quest, as called for in its annual report, for a joint effort in developing an "overall strategy" to address the tax gap – a collective effort of the Board, Congress, the

[1] IRS Oversight Board 2006 Annual Report, January 2007, page 2.

Administration, and other stakeholders, including the AICPA. The AICPA welcomes the opportunity to join this public/private partnership; and we are ready to provide our expertise and input in tackling the estimated $290 billion net tax gap. We are committed to this common effort of mitigating the tax gap and fostering fair and efficient tax administration. We recognize that enhanced information reporting and IRS enforcement measures can be positive methods for reducing the tax gap, but such measures need to be balanced with ensuring honest taxpayers are not unduly burdened. In this context, we are pleased to announce that the AICPA plans to survey our Tax Section members soon to assess the perspective of CPAs on ways to address the tax gap.

In reviewing the IRS Oversight Board's annual report, we would like to highlight three of the Board's strategies for addressing the tax gap which we believe are critical to understanding small business' stake in the overall tax gap debate. This written statement addresses the Board's tax gap strategies involving: (1) tax code simplification, (2) improving customer service, and (3) developing a long-range plan for research; and the statement also addresses (4) the Small Business Tax Flexibility Act, (5) tax penalties and the tax gap, and (6) a Joint Committee on Taxation staff proposal on modifying amounts subject to self-employment tax for partners and S corporation shareholders in personal service businesses.

1. TAX LAW SIMPLIFICATION

Simplifying tax rules is a high priority of the AICPA. Of the various strategies under discussion by Congress, we believe that tax simplification should be the first recommendation for reducing the tax gap. The IRS Oversight Board report correctly states that "complexity makes voluntary compliance difficult for honest taxpayers to achieve, gives aid to those who want to cheat, and makes it hard for the IRS to identify non-compliance."[2] Commissioner Everson shared similar views when he publicly stated that "the complexity of our current tax system is a significant reason for the tax gap and that fundamental reform and simplification of the tax law is necessary in order to achieve significant reductions.[3]

We are committed to helping make our tax system as simple and fair as possible. Unfortunately, we believe that the law's complexity in certain key areas may be strangling voluntary compliance; for example, such as due to the corporate and alternative minimum taxes. The lack of deliberation in the legislative process, the frequent law changes in recent years, and the increasing magnitude and complexity of the Internal Revenue Code creates serious compliance issues for small businesses.

The AICPA has worked closely with the American Bar Association and the Tax Executives Institute in recent years to jointly identify specific proposals for simplification. Moreover, we released a September 2005 study entitled, *Understanding Tax Reform: A Guide to 21st Century Alternatives.* Our study discusses how many of the goals of tax reform can be achieved by

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[2] Ibid, page 36.

[3] IRS Commissioner Everson, Statement on the Internal Revenue Service's FY 2008 Budget, before the House Committee on the Budget, February 16, 2007, page 13.

modifying the current income tax system through tax simplification. The text of the full study is available at: http://www.aicpa.org/tax reform/.

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

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

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

There are various types of simplification that if enacted would update the existing tax system, such as: (1) simplification that reduces calculation complexity; (2) simplification that reduces the filing burden; and, (3) simplification that reduces the chances of a dispute between the IRS and the taxpayer. The first two types of simplification are sometimes the easiest to identify and fix, although sometimes the repairs involve hard choices. Computers help. Forms help. But this is not just about math. The last type of problem, adding certainty to the law and thereby reducing the likelihood of disputes, is the most difficult to effectuate yet, perhaps, the most important. Clarifying law that is hard to understand must be a priority if we are to achieve a simpler system.

The AICPA's 2005 report states that many goals of tax reform can be achieved through "bottom-up reform," which the report refers to as significant simplification of the current income tax system. The report makes a number of simplification recommendations, including: (1) repealing the individual and corporate alternative minimum taxes; (2) consolidating education and retirement savings incentives; (3) simplifying the earned income tax credit; and (4) eliminating phase-outs and temporary provisions when drafting tax legislation.

IRS statistics estimate the net tax gap to be about $290 billion. We believe tax simplification can play a significant role in helping to reduce the overall tax gap, as simplification would result in fewer errors on tax returns.

2. IRS MUST IMPROVE CUSTOMER SERVICE

The AICPA supports Commissioner Everson's call for a balance between enforcement and customer service. We also concur with the Oversight Board that a critical strategy for dealing with the tax gap involves (1) the IRS using customer service resources to help taxpayers be aware of their legal obligations; and (2) modernization as a positive avenue for easing taxpayer burdens.

The AICPA supports the Taxpayer Assistance Blueprint (TAB) – a congressionally mandated initiative calling for development of a comprehensive taxpayer service program for the IRS. TAB involves a collaborative effort by the IRS, the IRS Oversight Board, and the National Taxpayer Advocate. Phase 1 of the Blueprint, delivered to Congress in April 2006, identified five strategic themes for improving customer service: (1) improve and expand education and awareness activities; (2) optimize the use and support of partner services; (3) enhance self-service options for taxpayers; (4) improve and expand training and support services; and (5) develop short-term performance and long-term outcome goals and metrics.

IRS delivered the Blueprint's Phase 2 earlier this month to Congress, a document outlining the Service's strategic plan and recommendations for delivering taxpayer service. As the IRS develops specific programs to implement the TAB recommendations, we continue to stress the need for the Service to maintain the appropriate balance between customer service and enforcement – a balance that the government, Congress, and stakeholders recognize and support. Moreover, we urge the IRS to maintain its commitment to further improvements in the Business Systems Modernization (BSM) program and other technology efforts; such as the customer account data engine (CADE), the system designed to replace the master file for taxpayer records.

In Congressional testimony on February 16, 2007, Commissioner Everson referred to projects that the IRS envisions implementing as part of TAB, including enhancements to the Service's telephone service and www.IRS.gov, as well as multi-year research studies designed to promote an understanding of optimal service delivery and the effect of service on compliance.[4] The AICPA views these projects as laudable, and we stand ready to provide input for TAB throughout the implementation process.

3. GREATER EMPHASIS AND FOCUS ON RESEARCH

The AICPA believes the National Research Program (NRP), the Service's primary research strategy, is a positive foundation for meeting the IRS's needs for data and analysis of the tax gap. When the Service rolled out NRP a few years ago with a focus on individual tax returns, the taxpayer and practitioner communities were deeply concerned that the program would prove extremely burdensome to the public, much like the NRP's unpopular predecessor – the Taxpayer Compliance Measurement Program (TCMP).

