FULL COMMITTEE HEARING ON IRS OVERSIGHT: ARE TAX COMPLIANCE COSTS SLOWING DOWN THE ECONOMIC RECOVERY?

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

HEARING HELD
APRIL 1, 2009

Small Business Committee Document Number 111-014
Available via the GPO Website: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

48–125 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
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FULL COMMITTEE HEARING ON IRS OVERSIGHT: ARE TAX COMPLIANCE COSTS SLOWING DOWN THE ECONOMIC RECOVERY?

Wednesday, April 1, 2009

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

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

Present: Representatives Velázquez, Dahlkemper, Schrader, Altmire, Clarke, Graves and Luetkemeyer.

Chairwoman VELÁZQUEZ. I call this hearing of the House Small Business Committee to order.

Every American circles April 15 on their calendar, but outside of a few eager CPAs, most people do not look forward to tax day. While this time of year brings an annual headache for us all, it is especially daunting for our nation's entrepreneurs. Historically, tax code complexity has been the greatest source of frustration for small businesses. No surprise there, the tax code contains over 200 small business provisions.

Simplification is key, and this Committee has held hearings on this issue, but today in light of historic economic challenges, that matter has taken a back seat to more immediate concerns.

This afternoon we will explore ways in which the IRS can help entrepreneurs meet tax obligations during a recession. We will also discuss the role of the agency in handling incentives within the stimulus.

In February small businesses finally got their stimulus. Within that bill were critical tax incentives from bonus depreciation to net operating loss extensions. This is the kind of relief entrepreneurs need, but like most tax policies, these initiatives are complex.

The IRS needs to insure their meanings are clear before small firms can take advantage of incentives. They need to understand how they work. Otherwise the benefits of these provisions and of the stimulus overall may be diminished.

Unfortunately, clarification has never been an IRS strong point. After all, we are talking about the agency that handles the 54,000 page tax code, but with new stimulus policies on the books, the IRS will have to improve communications. Part of that improvement process should include increased outreach and enhanced client services.

Entrepreneurs need to know they can count on the IRS to answer their tax question quickly and accurately. In an era of growing uncertainty, those kinds of resources are critical, especially considering recent increases in small businesses' audits. Unlike big businesses, small firms do not have an army of tax attorneys and accountants. As a result, they are largely defenseless against the IRS, making them easy targets.

In the two years between 2005 and 2007, small business audits shot up 41 percent. Meanwhile, investigation of the biggest companies plummeted 40 percent. It does not matter who you are or how big your business is. No one had the right to skirt their taxes. But at a time when small business audits are up and big business audits are down, you have to wonder where are the priorities.

Small firms have been battered enough by the recession. The last thing they need is the added nightmare of an IRS investigation. In the face of deepening recession, tax policies should be a means for small business growth and not the straw that breaks the camel's back.

I would like to thank today's witnesses and especially the Commissioner of the IRS, and in advance for the testimony. I know this is an especially busy time of the year, and I am pleased that they both can join us.

With that I would like to yield to Ranking Member Graves for his opening statement.

Mr. GRAVES. Thank you, Madam Chair, and thank you for calling this hearing on tax compliance costs for small businesses.

I also want to extend my special thanks to our witnesses, Commissioner Shulman, and the witness on the second panel, which is Kit Smith, a constituent from Missouri whom I am going to introduce later.

Every day it seems that we hear more bad news for entrepreneurs. The faltering economy, federal bailouts of big companies that owe back taxes, studies showing that small companies are increasingly targeted for audits. Our nation's small company owners are in the trenches day in and day out working hard during the recession to keep their businesses afloat, contribute to the economy, purchase equipment, and create the majority of new jobs, and of course, pay their taxes.

According to the Internal Revenue Service's National Taxpayer Advocate, tax issues present the single most significant set of regulatory burdens for small firms. The Small Business Administration's Office of Advocacy reports that firms with less than 20 employees spend more than $1,200 per employee to comply with tax paperwork, record keeping, and the reporting requirements that go along with it.

This is twice the cost of compliance for larger firms, and surveys by the National Federation of Independent Business consistently ranked federal taxes among the top five issues of greatest concern to entrepreneurs. Small businesses have good reasons to be concerned. Most of them pay their taxes and on time, and they want others to do so as well. We have heard about the tax gap, or the difference between what is legally owed and what is actually paid voluntarily and on time.

One prong of the IRS strategy to reduce the tax gap is to increase enforcement. And it appears the IRS has small businesses in its crosshairs. A 2008 Syracuse University study revealed that small businesses were 41 percent more likely to be investigated than large firms, while the audit rate for the nation's largest corporations fell to the lowest level in 20 years. One can only surmise that this is because small firms are less able to hire high-priced attorneys and accountants to fight back.