The Service's outreach and discussions with stakeholders about the NRP's objectives, prior to the program's actual rollout, did much to lessen the public's concerns about the NRP's initial focus on 46,000 individual tax returns from tax year 2001. The Service has now turned the focus of the NRP to business returns. With this in mind, we reiterate our call for the IRS to maintain a high level of outreach and dialogue with the stakeholder community to ensure positive implementation and minimal taxpayer burdens, both critical ingredients for program success.

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[4] IRS Commissioner Everson, Statement on the Internal Revenue Service's FY 2008 Budget, before the House Committee on the Budget, February 16, 2007, page 2.

As the IRS increasingly relies on the NRP to better target its examination and compliance activities, we stress the ongoing need to continuously refine the tax gap data, including the level of the overall tax gap and identification of the types of industries and taxpayers contributing to the growth in the tax gap "numbers." This recommendation involves further analysis of the components of the tax gap before hasty enactment of legislation.

4. SMALL BUSINESS TAX FLEXIBILITY ACT

Small businesses are one of the main drivers of the Nation's job creation and economic growth. Start-up business survivability is a critical area of concern. Census data indicates that 20 percent of start-up businesses disappear after one year, and 70 percent after 10 years. Small businesses that struggle with and file for bankruptcy over operational, financial, and tax problems could prevent many of their problems by having adequate year-around access to CPAs and other advisors; a critical avenue for ensuring both effective tax compliance for small businesses and mitigation of the tax gap. Thus, the AICPA supports the Small Business Tax Flexibility Act which has been introduced in the 110th Congress as S. 270, and has been included as part of H.R. 46 thanks to House Small Business Committee Chair Nydia Velázquez. This bill gives most S corporation and partnership start-ups the flexibility to adopt any fiscal year-end from April through November.

Such flexibility would:

- Spread a start-up business' regulatory, financial, and tax burdens away from their busiest operational periods, thus increasing productivity;
- Spread the regulatory, financial and tax workload of CPAs and other advisors throughout the year, thus promoting a more balanced family-work protocol for advisors;
- Increase the occurrence of non-extendable financial and regulatory deadlines, such as bank loan paperwork or HUD filings, outside of the tax "busy" season; and
- Provide the same flexibility that C corporations (typically larger businesses) have in choosing the right fiscal year-end for the business.

5. TAX PENALTIES AND THE TAX GAP

A number of legislative proposals involving tax penalties have been raised under the guise of closing the tax gap. As a general principle, the AICPA supports carefully crafted penalties that promote tax compliance and result in a meaningful reduction in the tax gap. However, we are concerned that many of these civil penalty proposals are being raised by Congress and the Administration in a narrow, rifle-shot perspective. Instead, we believe greater levels of tax compliance could be achieved among the public if Congress established a legislative oversight process similar to that which was used in the drafting of the *Improved Penalty Administration and Compliance Tax Act*, which ultimately became law as part of the *Omnibus Budget and Reconciliation Act of 1989*.

In our opinion, establishing a broad legislative oversight (penalty) review process would not only achieve higher levels of tax compliance, but should also result in greater numbers of taxpayers believing that tax fairness has been achieved. This is consistent with a 2006 statement by J. Russell George, Treasury Inspector General for Tax Administration (TIGTA), that "...it is often difficult to ascertain whether a taxpayer has intentionally evaded taxes, or whether there was an honest misunderstanding. Therefore, the IRS use of punitive penalties must be tempered to ensure taxpayers are not penalized for honest misunderstandings."[5]

Prior to the 1989 reforms, taxpayers and tax professionals saw penalties as (1) an IRS tool for punishing taxpayers and a bargaining chip in audit examinations; and (2) a means of raising revenues for the U.S. Treasury. Before 1989, penalties were viewed as being applied unevenly in differing regions of the country, as well as lacking in coordination and overlapping in application.[6] Representative J.J. Pickle, one of the main proponents of penalty reform at the time, viewed the 1989 reform measures as fairer and less complex than the prior penalty regime, and an inherent extension of tax reform and simplification.[7] The fundamental purpose of the 1989 penalty reform was to overcome the piecemeal approach to legislative penalty changes.

6. MODIFYING AMOUNTS SUBJECT TO SELF-EMPLOYMENT TAX FOR PARTNERS AND S CORPORATION SHAREHOLDERS

The Senate Finance Committee issued a press release on October 19, 2006 requesting comments on several tax gap initiatives that are taken from the August 3, 2006 Joint Committee on Taxation staff report, *Additional Options to Improve Compliance*. One of these initiatives would have a significant impact on small business persons who are partners and S corporation shareholders in personal service businesses.

The August 3, 2006 JCT staff report provides two general approaches for increasing the self-employment taxes of partners and S corporation shareholders. First, this report restates a 2005 JCT staff proposal which would generally subject all income of service partners and S corporation shareholders to self-employment tax (SECA). The second approach (hereafter referred to as the 2006 proposal) would subject all such income of service partners and S corporation shareholders to SECA, except that the proposal would retain the current Internal Revenue Code section 1402(a) exclusions. More specifically, based on section 1402(a), rental income, dividends, interest, capital gains and other currently excluded non-active types of income would continue to be exempt from self-employment taxation.

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5 Statement of the Honorable J. Russell George, Treasury Inspector General for Tax Administration, on "A Closer Look at the Size and Sources of the Tax Gap," before the Senate Finance Committee, Subcommittee on Taxation and IRS Oversight, July 26, 2006; see document section entitled "Reduce the Complexity of the Code."

6 "Tax Politics and a New Substantial Understatement Penalty," by Dennis J. Ventry, Jr., Tax Notes Today, October 3, 2006.

7 Ibid.

The Proposals' Impact on Choice of Entity

The JCT proposals, in part, intend to improve tax neutrality with a goal of minimizing tax considerations in choice-of-entity decisions among pass-through entities. However, based on our broad practice experience, taxpayers and their advisors generally make choice of entity decisions based on legitimate tax and non-tax factors, including:

- Capital structure and capital contribution requirements
- Compensation plan design
- Personal liability exposure
- Asset protection planning
- Corporate governance provisions
- Liquidation rights
- Industry standards and common practices
- State regulatory guidance
- Size and type of business
- Franchise, income, estate and gift taxes
- State and federal tax law complexity

It is impossible to isolate self-employment tax -- or any other tax, for that matter -- as a major factor when deciding whether to form an S corporation because if each one of the above issues is not addressed, then taxpayers and their advisors have not properly analyzed all of the factors to make the determination as to the best choice of entity. Congress should consider that the choice of entity decision is complex and takes into account not only the self-employment tax but all the issues listed above.

The JCT proposals highlight one of the long standing tax differences between S corporations, partnerships, and limited liability companies (LLCs) – how the self-employment tax applies to the owners of these entities. Different self-employment tax rules apply depending upon the type of entity. General partners are subject to self-employment tax and certain limited partners are only partially subject to self-employment tax. For LLCs that have been the most popular entity of choice for start-up businesses, the LLC members have operated in an area of conflicting guidance for a number of years. Because an S corporation is a corporation, their shareholders are not subject to self-employment tax; instead, shareholder-employees pay employment taxes on their paid compensation like any other employee. While different tax rules (primarily statutory-based) apply to the compensation of owners for each type of entity, the different tax rules are not *prima facie evidence* that taxpayers are "abusing" the system.

We agree that the number of S corporations and partnerships has grown faster than C corporations. According to the IRS Statistics of Income Bulletins and the IRS Data Books, 1,580,300 partnership returns were filed for tax year 1994 and 2,530,846 for tax year 2004 – a 60 percent increase. Similarly, the number of S corporation returns filed increased 62 percent from 2,161,000 to 3,503,932 over the same period. We believe that the effective repeal of the *General Utilities Doctrine* in 1986 is responsible for this substantial increase in the number of partnership and S corporation returns and not the intent to circumvent self-employment taxes. Further, more

partnership returns are filed because more taxpayers are choosing LLCs as the pass-through entity of choice in large part due to the check-the-box entity classification rules.

In our opinion, self-employment tax exposure is one of many factors taxpayers consider in addressing the choice of entity question. If S corporations were chosen predominately to save employment taxes, one would expect to see a much higher increase in the use of S corporations relative to partnerships. The parallel growth of partnerships and S corporations, and the fact that new entities are more likely formed as LLCs rather than as S corporations, support the view that multiple factors drive the choice of entity decision.

Social Security/Self-Employment Tax Should Apply Only to Labor

The self-employment tax is intended to apply to income generated by an individual's labor. Partnerships have long been divided into categories for determining how the self-employment tax applies, for example: (1) general versus limited partnerships; (2) bifurcated or multiple partnership interests; and (3) managing LLC member versus non-managing member. Further, uniform state partnership laws have always interacted with the Internal Revenue Code to help define the parameters of self-employment tax applicability.

The question for S corporations is whether a shareholder provides services to the corporation. To the extent a shareholder works and receives reasonable compensation for such services, he or she should pay employment taxes. The S corporation employment tax system, in fact, is more logical than that used for imposing labor-based taxes on partners and reflects the original intent of the FICA and SECA rules by more clearly drawing the division between labor and capital.

In our experience, the vast majority of operating S corporations and partnerships are engaged in business activities in order to generate a profit, and a majority of this profit is generated by the efforts of the non-owner employees. Therefore, in these common cases, the corporation and partnership are already contributing to the FICA system by paying their share of employer FICA and the net profit represents a return of capital to the stockholders and partners. Therefore, simply subjecting substantially all of an S corporation and partnership's profit to self-employment tax is not appropriate because not all its profits can be attributed to the labor of its owners. In *Pediatric Surgical Associates*,[8] the IRS, itself, argued that profit attributable to services performed by non-shareholder employees could *not* be treated as compensation when distributed to shareholder employees. Contrary to the Service's position, the JCT proposal would apply self-employment tax to S corporation shareholders on their shares of the corporation's net income.

The AICPA believes that it is premature to enact either of the JCT proposals without first identifying whether a SECA tax avoidance problem exists. If a problem is determined to exist, the IRS should first utilize its existing system of enforcement to remedy the issue. There is no

[8] *Pediatric Surgical Assoc. v. Commissioner*, T.C. Memo 2001-81.

reason to further complicate the tax law by needlessly layering on more rules. If the existing rules do not work, those rules should be analyzed and improved. If more enforcement of the existing rules is determined to be needed to achieve the intended goal, the AICPA stands ready to support the IRS with its enhanced enforcement efforts.

STATEMENT OF
DONALD C. ALEXANDER
AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
HEARING ON CLOSING THE TAX GAP WITHOUT
CREATING BURDENS FOR SMALL BUSINESS

April 26, 2007

First, I wish to commend the House Committee on Small Business, Chairwoman Velázquez, and Ranking Member Chabot, for holding this hearing on closing the tax gap, a subject extremely important to our economy and to small business.

Recently we have heard much about the "tax gap", the annual difference between the amount of Federal taxes that should be collected and the amount actually collected. The gap is said to amount to a gross $345 billion, with about $50 billion later recovered by the Service's enforcement efforts, leaving a net gap of just under $300 billion. I think the gap is actually considerably larger because some revenue sources (mainly excise taxes, some nonfilers, and the illegal sector) are not included in the base and the compliance percentages (some of them ancient) are probably optimistic. In any event, there is a large number to work with.

Should we try to close or reduce the gap? The FORT WORTH STAR-TELEGRAM recently answered this way:

> America needs to do more to help taxpayers – honest taxpayers, that is.
>
> In the lingo of NCAA basketball's March Madness, we need a full-court press against those who skimp on paying what they owe.
>
> If we do, we can bring in tens of billion of dollars of additional federal tax revenues annually, perhaps as much as $100 billion. That would be a fair and sensible way to reduce federal budget deficits without increase the tax liabilities of honest Americans.*

How, then, can we reduce the tax gap without imposing unfair burdens on compliant taxpayers, particularly small business?

First, the Internal Revenue Service should seek to increase audit coverage, but the Service is fully aware that it can't audit its way out of the tax gap, even taking into account the substantial indirect effect of audits. That would be unacceptable. The Service should also

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*Jack Z. Smith, *An Honest Effort Could Reap Billions*, FORT WORTH STAR-TELEGRAM, Mar. 16, 2007, Section B.

strengthen its efforts to collect overdue taxes, particularly taxes withheld from employees' wages. Improving the quality and delivery of taxpayer service would play a meaningful role for middle- and low-income taxpayers.

Then we turn to other ways of reducing the gap: improved information reporting, document matching, and withholding.

An example of what more comprehensive reporting can do to improve compliance dates back to our last effort to simplify the Internal Revenue Code, the Tax Reform Act of 1986. Section 1524 of the 1986 Act required a taxpayer claiming a dependent at least five years old to report the dependent's taxpayer identification number. This provision resulted in the disappearance of more than seven million dependents in 1987. They never existed.