Today we will hear from one of my constituents, Mr. Smith, who is going to describe the horrific IRS audit of his small business. If small firms did not have enough stress trying to run a small company in a recession, we burden them with countless laws, regulations, reporting requirements, and we continue to do so every year. We must simplify our tax code and require the IRS to do a better job of helping small businesses comply. Small businesses deserve better.

Madam Chairman, again, I appreciate your work on this and the hearing you are having today.

Chairwoman VELÁZQUEZ. Thank you.

And now I welcome the Honorable Douglas Shulman, IRS Commissioner. Mr. Shulman is Commissioner of the Internal Revenue Service. He is the 47th Commissioner and began his five-year term on March 24th, 2008.

Prior to joining the IRS, he worked for the Financial Industry Regulatory Authority, the private sector regulator of all security firms doing business in the United States. The IRS collects approximately $2.4 trillion in annual tax revenue that funds most government operations and public services.

Welcome.

STATEMENT OF THE HONORABLE DOUGLAS SHULMAN, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. SHULMAN. Thank you, Chairwoman Velázquez. I very much appreciate being at this hearing. Ranking Member Graves, other members of the Committee, I am happy to have an opportunity today to testify about the Internal Revenue Service's efforts to assist America's small businesses, particularly during the current economic downturn.

As President Obama recently observed, our recovery in the present and our prosperity in the future depend upon the success of America's small businesses and entrepreneurs. I believe, and I have been very public in this belief, that the IRS has two equally important parts of its mission: service and enforcement. We need to provide world class service to the small businesses, the individuals who are out there trying to wrestle with an incredibly complex tax code, and we have to have enforcement programs for those who aren't paying their taxes across the spectrum.

I have started two small businesses personally in my career, and therefore I am acutely aware of the many problems confronting a small business. From struggling with the economic environment to securing a loan, to hiring employees, to getting sales, to the obligation to pay their taxes.

I have included information in my written testimony about a number of issues. Let me highlight a couple of things we are doing now to try to help small businesses during this recession.

It is inevitable during these kinds of times that taxpayers may fall behind in their taxes. As the IRS Commissioner, I am very committed to striking the right balance between collecting the revenues needed to fund the government and using all the tools that we have available to work with small businesses who find themselves unable to pay. I have told our people, from the most senior to those working on the front lines, that we need to be flexible, principled, and that we need to empower all of our people to use their judgment when they are working with taxpayers.

As the economy got worse last summer, I sat down with our senior team and said what can we do for taxpayers and where are we going to find stress in our system between us and taxpayers. We did a number of things that benefit small businesses. Let me take you through a few.

First, our employees were reminded of their ability to offer install agreements at the end of an audit when taxpayers are having difficulty satisfying their obligations to pay immediately.

Second, I gave IRS employees more flexibility to suspend collection actions in certain hardship cases.

Third, we gave employees more flexibility to work with previously compliant taxpayers in an existing installment agreement who cannot pay because of an economic hardship.

Fourth, taxpayers unable to meet the payment terms of an accepted offer in compromise are now being informed of the options available to them to help them avoid a default.

And, fifth, we are speeding up levy releases by easing requirements on taxpayers who request expedited levy release.

Turning to the American Recovery and Reinvestment Act that you mentioned, Madam Chairwoman, the IRS announced last month that small businesses with deductions exceeding their income in 2008 can use a new net operating loss tax provision to get a refund of the taxes paid in prior years. This new provision enables small businesses with a net operating loss in 2008 to offset losses against income earned and allows a carry back of up to five years instead of the normal two years.

This could throw a lifeline to struggling businesses with an infusion of cash. I have made sure that we have the resources to move quickly to get cash into the hands of small businesses when they apply for such a refund. We are going to be monitoring this on a daily basis, and if we find a backlog or any clogging in the system, I am going to apply more resources so that we can implement this smoothly and seamlessly.

Madam Chairwoman, the IRS is always looking for ways to better serve taxpayers through outreach and education. As you said, a lot of small businesses do not have all of the high priced lawyers and accountants and other sort of service providers, and so we are acutely aware that we need to be directly helping small businesses.

Last year we participated in more than 2,600 meetings with small businesses, reaching directly 162,000 small businesses through outreach efforts. We hold national and local small business forums to have an avenue of communication with the IRS. At the

local level we have special business units that work with Chambers of Commerce, small business development centers, better business bureaus, and other groups that assist small business owners.

We also work with the Small Business Administration to get the word out to taxpayers. We are also very focused that we are never going to be able to get to all of the taxpayers ourselves, and so we try to work with associations to reach taxpayers.

Finally, we recognize that we are not going to be able to reach everybody through direct contact. We have phone-in forums. People can call our 1-800 number if they have questions or concerns.

We also have an E-newsletter for small businesses with 140,000 small businesses subscribing.

Let me just say that again I want to thank you for the opportunity to testify about what we're doing to help small businesses, as we are all trying to be on this road to recovery. We have made some progress, but I am a believer that institutions can always get better, and you have my assurance that I am going to push the institution to work with small businesses.