The Government Accountability Office believes that an effective withholding system produces 99 percent compliance, and an effective system of document matching (information returns) is close behind at almost 96 percent. When there is neither withholding nor document matching, compliance can fall below 50 percent. Various steps have been proposed. Among these is reporting of tax basis by brokers. If that proposal were adopted, it might seem advisable to distinguish between giant organizations with the needed data and capability and small brokerage houses with neither. Similar recommendations have been made regarding state and local property taxes and mortgage interest. Another recommendation would call for reporting of some auction and Internet transactions. The Treasury and GAO have proposed information reporting on payments to corporations and tighter rules on payments to independent contractors. Comprehensive and effective exchange of information with our foreign trading partners is a needed remedy. Proposals like those have merit but should be carefully designed to prevent unintended consequences.

Provisions calling for tightened information reporting and especially withholding should be carefully considered and, if possible, tested before enactment. Will the anticipated increase in compliance resulting from the proposal justify the burden and cost imposed on taxpayers? The poster child of what not to do was the subject of your hearing on March 22: the recently enacted provision requiring withholding at a three percent rate on gross payments to government contractors. While a description of the provision claimed that it "balances the goal of greater compliance with concerns regarding administrative burdens of imposing withholding", there is *no* such balance. Substantially all tax revenues expected to be produced by this provision result from its mandated float. Taxwriters should learn from the government contracts example: don't overdo it. Withholding on gross revenues is a blunt instrument almost certain to have a drastic adverse effect, particularly on small businesses where working capital is vital to survival.

In summary, I believe that the tax gap cannot, and should not, be *fully* closed. But our many honest taxpayers should not have to continue to shoulder as much of the burden of the dishonest as they do now.

Testimony of Joe Samuel, Senior Vice President, First Data Corporation
Before the House Small Business Committee
Thursday, April 26, 2007

Good morning, Chairwoman Velazquez, Ranking Member Chabot, and members of the Committee. My name is Joe Samuel, and I am Senior Vice President at First Data Corporation. I am pleased to be here today to discuss First Data's role in the payments industry, specifically merchant processing, and the costly impact of the proposed IRS mandate that would require merchant acquirers to report aggregate credit and debit card "reimbursements" of merchants on an annual basis. This proposal will create substantial compliance costs and expose First Data and other payment processors to considerable legal liabilities. We believe that the consequences of this proposal will have a negative impact on America's small businesses, which are the backbone of our nation's economy.

Let me begin my testimony by describing First Data and the unique role we play helping millions of consumers, businesses, and governmental entities buy products and services on a daily basis. Most people don't realize it, but First Data's products and services touch people's lives every day. We make buying and selling easier. Many of you do business with First Data everyday, although you may not know it. Whether you're writing a check at the gas station, using your ATM/debit card to pay for groceries, buying a book online, getting cash out of an ATM, paying for dinner with your credit card or using a gift card to purchase something special, chances are your transaction is moved quickly and securely by First Data.

Although we have many interesting products that enable various types of payment instruments to be used to purchase goods and services, I will focus my testimony on merchant acquiring and processing because that is the area that would be significantly impacted by the aforementioned IRS proposal. Our merchant acquiring and processing services facilitate the ability of merchants to accept consumer transactions (e.g. credit, debit, stored value, and loyalty cards) at the point of sale, whether those transactions occur at a physical merchant location, over the Internet, or at an ATM. In other words, our processing services enable businesses of all sizes to accept various forms of payments from consumers, including credit and debit cards.

The term "processing" can be described as those functions associated with authorizing, capturing, and settling merchants' credit, debit, stored value and loyalty card transactions and includes the handling of charge backs. In addition, we provide the point of sale devices and other equipment necessary to capture merchant transactions. Cumulatively, we provide merchant processing services to approximately 3.5 million merchant locations in the U.S. At First Data, a majority of these services are offered to merchants through joint ventures or similar alliance arrangements with financial institutions. In other words, the services we provide with our partners enable you to walk up to a check-out counter and pay for your goods or services with a credit, debit, or stored value card.

Overview of a Credit Card Transaction

The path of a typical credit or debit card transaction can involve up to five different parties. As a high level example of how this process works, a cardholder makes a

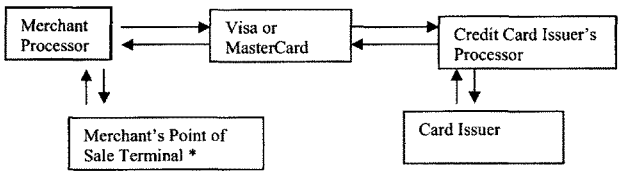
purchase using a VISA credit card at ABC Hardware and swipes his or her card through the point of sale terminal at the check-out counter. Immediately after the swipe, ABC Hardware sends an authorization request with the card data and the sales amount to the acquiring bank by way of the merchant acquiring processor (e.g. First Data).

First Data routes the authorization request to the network, which in this case is VISA, and VISA routes the transaction to the cardholder's bank (the bank that issued the card that was used to make the purchase). In a number of cases, this will be done by way of a credit card issuer processor (which could again be First Data). If the cardholder has sufficient unused credit, the issuing processor authorizes the transaction on behalf of the credit card issuer and sends the authorization approval back to VISA (at this point the cardholder's open to buy/balance is decreased). In turn, VISA forwards the authorization response back to First Data (the merchant acquiring processor), which sends the approval code to ABC Hardware's point of sale terminal. Remarkably, this all takes place within seconds by complex systems and processes that have taken years to develop and refine. Consequently, small businesses and our nation's economy depend on these systems to continuously operate quickly, efficiently, and reliably.

At the end of the day or within a predetermined time frame, the settlement process for credit occurs, in which transactions are sent from merchants to their acquirer processor for settlement. The acquirer processor then sends transactions to the bankcard associations who then settle with the card issuing banks. Funds are collected from the credit card issuer and transmitted to the merchant acquiring bank via the bankcard

associations. Effectively, the credit card issuer has electronically purchased the consumer's transactions from ABC Hardware's bank (the merchant acquiring bank). ABC Hardware's bank credits the merchant's bank account and then the credit card issuer sends payment to the bankcard association who in turn settles with ABC Hardware's bank. The cardholder receives their monthly statement and settles with the credit card issuer for their credit card purchases.

Path of a Typical Credit Card Transaction



Under the bankcard association rules, in order for a merchant to accept VISA or MasterCard transactions, a member bank must "sponsor" that merchant into the system. Any one of the banks in the United States that is a member of the bankcard associations must be on the merchant contract. For the actual processing services, however, many bank members outsource to third parties like First Data.