I look forward to working with you, other members of the Committee, and the staff to make sure that this great engine of economic growth and prosperity of the country continues to operate at its full potential.[The prepared statement of Mr. Shulman is included in the appendix at page 25.]

Chairwoman VELÁZQUEZ. Thank you.

I recognize Mr. Schrader.

Mr. SCHRADER. Thank you, Madam Chair. I appreciate that.

Commissioner Shulman, I will not blame the IRS for all of the rules and regulations you have to deal with because obviously they came from somewhere, and oftentimes that is this great, august body as we try and help people, but recognize fully that things are very complex. There has been a lot of interest in simplifying the tax code. As Chairman of the Subcommittee on Tax and Finance, I am interested in your thoughts on for particularly small businesses, let's say, under that $15 million gross threshold. Are there certain ways one could really simplify their filing of taxes and make it very, very simple?

Mr. SHULMAN. Let me say a couple of things about it. One is I could not agree with you more. The tax code is incredibly complex, and we certainly can do better in administering it, but a lot of the complexity is in the law, not in the administration of it, and so I appreciate the observation.

As you know, the President has appointed a working group to look at a variety of tax issues, and certainly simplification is one of the things on the agenda. We are going to keep trying to do everything we can to simplify our forms to things like, for very small businesses, we have recently said that you do not need to file quarterly employment taxes. You only have to file annually. We can do things like that.

I do not have big, broad policies to announce around simplification. Clearly, the administration is going to be working with Congress on those kinds of things.

Mr. SCHRADER. There has been interest, and it has been articulated by different small business groups, members of this Com-

mittee with regard to some sort of flat tax for very small businesses. What are your comments on that extreme simplification?

Mr. SHULMAN. I will reserve judgment. I recognize there has been a lot of debate about all of the taxes, including the flat tax, and I will not make any comments on it.

Mr. SCHRADER. I guess I will defer my questions then at this point.

Thank you, Madam Chair. I yield back.

Chairwoman VELÁZQUEZ. Mr. Graves.

Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Madam Chair and Ranking Member Graves.

Just kind of quickly, thank you for your service. I know you have a difficult task, and sometimes I am sure it is maligned in many instances, but I would just ask you to continue to do the good job you are doing. Obviously most taxpayers are more concerned with fairness. I think that is the issue that most are most concerned with, from the standpoint that while they do not like to pay taxes, they are more than willing to do so as long as they believe that their neighbor and everybody else that they are acquainted with pays their fair share as well.

And I think it is incumbent on us as legislators to make sure we pass laws that do not impact things in an unfair way, and hopefully you will enforce those laws in a fair manner as well.

Along that line, I have an E-mail here, if you will bear with me just a moment. One of my constituents E-mailed me this, and we were talking about instances where we have concerns with impacts on small business, and he's a stock broker. He is with Morgan Stanley, and his CPA filed his tax return the 24th of March electronically and did not get his refund back in a timely fashion and tried to check with the IRS office, and the only explanation was that because he had a Morgan Stanley tax ID, it must have been flagged because of the TRAP funds.

Are we flagging certain businesses for oversight, for further audits? I mean this an isolated instance where somebody just shot an opinion off the top of their head, or is that kind of stuff going on?

Mr. SHULMAN. Oh, I do not think anyone would have said that. So I am happy to look into that, and I encourage you to send it to my office. We are not targeting any individuals because of any broad government program. So that is a surprise to me.

Mr. LUETKEMEYER. Okay. Well, I was just curious because obviously the Morgan Stanley folks do have some TARP funds. I am just wondering if that is a broad category that you are as well looking at a little bit differently.

Mr. SHULMAN. We certainly are not looking at any individuals. There are a lot of new moving pieces that are happening as the federal government is getting involved in trying to shore up financial institutions and lots of pieces of the economy. We are quite aware that when people or institutions are given support by the federal government, they have got an obligation to pay their taxes, but we are not doing anything to target any individuals of institutions with any sort of other piece.

And so if they filed on March 24, if you file electronically and get a direct deposit, you usually get a refund within about ten days.

If you file using paper and you get a check, it can be up to six weeks, and so I am assuming this person, if they filed electronically, is trying to use direct deposit. I encourage them to call our 800 number and find out where they are in the process. They can let them know.

Mr. LUETKEMEYER. All right. Thank you.

To follow up further, I noticed one of the things I think is important, we are talking about small businesses today, and many of them are partnerships, S corps. who oftentimes run those dollars through their personal income taxes.

And I am just kind of curious if you have some thoughts. I know that the administration, the tax policy in the new budget is indicating they are going to try and tax those individuals over 250,000, which would put a lot of these partnerships and S corp. folks directly into the category of being taxed.

Do you have any idea of how many businesses that would be or how many individuals file partnerships and S corps. as a percentage of the small businesses in this country?

Mr. SHULMAN. Yes, small businesses come in a number of forms, and that is why sometimes when you look at our statistics, it is hard to get a grasp on small businesses. The vast majority actually come in 1040 Schedule C, sole proprietors and others. Then there are a number of C corps., which are small corporations, which if you look at our statistics there, and then there are lots of people who have flow-throughs, S corps., partnerships, LLCs.

I do not have the exact number on me now. I can get back to you. What I will tell you though is since 2000 the number of flow-through entities, filing returns for those entities, so S corps., LLCs, partnerships, has increased about 50 percent while the number of C corporations has been relatively flat. For us that is an interesting phenomenon because if you think about us doing our job, my belief is any time you are running a regulatory agency or government agency, there are all sorts of incorporations that make a difference, but what really matters is the economics that you are looking at. So it makes our job much harder, I will tell you, because it is much more complex to look at a partnership where it is really a network of lots of other activities happening flowing through that partnership than it is C corporation where the taxes and the entity all stops right there.

Mr. LUETKEMEYER. I see my time is up. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Mr. Altmire.

Mr. ALTMIRE. Thank you, Madam Chair.

And, Commissioner Shulman, thank you for being here.

Last week the IRS stated that COBRA provisions in the stimulus plan are a top priority, and I understand that one of the outstanding items for the IRS is defining involuntarily terminated to determine that eligibility.

When does the IRS expect to issue guidance on this matter that affects COBRA obligations and rights?

Mr. SHULMAN. We issued the first set of guidance several weeks ago. Today some questions and answers were put up on the IRS Website to try to answer a lot more of those pieces. The COBRA provision is one of the most complex for us to administer because

right now when an employer sends their form 941 into us, we actually do not have individual taxpayer information. They just send gross employment tax to us. And so really the employer is going to have to do all of the true-up with the individuals, which we recognize them, and it is the way the law was written. The decision was to provide this medical benefit through the employment tax system. We have tried to simplify it.

Your specific issue, I will check and see if it is on the Q&As that went out to day. If not, I can get back to you with the information.

Mr. ALTMIRE. Okay. Thank you.

I wanted to ask a question about home-based businesses. For many entrepreneurs running a home-based business, the home office deduction is simply too complex and time consuming. It is clear that something needs to be done since only nine million of the nearly 30 million home-based businesses even took that deduction.

Is the IRS considering writing new regulations that would make it easier for small businesses to take that deduction?

Mr. SHULMAN. Yes. I will tell you when I said I have started a couple of small businesses, the first one I started, started in my home, and then we moved, and then we put phones in, and then we got employees, et cetera. So I am well aware of the complexity of that deduction.

I know it is very hard for taxpayers. It is very hard for the IRS. The law is pretty clear about it. We are trying to administer the law, but I am interested in this issue, and these are broader conversations within the administration and with Congress. I would encourage Congress to simplify it and create a safe harbor, but it would not be out of the question for us to at least explore if there is a way to have some sort of safe harbor because we recognize this is a very complex area of the law.

Mr. ALTMIRE. Great. I want to ask one more question to what Mr. Luetkemeyer was asking. You may not have these numbers in front of you, I realize.

With regard to the flow-through that you were talking about and that $250,000 income threshold, you were addressing the question that you were asked, which was how many total small businesses are there that fall into that category. How many are there that would be over that $250,000 threshold that would actually be subject to that new level of taxation?

Mr. SHULMAN. I am going to have to come back to you on that. There are a lot of small business owners, the ones who are fortunate enough to make $250,000, and obviously if you are a flow-through, it shows up on your individual tax return.

Mr. ALTMIRE. Do you have any idea of the percentage with regard to businesses?

Mr. SHULMAN. I do not. I am sorry, but I can get back to you with those numbers.

Mr. ALTMIRE. Okay. Thank you.

Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Mr. Graves.

Mr. GRAVES. Thank you, Madam Chair.

I want to follow up on Jason Altmire's point, I appreciate what you said about trying to make the IRS do a better job, and you can always do a better job, and I very much appreciate that. And I

know you understand, but do your auditors and the folks below you understand, the people who are making the decisions, you know, what it is like to start a small business and run a small business?

Then I also wanted to ask you, too, I mentioned the Syracuse study from 2007. I did not know if you were aware of it, but my curiosity is, is it more likely for small businesses to get audited than larger businesses?

The study was pretty clear, but you know, I would just ask you to comment on that.

Mr. SHULMAN. A couple of things. One, on your question about people understanding small businesses, one of the first things I did when I came in because I am a big believer that if you are going to run a government agency and if you are going to operate with the power and authority of law that a government agency has, you need to be very focused on understanding the impact on the people that you affect.

And so the phrase I always use with our people is we need to walk a mile in the taxpayer's shoes, and we talk a lot about that. You know, the fortunate thing that we have is everybody who works at the IRS is a taxpayer. So I think everyone files every year and has to wrestle with the code. So they understand that.