Concerns with IRS Reporting Proposal

First Data understands that the intent of the IRS proposal is to help narrow the tax gap by increasing reporting by small businesses. While at first blush it seems logical that merchant acquirers could help report transaction information to the IRS to increase reporting compliance, the reality of the processing world makes this a very challenging operational undertaking. For example, this proposal is vague and would clearly lead to

widespread inaccurate reporting of data due to: (1) merchant data utilized solely for payments processing that may not accurately reflect the business' reporting structure; (2) offsetting transactions such as charge backs; and (3) PIN debit cash-back transactions. We believe it highly likely that these inaccuracies could lead to serious and irreparable harm to many small businesses. Ironically, this proposal could have the unintended consequence of discouraging merchants from offering consumers the ability to make electronic payments, namely via credit, debit, and stored value cards. Furthermore, while electronic payments continue to grow in terms of consumer usage, cash and checks remain the dominant forms of payment by consumers. As a result, the proposed requirement to report information specific to electronic payments will provide the IRS with information that is of little value.

- System Functionality

The IRS assumes that the tax reporting information it is seeking (e.g. TINs, transaction information, etc.) exists together in one place. Unfortunately, that is not the case. When First Data signs up, or acquires, merchants for processing services, we ask them questions to help us understand who they are, including obtaining their taxpayer identification number (TIN) or, in the case of sole proprietors or individual franchisors, their Social Security Number (SSN). We also obtain information about the level of activity they expect (e.g. sales, volume, average ticket amounts, etc.) so that if the activity levels change, we can review to determine if fraud is occurring or if the merchant is engaging in illicit activities.

Once the merchant is approved for services, we no longer identify them by their SSN or TIN in our system. Instead, First Data assigns each merchant a merchant identification number. (This is another procedure to help mitigate data security breach risks and vulnerabilities that would arise if sensitive information like SSNs and TINs were flowing through our systems linked to every transaction.)

Appropriately identifying the TIN or SSN with the merchant ID would prove to be very difficult, and in some cases impossible, largely due to merchants with franchises and multiple locations. In a franchise situation, the merchant doesn't always use the corporate TIN in the initial application process; many times, it is their individual SSN. For merchants with several stores or chains around the country, we assign different merchant ID numbers for different locations. For example, a Hilton hotel in Denver would have a different merchant ID number in our system than a Hilton hotel in Washington, D.C.

It is important to note that the transaction files in our systems are maintained no longer than 18 months (and several systems maintain archives for as little as 45 days). We do not currently have a mechanism by which to generate annual transaction reports that coincide with merchants' TIN/SSN. Thus, to comply with the IRS proposal, payment processors like First Data and our acquiring bank partners would need to expend considerable resources to develop a system that would still provide inaccurate information on small business payment transactions.

- Aggregate Data

The IRS' proposal also references reporting aggregate data. The information that First Data has on its processing system is not a database, but a daily file that contains gross transaction information. From that gross number, fees, the merchant discount, interchange, assessments, charge backs and additional billing items may be deducted. Therefore, reporting aggregate data would not provide a clear picture of the merchant's transaction data.

- Lack of Identification of Merchant Goods or Services

When First Data authorizes a transaction on behalf of a merchant acquirer, we see the financial piece of the transaction, which is typically only the date, time, amount of the transaction and card number, as well as industry specific criteria such as the merchant category code, which is a code created by the card associations to assist bankcard issuers in making authorization decisions and obtaining interchange rates. We don't know whether the transaction was for goods or services.

- Accuracy of Information

If the IRS proposal were enacted, it would have a tremendous impact not only on our costs, but also on the ability of small businesses to accept electronic forms of payment. In an effort to avoid identifying merchants with incorrect TINs, we would have to implement an extensive process whereby our employees would need to continually update merchant records and respond to various parties who assert that we've

disassociated their data. We process for nearly 4 million merchant locations – keeping up with the demand to maintain accuracy and correct errors is almost inconceivable.

Unlike traditional concepts of accounts that reflect "ownership" of a fixed asset or fund, such as a bank account or a brokerage account, the payment processing relationship represents an ongoing stream of transfers that may not be directly associated with the legal entity that is the owner of the funds. Managing agent, franchise and secured lending relationships will frequently cause a situation where the funds that flow through the processing relationship belong to a completely different entity.

- Privacy

As already discussed, many merchants establish an account with First Data using their SSN instead of a TIN. If merchant acquirers were mandated to transmit that information to the IRS, significant privacy concerns would have to be overcome, including whether permission would need to be obtained from the individual; securing the data as it is transmitted to the IRS; ensuring appropriate safeguards in the storage of the data within the IRS' systems; and determining who would assume liability and responsibility if a breach were to occur. These costs would be borne by merchants, and ultimately by consumers who would pay for higher priced goods and services.

Moreover, the bankcard association rules specify that the transaction information belongs to the member bank and there are strict limitations on sharing that information. At the

very least, the bankcard associations would need to be involved in the discussions to determine whether sharing the information violates their operating rules.

Reporting Electronic Payments vs. Credit and Debit Card Transactions

Although the IRS proposal is vague, if we assume that this proposal would incorporate all electronic payments, then the reporting would include transactions beyond credit and debit cards and incorporate gift cards, electronic checks and more. We have identified significant problems associated with reporting some of the most common types of electronic transactions.

- Debit Cards

The debit networks, such as STAR, PULSE, and NYCE operate differently than the credit card networks in a number of ways. Our concerns involving the reporting of debit card transactions center on consumers' growing use of PIN debit transactions. With this type of payment method, consumers are often afforded the ability to get cash back at the point of sale. For example, in a situation where a customer buys $20 of merchandise and opts to get $40 cash back, the processor sees the $60 total for the transaction. In this scenario, the $60 number would have little bearing on what the IRS is trying to achieve and, in fact, would clearly lead to inaccurate reporting of information biased against the merchant. This over-reporting of transaction information could unfairly subject small businesses to costly and time consuming audits.

- Gift cards

Gift cards present another complex scenario because a merchant does not actually consider the purchase of a gift card as revenue until the card is redeemed. However, until the time that the card is redeemed, the money is cash on the merchant's books. Dormancy or other service fees and escheatment also affect the total value. In that case, it is unclear whether the IRS would want the reporting to cover when the gift card was purchased or when the card was redeemed?

Conclusion

The IRS proposal would have far reaching impacts that would add significant costs to payment processing whose costs would be borne particularly by small businesses unless the government is willing pay for these costs. The examples I have illustrated underscore that our processing systems were not designed to accommodate such a vague and unworkable proposal. Ultimately, we believe that the burden that this reporting requirement would place on merchant processors and small businesses, along with the certainty of reporting a high degree of inaccurate data, will vastly outweigh any perceived benefits.

April 27, 2007

Honorable Nydia M Velazquez
Chairwoman
Committee on Small Business
United States House of Representatives
2361 Rayburn House Office Building
Washington, DC 20002

RE: Tax Gap Hearing
April 26, 2007

Dear Chairwoman Velazquez:

As a self-employed attorney, I have spent the past 25 years providing advice to financial institutions on IRS withholding and reporting requirements. Given this unique background, I respectfully submit the following statement for your consideration in conjunction with the Committee's examination of issues surrounding the "Tax Gap" generally and the "Acquirer Reimbursement" proposal specifically, topics which were the subject of a hearing on April 26, 2007. My comments are my own and should not be attributed to any of my clients.

We are all committed to tax compliance, and all of us would agree that well-target, properly crafted information reporting generally increases compliance. But each proposal needs to be analyzed according to several measures of adequacy and effectiveness. Burdens imposed on the private sector should be imposed only when it can be shown that the resulting information will serve a specific vital purpose and that there are no less-burdensome means to obtaining that information. Toward that end I first lay out some guidelines for analyzing compliance proposals, and then apply those standards to the Acquirer reimbursement proposal

Guidelines for Analyzing Compliance Proposals

1. Identify the problem and how the proposal will address it. Are there any other less burdensome ways to obtain this information?

The Treasury description of this proposal is -kindly put-minimal. It does not fully describe just what problem this proposal is supposed to solve. Information returns are traditionally used in what I call an "absolute" sense. They are compared to a tax return to insure that income is properly reported, or to substantiate that the taxpayer is entitled to the deduction. This new proposal has been characterized as one which would use information returns in a "relative" sense, that is, not to directly determine the accuracy of a taxpayer's return, but to compare one taxpayer to another or to a group of other taxpayers to suggest who might be the best candidate for an audit. In the case of the Acquirer proposal, it apparently is to compare credit card merchants to those who deal in cash.

Credit card transactions already generate a paper trail. If IRS wished to determine the accuracy of a merchant-taxpayer's income from card transactions, that can be determined without a new reporting requirement. It is not clear to me why or how

knowing the amount of card transactions will lead to identifying or reducing non-reporting of cash transactions.

2. Know well the structure of the affected payor community-what information do they already gather? Who has it and at what point in the transaction? All of us have personal experience with using credit cards to purchase goods and services. But how many know how that transaction is accomplished? How does the information flow? To whom? When? What sequence of events transpires to get payment to the merchant and the transaction listed on your monthly statement? These are two separate processes.

What parties are involved? What does each do? Who issues the cards and what do they represent legally? When you conduct a transaction what you have done is draw down on a line of credit between you and that issuing bank, and once the transaction is authorized, the merchant is guaranteed payment; if you do not pay your bill it is the issuing bank that takes the hit.. The merchant is paid with 2-3 days but you might not get your statement for a couple of weeks and not pay for even longer still.

Any reporting required of any party within the card industry must take all of this into consideration. As will be evident later in this letter, there are some technical issues related to how transactions are processed that would need to be addressed to make this proposal feasible.

3. What are the burdens that would be imposed? Financial? Lost Opportunity? On whom? Taxpayers? Payors? IRS? Is this an appropriate use of resources? Who should pay? Will it result in reduced efficiency in payments?

For the past 60+ years, entities paying for services have had to report them-using Form W-2 for employees and Form 1099-MISC for independent contractors. This is true whether you pay for the transaction with cash, by check, or with a card. So there already is reporting within the card sector. The Acquirer proposal would shift that reporting from the cardholder to the Acquirer (or, worse, duplicate it).

As the term is used in the industry, the Acquirer is the member bank that brings the merchant into the system and is responsible for the merchant's compliance with system rules. It is to the merchant what the issuing bank is to the cardholder. The Acquirers have never had to do any tax-related reporting before, so they would be starting from scratch. They would have to obtain hardware, software. They would have to develop processes and design systems. They would have to train personnel. All of this is expensive and takes time. Should the Acquirers be forced to shoulder this burden alone? Or could they pass along some of the costs to the merchants on whose behalf they are reporting? Or would a tax credit be

better-since the claim is that the entire nation benefits from greater reporting, should not the cost be borne by all?

And what about the lost opportunity costs? If an Acquirer is forced to use scarce resources to implement this proposal what other projects-projects that would benefit the entire economy by facilitating commerce-would be delayed or dropped entirely?

And costs to IRS. Every information returned filed must be processed. Given IRS's own limited resources it is important to be sure that the information provided will be worth the cost of processing it, and would be useful in improving compliance. It is not clear that this is the case in this instance.

4. Is it fair? Who benefits? Who doesn't? Cardholders currently report payment card transactions. If you have the Acquirers report, it is necessary to provide that cardholders no longer need to, otherwise you will have double reporting. (Same for the 3% provision passed last year.) Is it appropriate to shift the burdens this way?

5. What collateral issues does this raise? Impact on other industries or reporting requirements? Shifting reporting to the Acquirers is a fundamental shift in the definitions of payor and paying agent. These definitions are also important for broker reporting, real estate reporting, and mortgage interest reporting-any transaction where there are chains of intermediaries involved. Any legislation should make it clear that no change in those reporting sections is intended.

In addition, onerous reporting provisions could have the effect of slowing the transition to payment cards for procurement transactions. Since the Federal government alone saves nearly $2 Billion each year by using the cards over conducting identical transactions by check, it is critical that any compliance proposals do not dissuade agencies from using cards because of inability to meet ill-founded "compliance" requirements.

6. How much time will be needed? Effective dates need to realistic. The proposed effective date on this proposal is totally unrealistic.

That is the framework for any compliance proposal. These issues will be expanded upon below in my examination of the Acquirer Reimbursement proposal.