And I am very focused on doing what we can to increase outreach, increase dialogue and make sure people are really kind of stepping out of their mind and sitting on the other side of the table and feeling what it is like.

So I cannot say we are all the way there. No business or government entity is all the way there, but it is a big focus of mine while I am here.

Let me give you a couple of numbers that I think are interesting and tell you, one, if you looked at any of the public comments I have made in the last year in any of my testimony, I have talked about three focus areas. One is international tax evasion. Two is large business, and three is high net worth individuals. And so that is where my emphasis has been.

If you look at businesses with less than $10 million of assets, and this is kind of how we break it down, we are eight times more likely to audit a business between ten and $250 million of assets than we are a business with less than ten million of assets, and we are 18 times more likely to audit a business with over 250 million of assets, so the big businesses, than we are a business with less than ten million of assets.

And so, you know, I am the IRS Commissioner. One of my jobs is to have every American feel like we are keeping an eye on everyone so that your neighbor is paying and your competitor is paying. So I would not say that we do not have good audit coverage everywhere. I would not be doing my job if I said that. But I really do not believe that we are unfairly targeting small businesses, and the numbers pretty much speak for themselves. You are a lot more likely to get audited, 18 times more if you are a very big business, than you are if you are a very small, and you are eight times more likely if you are a mid- size business than a very small business.

Mr. ALTMIRE. Thank you, Madam Chair.

Chairwoman VELÁZQUEZ. Ms. Dahlkemper.

Ms. DAHLKEMPER. Thank you, Madam Chair.

Mr. Shulman, I want to go back to the COBRA issue because I have had a calls from small business owners regarding this, and although they agree with it and they think it is a great way to cover some of their employees that they have had to let go, they are concerned about the up-front payment.

And how long currently under your current guidance, how long until they can be reimbursed for their out-of-pocket expenses on that 65 percent?

Mr. SHULMAN. Yes. I have heard this issue. I think you are referring to people usually have to reimburse for premiums and pay premiums monthly, but do not get reimbursed until the end of the quarter, and so the time that you can take the 65 percent out of your payroll taxes is when you file your 941 quarterly returns.

This is a timing issue that is in the law. There is not a lot we can do about it. What we have done is while it was going through the legislative process first we made sure Congress knew that this was going to be a problem.

Two, we actually pushed back and we think we eliminated some complexity. One of the issues that was on the table is to make this reporting on the W-2, which would have made payroll processors and employers all have to change their W-2s, which we pushed back and did not do.

We are well aware that this is an issue for small businesses. We have looked at it. We are going to do what we can, but some of these timing issues are really through the legislation, and there is not a lot we can do.

Ms. DAHLKEMPER. And I know it is quite a financial burden on a lot of companies who are just living on a shoestring right now. Anyway, I appreciate your answer on that.

My other question is regarding, you know, the meetings and the forums that you had, you know, for small business communities. Often we have these meetings and we have forums and everyone voices their concerns, but that does not lead to any reforms. Can you tell me some specifics, some action that the IRS has taken as reforms as a result of the meetings and the forums that you had last year or any time in recent history?

Mr. SHULMAN. Yes, there are a couple of things. One, a big purpose of these meetings is because a lot of small businesses are not hiring accountants and lawyers and others; it is literally to give them face-to-face advice. So a lot of what we are doing is saying how do you open a business, how do you close a business, how do you work through an audit, what kind of information and record keeping do you take. So it is not all feedback. A lot of it is education and outreach.

A few examples of things that have happened because of feedback from small business community in recent years. One is when there is a lifetime exchange of property. A small business sells a building and then buys another building, and it is a lifetime exchange of property. They have to actually hold the proceeds in an escrow account.

The law allows that the proceeds in the escrow account to pay interest, and if they are not paying a certain amount of interest, there is imputed interest to the small business. We heard a lot of

small business owners say that I was not getting any interest and then there is this imputed interest. I have to pay a tax.

We have created an exemption for under $2 million. The other thing we heard is there are a lot of people who are very small businesses who were having to file quarterly employment taxes. We extended that. We heard from a lot of small businesses that when you filed an extension of your income tax, especially Schedule C filers, you had to file a four-month extension and then another two-month extension. Through hearing from many people, including small businesses, we made that a one time six-month extension.

The other thing we have done is we increased the threshold to file the Schedule C EZ to $5,000 of business expenses, and so we tried through the dialogue to hear from people. Do we do a perfect job of it? Absolutely not. Could we do better? Yes. But we are quite committed to trying to hear and do what we can, again, within the confines of knowing we also have a job to fund the government.

We need to work with the Treasury Department on these pieces, and there are a lot of issues that are really purely legislative.

Ms. DAHLKEMPER. I appreciate that, and I think, you know, listening to the people who are out there every day trying to create jobs and keep this economy going and seeing what you can do within the constraints that you have is important because I think a lot of people who are doing their job in your agency really do not know what small businesses are going through every day. So I appreciate your listening to them.

Thank you. I yield back.

Mr. SHULMAN. Thank you.

Chairwoman VELÁZQUEZ. Thank you.

And now the Committee is going to stand in recess until we finish up voting on the floor.

[A recess was taken.]

Chairwoman VELÁZQUEZ. The Committee is called back to order.

Thank you, Mr. Commissioner, for your indulgence.

I will recognize Ms. Clarke.

Ms. CLARKE. Thank you, Madam Chairwoman and Ranking Member Graves, for holding this hearing on tax complying costs and whether it is slowing this country's economic recovery.

As I have always stated, as we move forth in the 21st Century, small businesses will become more and more an essential element in driving the U.S. economy. About 30 million small businesses operate in the U.S., which employs virtually 80 million workers.

When it comes to tax compliance issues, small businesses benefit from greater flexibility and fewer bureaucratic controls. But today during these tough economic times, small businesses are having difficulty staying open. Now, is the time for the IRS to do much more in outreach and education to small businesses to answer the many questions and address their legitimate concerns.

For small business the tax code is simply too complex and burdensome, and I hope that our conversation here today will enable us to come out with recommendations to assist in those outreach efforts.

So, Mr. Shulman, a lot of the tax issues are not merely about the money, but about the compliance problems when dealing with the government, especially when it comes to reporting. Most sole pro-

prietorships have to pay federal and state payroll taxes, as well as unemployment insurance, and therefore have to meet so many deadlines. And yet when the IRS alleges that a small business tax return is incomplete, they attempt to reprimand the small business without any inquiry to determine what may have happened.

If that is the temperament and culture of the IRS, do you think that the burden of proof should then be on your agency to show paper work was, indeed, not reported by a small business?

Mr. SHULMAN. Thanks for all of your comments and I could not agree with you more that in this tough time everyone is counting on small businesses bouncing back. The President has been very clear that small businesses and entrepreneurs are an essential part of the engine that is important for the country.

I talked quite a bit in my oral testimony about the outreach efforts we have, about the things that I ask every person in the agency to do around making sure we are flexible with businesses who are experiencing hard times.

I guess I have not experienced the culture that you are talking about. We have got a lot of employees, and there are always going to be exceptions, but in general, our people I think try to work with taxpayers. They have a job to do, obviously, to make sure that they audit businesses and individuals, nonprofits to make sure they are abiding by the law.

When it comes to paper work, one of the things that I know for sure, I have talked with our Commissioner of Small Business, who is here today, who has actually gone out and done round tables with our agents. We seldom disallow expenses because records are not there for small businesses. Our agents usually work with the taxpayer to try to reconstruct those records.

So I guess I would not necessarily agree with the characterization, but I very much agree with the sentiment that you put forward, which is that we need to go out, we need to be reasonable, we need to work with taxpayers. We need to assume that the majority of small businesses are wrestling with an incredibly complicated code and just trying to get it right.

Ms. CLARKE. Fair enough, Mr. Shulman. The hope is that there can be that level of engagement sustained in terms of quality across the span of the agency. As you have said, you know, you send forth a certain culture within the agency, and you hope that is followed through to the end, and certainly there are nuances with each individual business that you may confront.

So we are looking for that consistency and quality, commitment to small business, and I am glad to hear that that is your goal, your aim, your philosophy within the agency.

I understand that recently you held a program called Super Saturdays, and this program provided free tax help to communities nationwide. My question is why has there been no Super Saturday directly focused on small business, especially during these tough economic times.

Mr. SHULMAN. Yes. Last year actually was the first year we did Super Saturday, while we were trying to get 120 million stimulus checks out to the American people. There was a whole category of seniors and veterans who usually would not have to file a tax return but did last year because of the stimulus.

It was such a success, and frankly, we had employees from all over the agency work directly with taxpayers. One of the things I talked about before is a key and a focus of mine is to make sure we walk in the shoes and we understand what it is like to be the taxpayer.

So having our executives from across the country deal face to face with taxpayers was a great experience. So we did it again. We opened up on Saturdays. We had people come in. This was open to individuals; it was open to small businesses, to any taxpayer.

Last year we actually held 2,600 seminars, education events, forums for small businesses, and I will refer to my written testimony so that I do not go through it again, but I think we have a lot of outreach for small businesses. We could always have more, and one of my jobs is to triage the resources between our phone people, people who make the Internet work, people who do service, people who do enforcement around small businesses, large businesses, individuals, both service and enforcement, and so we are just trying to balance that.

But you have my commitment that we are very focused on trying to give support to small businesses.

Ms. CLARKE. Thank you very much.

My time has expired and I yield back.