Issues Associated with The Acquirer Reimbursement Proposal

1. Who is Responsible. In the credit card world, an Acquirer is the member bank which extends credit to and is responsible for the activities of its merchants. The actual enrollment process, the processing of transactions, and the payment

relationship may be handled directly by the Acquirer or may be out-sourced to a third party, or some combination of the two. If the "Acquirer" must report, the statute must define who is meant by this term. In situations where a third party maintains the account relationship with the merchant and is the party which pays the merchant, it may be more appropriate for that third party to do the reporting since they would have more direct access to merchant data as well as the transaction data. If the definition is not clear in the statute, implementation time will be lost awaiting a regulation, for both Acquirers and third parties may assume that the other is the one responsible No one will devote the time and money to building the necessary systems if they are not sure they need to.

Under IRC section 6050H, which establishes the mortgage interest reporting requirements, it is the first person who receives the mortgage payment from the borrower that is responsible for reporting even if they are not the lender. Under IRC 1441, which provides rules for reporting payments to non-resident aliens, it is the last person in any chain of middlemen which has to do the documentation, reporting, and any withholding. These rules are mirror images of each other; both stand for the proposition that the person next in line to the taxpayer has to do the reporting. It may be appropriate to following the same reasoning here. But regardless of the definition of Acquirer used, it needs to be provided in the statute.

2. What Amount to Report. It is well known that a merchant pays the credit card system a fee for each transaction it conducts. This fee is deducted from the payment due the merchant before remittance. This proposal if enacted must define the amount to be reported. Should it be the total transaction amount? The transaction amount less fees? And what should be done when a transaction includes cash back to the cardholder? For example, If the underlying transaction amount is $100, and the fee is $2, and the cardholder requests $20 cash back, should the reported amount be $100, $98, or $120? Clearly, including the cash back to the cardholder grossly inflates the purported income of the merchant, which could lead IRS to question the accuracy of the merchant's tax return. Yet there is currently no way in the system to separately track the underlying transaction amount. As between the full transaction amount ($100), and the gross amount less the fee paid to the system ($98), it may be advisable to follow IRS practice under IRC section 6045 and permit the Acquirer to select either option, and indicate the selection on the information return. And the issue of cash-back can be largely avoided if the current exception for payments for merchandise is retained (see below), as few service-related transactions involve cash back.

3. Duplication. Under current law, anyone that makes a payment in the course of a trade or business must report if the amount is at least $600 annually and no other exception applies. As a result, if the Acquirer proposal is adopted without changing the current statute two persons will be reporting the same transactions-the cardholder and the Acquirer. The obvious solution to the problem is for the statute

to eliminate the need for the cardholder to do the reporting where the Acquirer does the reporting. This is a critical inclusion in the statute; duplicate reporting is worse than no reporting at all since it result in inflating the purported income of the merchants.

4. Scope. IRC section 6041, in effect for almost 65 years, requires anyone that makes a payment in the course of a trade or business to report if the amount is at least $600 annually. The regulations provide some exceptions (discussed below). Because the statute is limited to payments in the course of a trade or business, individual taxpayers are not required to file information returns when, e.g., they pay the plumber for work done on their home. Does the Acquirer proposal apply only to corporate cards keeping in line with over six decades of requirements? Or is the proposal intended to cover all cards including consumer cards? If the former, transactions conducted by a sole proprietor with the individual's personal credit card--a common occurrence-- would not be picked up, leaving the small business person to file the information returns themselves, but giving big business freedom (assuming the duplication is eliminated as described above) from the IRS requirements since the card system will do the reporting for them. This seems unfair, yet there is no way in the card system to identify individual transactions on a card, only card lines. So it will need to be decided whether to expand the scope of IRC section 6041 to include consumer card transactions or to retain the decades-long practice of reporting only B-2-B transactions.

5. Payee Exceptions. Current regulations provide that no reporting is required for payments to governments, tax-exempt organizations, and (for most payors except Federal agencies) corporations (except medical and legal corporations.) Would the Acquirer proposal retain those exceptions? Card payment systems are not keyed into the structural identity of the payee. Determining which payees fit those exceptions may be difficult, though some of the information has been gathered recently for the IRS "QPCA" program. Should a merchant be excluded from the reporting requirements just because they have incorporated? Is this fair to merchants that are partnerships or sole proprietors? On the other hand, information returns filed for payments to corporations usually cannot be easily matched to a corporate tax return because information returns are filed on a calendar/cash basis and many, if not most, corporations file tax returns based on fiscal/ accrual systems of accounting. Payors should not be required to file returns that cannot be used, but, since identifying exempt payees may be burdensome to the Acquirer, any exception based on the structural identity of the payee should be optional, not mandatory.

6. Merchandise. Current regulations provide an exception from information reporting for payments for merchandise, and some other transaction types. Will this exception be kept? The system can identify merchants that engage primarily in merchandise transactions by reference to the Merchant Category Code assigned

upon enrollment. See IRS Revenue Procedure 2004-43 which lists the MCCs which identify non-reportable merchandise-based merchants

Treasury has separately proposed eliminating this exception for federal, state, and local government payors. The card system would not be able to accommodate such distinctions.. While it would be easy to exclude all merchandise transactions, it would not be possible to identify and exclude merchandise transactions conducted by non-governmental agencies. Indeed, reporting on merchandise transactions only when a governmental agency is involved would not provide any useful information, thus violating the first rule of compliance burdens-the information requirement should serve a defined and necessary purpose.

Also, by retaining the merchandise exception, most problems associated with "cash-back transactions" will be eliminated as it is rare that a service-related transaction involves cash back to the buyer.

7. TINs. Currently, merchants are required to provide their Taxpayer Identification Numbers (TINs) to cardholder-payors but are not required to certify them on Form W-9 as is required of payees in other situations such as bank and brokerage accounts. Will these rules carry over if Acquirers do the reporting instead of the cardholders? Or will another Treasury proposal to require all TINs be certified be adopted?

Given enough advance notice, obtaining certifications from new merchants would not be difficult since the TIN is already requested in order to do the credit check. Certification could be incorporated into the application process prospectively. But obtaining certifications from the 5 or 6 million merchants currently in the system would be an incredible burden on the Acquirers and could negatively impact merchants. Each card system used by a merchant would have to be separately supplied with a certification. If one was not supplied by the effective date, merchants could be hit with backup withholding (see below), reducing their cash flow by 28 percent. Grandfathering current merchant accounts that contain a TIN would be ideal-and fair. This approach would mirror the one taken in the 1980's when banks and brokers were first required to certify the TINs of their account holders. So long as a TIN was provided, though not certified, no backup withholding was required. For accounts opened after the effective date, a certification is required, or backup withholding applies. It would be appropriate to apply the same rules here.

This approach would also reduce or eliminate the need for backup withholding as nearly every merchant has already provided a TIN. By eliminating the need for withholding, you also avoid significant system issues with transactions reversals (see below).