Chairwoman VELÁZQUEZ. Mr. Commissioner, the IRS procedures require consideration of whether a collection against a taxpayer will impose an economic hardship. In a March 11 release, the IRS stated it would be flexible when considering collectability during these times. Could you be more specific?

And you mentioned that you are telling your staff to be more flexible, to even suspend collection or work out agreements. Can you be more specific regarding any procedures the IRS plans to implement in light of the economic downturn?

Mr. SHULMAN. Yes. So a couple of things we did. When I mentioned postponing collection, we give thresholds which are not public about how much tax is due, where the front-line employee who is talking to the taxpayer can actually take that collection case and put it back to the queue because of economic hardship. We actually raised those thresholds, meaning it can be a larger amount of tax and our front-line employee has that flexibility. So that is one of the things we did.

In the past, if you missed one payment, if you either had had an offer-in-compromise or an installment agreement, it was an automatic default. We actually gave, again, flexibility to people that you could miss more than one if you show some economic hardship.

We gave some flexibility that that can be a discussion with people because, as you have all mentioned, at the end of the day you have got to trust the judgment of your people out in the field. If you are going to tell them to use their judgment, you have got to trust them, and so we gave them more flexibility and less rigorous documentation requirements.

With liens, we actually have now made it clear. A lot of small businesses, the way they get a loan is they actually have the security be their house, and so we have actually made it that if somebody in this down real estate market is either trying to refinance

their house or renegotiate or sell their house, that our lien will not stand in the way of that action.

There is more which I would be happy to give you. What we have tried to do is do all of this, but also we have to protect against a flood of people who can pay their taxes saying they cannot pay their taxes, and so we are just trying to get this balance right.

I think some have criticized and said I have leaned too far towards the taxpayer. I think in these times it called for extraordinary measures, and that is why we took some of them.

Chairwoman VELÁZQUEZ. Okay. You mentioned that you are going to pay more attention to recoup some of the money in terms of international tax evasion, do more audits of international tax evasions; is that right?

Mr. SHULMAN. Yes, yes.

Chairwoman VELÁZQUEZ. So do you have the manpower, the resources to go after this type of tax evasion?

Mr. SHULMAN. A couple of issues. One is once you leave our border and we do not have all of the authorities we have inside the border to follow the money trail, we have to coordinate with other governments. There is a lot of diplomacy that is needed, and it is easier to hide money. So this is some of the toughest work that we do.

When we started a continuing resolution at the end of last September, we essentially had a freeze on staffing. What I did was move some staffing from other areas so that we could keep staffing up in international, and you might have seen in President Obama's budget he put a line item for robust international enforcement efforts from the IRS, and we anticipate getting significant increases in agents, both civil and criminal, for international lawyers so that we can work through some of the complex issues, et cetera.

Chairwoman VELÁZQUEZ. Well, you are saying you are reprogramming the manpower that you have so that you are going to use the staff for international compliance?

Mr. SHULMAN. It is a priority. I have already done some shifts, and we are certainly as we get more staff going to lean towards international.

Chairwoman VELÁZQUEZ. So my concern is how then will you have the people in your staff, the numbers that are required to be able to answer the questions coming up from small businesses who need to call the IRS or for you to process some of the returns in an appropriate manner.

Mr. SHULMAN. Yes. So we have three appropriations. We have a support appropriation, we have an enforcement appropriation, and a service appropriation. This is in our enforcement appropriation. We are not planning on taking people out of service roles. We really triage our enforcement people.

And so it is a perennial issue. I mean, just an interesting statistic, we have had a nine percent decline in staffing over the last five years and a ten percent increase in returns filed. We have had a 23 percent increase in productivity. Technology and electronic filing helps. The Web helps, but we are always having to manage resources.

But a lot of people ask you when you become the IRS Commissioner are you going to focus on enforcement, are you going to focus

on service. I have been very clear. I am going to focus on both. By no means am I going to overemphasize enforcement at the expense of service.

Chairwoman VELÁZQUEZ. Okay. So we know that so many businesses are experiencing a downturn and many will be taking advantage of the expanded net operating loss provision in the recovery bill. What special steps has the IRS taken to insure a timely processing of returns so many small businesses can get an infusion of capital?

Mr. SHULMAN. Yes. Right when this conversation started around increasing net operating losses we brought together our teams who work on this. We assigned an executive to review the procedures and make sure there were not any clogs in the system.

There are two ways to get these expedited returns. One is by filing form 1139 for the Schedule C filers or for corporations, and one is form 1045 for the Schedule C filers. We have actually staffed up. So some of these areas we have been triaging we have made sure there is enough staff there. I am very confident that we are going to get these out quickly. We have made a commitment that all of them will get out within 45 days, but I have challenged the staff to get it sooner, and that is quicker than these usually get processed, and I am going to be monitoring it daily.

If we see a surge beyond what we are expecting, we will put more staff. We are going to make sure that we do this right. We recognize how important it is.