Also note that if certifications are required for currently enrolled merchants, it will take at least 2-3 years to accomplish.

8. TIN Matching. Another separate Treasury proposal would make the current voluntary TIN matching system mandatory. As with TIN certifications, submitting TINs of new merchants would not be overly burdensome, but submitting the current portfolio of merchants would be very burdensome and would take multiple years to work through.

This provision would be particularly onerous if TIN matching was not only mandatory, but (unlike current rules) resulted in backup withholding if the TINs did not match IRS records. Experience has shown that the IRS files are not entirely accurate; some merchant name/TIN combinations may in fact be correct even if they do not match IRS records. If IRS found no match, and if backup withholding was necessary as a result, merchants would be hard hit, suffering a 28 percent reduction in their cash flow.

Even more likely are the mismatches which will occur because the card system data bases and the IRS data bases are constructed around two different purposes. IRS keeps records according to the taxpayer's legal name; the card industry keeps most records by the business name. If the card industry submitted the name "Amtrak" it would not match IRS records since the legal name of that entity is the National Passenger Railway Corporation. Both names are correct in their own context, but they are not the same.

The same could easily happen to a small business, especially sole proprietors. IRS wants the individual sole proprietor's name and SSN; the card industry most likely has the DBA name and possibly an EIN for that business. A non-match result could cause the business person great frustration, if not impair cash flow, even though the information provided to the card system is correct for its purpose. Any requirement to go back and sort through such cases and determine the actual legal name of the merchant to satisfy IRS would be very expensive and time-consuming.

9. Withholding. The Treasury's description does not address whether Acquirer reporting would be subject to the backup withholding rules of IRC section 3406. And since there is no legislative language yet, it is not clear where the reporting provision would be placed. But if it is included under IRC section 6041, then the backup withholding rules would come into play.

Banks and brokers have spent over twenty years cleaning up their account files. As a result, relatively little backup withholding is required to be done today. However, in the early years of backup withholding in the 1980's, much more withholding was required. This was not because payees were cheating, or payors were not recording data properly, but just because of the differences between business files

and IRS files as described above, and because IRS does not itself have perfect files.

If amounts reported under this proposal were subject to backup withholding where either no TIN is provided or an incorrect TIN/name combination (see TIN Matching, supra) is on file, many merchants will find themselves receiving only 72 percent of their transaction amounts. Such a severe impairment of cash flow could cause some merchants to fail entirely through no fault of their own.

In addition, if Acquirers must report the total amount of the transaction, including any cash back to the cardholder, their cash flow would be reduced even more. In the example used earlier of a $100 transaction where the cardholder gets $20 cash back, if backup withholding applies to the total amount shown ($120) the amount withheld would be $33.60, not the $28.00 if the withholding is applied only to the actual transaction amount.

Problems would also be generated by returns and credits. If backup withholding were done on the $100 transaction, and the transaction were reversed, the merchant would have only $72.00 ($66.40 if withholding were done on the cash back transaction) to return to the cardholder since $28.00 would have been deposited with the IRS. The system has no capacity to do accomplish this. By applying reasonable TIN rules (see above), the problems of backup withholding could be avoided.

10. Penalties. The Treasury has proposed, and the Senate has already included in its version of H.R. 1591, an increase of the information reporting penalties from $50 per error with an maximum annual penalty of $250,000 to $100 per error and a maximum penalty of $1.5million (These are the Treasury numbers, the Senate's version would increase the penalties even more.) If penalties are increased, and the Acquirer proposal is adopted, Acquirers will be establishing their systems and cleaning up their data files under the threat of significant penalties. Banks and Brokers have had the opportunity to do the same over the past 20 years under a far less onerous set of penalties. There is a separate penalty on the merchants themselves for failure to provide the correct information. Both Acquirers and merchants should be given some time to catch up with the banks and brokers while either having no penalties or being subject to the existing penalties. IRS should be directed to provide significant educational outreach to the Acquirer community, and to use a lenient approach when facing the possibility of imposing penalties on these newcomers to the reporting system. Only after having a few years to work out the inevitable data problems should they beheld to the higher standard proposed by Treasury.

11. Burden. For 65 years it has been the cardholders' responsibility to file information returns for transactions with merchants. Apart from the obvious

technical difficulties which need to be addressed by shifting that burden to the Acquirers, Congress needs to realize that the Acquirers would be starting from scratch. They do not have the hardware, software, systems, processes, procedures or trained personnel to immediately file information returns. The cost will be significant in any event, but crushing if TIN certifications and matching, backup withholding, and higher penalties are thrown into the mix. Serious consideration must be given to the impact these costs will have on the Acquirers, the merchants, and the nation as a whole.

12. Effective Date. There is no possible way Acquirers could begin filing information returns in 2008. It will take at least three to five years to create the mechanisms to properly file. The shorter time frame can be met only if the reporting is not complicated by changes in TIN rules, and if backup withholding and cash-back issues can be resolved. And it can be done in the lower end of the estimate only if you answer critical questions in the statute itself so that systems development does not wait for IRS regulations

13. Negative Impact on Procurement Costs. For over a decade, it has been the policy of the Federal government to promote expansion of the use of electronic procurement processes. According to studies by Professors Richard Palmer and Mahendra Gupta[1], in 2005, the 25.9 million purchasing card transactions of the Federal Government saved the taxpayers $1.7 billion over the cost of doing the exact same purchasing by check/invoice. That is an average savings of $67.38 per transaction. Care should be taken to make sure that this proposal does not interfere with card usage or procurement costs might rise, not fall.

The professors also note that if every Federal Agency used the payment card for just 5 percent of its budgeted spending, the savings to the Federal Government would be $12.4 billion per year. By doing so, the government would save more in one year than they would in ten years of the Acquirer reimbursement proposal, and without the costs in time and resources to create the reporting system.

These tremendous savings are not restricted to the Federal Government. State and local agencies, universities, and the private sector save similar costs per transaction. Instead of burdening the card system as a back-door way to address non-compliance in the cash sector of the economy, efforts might better be directed towards expanding use of the current system and using some of that money to increase IRS funding for audits.

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[1] See Palmer and Gupta, 2005 Purchasing Card benchmark Survey Results, page 188.

Congress needs to address all of these issues before proceeding with this Acquirer reimbursement proposal. I thank the Committee for this opportunity to express my concerns. I would be happy to discuss them further at your convenience.

Sincerely,

Paula D. Porpilia
TIN Compliance Consultants

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