Chairwoman VELÁZQUEZ. It is important since small businesses right now are having problems getting access to capital. You know, the credit crunch is incredible and it is impacting them. So this is a tool that would help get money back to small businesses, and I hope that our offices would not be inundated with phone calls telling us that they are not getting the rebates that were promised to them.

Mr. SHULMAN. No, I do, too. I know a lot of this came through with your leadership. Clearly, the President has asked every agency to prioritize the Recovery Act and making sure we implement it well. The Treasury Secretary has asked me this as well, and this is something that I am personally engaged in.

If your office gets any information to the contrary, please reach out because we are focused on this.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Graves.

Mr. GRAVES. Thank you, Madam Chairman.

I just want to follow up again on Representative Altmire, I too am concerned about the possible consequences to small business when it comes to the tax rates of $250,000 for couples and $200,000 for individuals, how many small businesses that is going to affect. You had said before that you were going to get that information, and I definitely want to make sure that we get it. I think it is something that is very important, and I would like to know just how many small firms that is going to affect.

Mr. SHULMAN. Absolutely. We will follow up.

Chairwoman VELÁZQUEZ. Ms. Clarke, any other questions?

Ms. CLARKE. Thank you, Madam Chair.

Mr. Shulman, I guess we keep reiterating how hard these times are for small businesses, but I guess it is a point that is worth driving home because they are really having a hard time paying tax liabilities, which not only impacts their businesses, but their families, too.

You know, I believe that this is a time when some of the reporting responsibilities really need to be reexamined when it comes to small businesses. For example, credit card companies can report to the IRS sales of small businesses, such as restaurants, which in the past was a chronic source of noncompliance. Do you agree that the IRS should be trying to reduce the noncompliance burden on small businesses?

And what is your agency doing to come up with new guidance to address this matter?

Mr. SHULMAN. A couple of things. One is, I think the biggest compliance burden is the law, very complicated. My favorite statistic is that the tax code is four times as long as War and Peace, and we are going to do everything we can within the confines of the laws that are passed by Congress and debated to make things simpler.

We have done a number of things that I walked through earlier that I would be happy to go through with you and meet with you individually or send you a letter about, that we have done to try to reduce the burden on the administrative side.

You mentioned the credit card reporting. A lot of information and all of the statistics show there is always higher compliance when there is third party reporting. The best compliance is the teacher or the firemen or the employee who has a W-2 because they know we are going to get information, and they get reported to them in a simple format exactly what their wages are. They copy it onto their 1040. They send it in to us. It is much easier.

My hope is that information reporting like credit cards, first of all, that reporting is not going to happen until 2012. So there is plenty of time to get a lot of input from the community as we do that.

But more importantly, my hope is third party reporting actually can simplify and get the information in a simple format for people, and so that is always my hope.

Ms. CLARKE. Thank you very much, Commissioner.

Thank you, Madam Chair. I yield back.

Chairwoman VELÁZQUEZ. Sure. Commissioner, I have a last question, and that is a major concern for some taxpayers is the lack of review of certain civil penalties, and one of the most draconian penalties is found on 6707(a). This section imposes mandatory penalties of up to $200,000 for failure to make disclosures of certain listed transactions.

Mr. SHULMAN. Yes.

Chairwoman VELÁZQUEZ. Unfortunately, there is no regulatory process or public comment period involved in determining what should be listed, a listed transaction. So is it possible for the IRS to suspend these penalties until a better review process is implemented?

Mr. SHULMAN. Yes. We have actually looked at this. I would agree with you. Let me just step back for a minute. The listed

transactions were an important thing that the IRS did, which was to put taxpayers on notice that there are certain transactions designed for big corporate tax evasion kind of transactions, tax shelters that we are going to be looking at that you need to file information on.

We recognize that some taxpayers have gotten caught up in this that the law never presented. We are trying to have dialogue about that. Right now we think our hands are tied, that the legislation, if I have this correct, and I will come back to you, is actually we do not have a lot of leeway for us to suspend it. But this is something that we are going to want to talk about. You know, we are in discussions and the administration is going to need to be discussions with Congress because we recognize this is an issue.

Chairwoman VELÁZQUEZ. Very good. Thank you. And let me take this opportunity to thank you, and I am sorry that we have so many votes on the floor, but this is the way it goes here.

Mr. SHULMAN. The people's business.

Chairwoman VELÁZQUEZ. Okay. So thank you so much.

Mr. SHULMAN. Thank you very much.

Chairwoman VELÁZQUEZ. The gentleman is dismissed.

So now we call on the second panel, and that will be Mr. Christopher Smith.

Are you going to introduce him?

Mr. GRAVES. Thank you, Madam Chair.

I am pleased to introduce Kit Smith. He is a constituent and owner of S.T.O.P. Restoration, LLC, and S.T.O.P.—Northland, LLC, in Pleasant Valley, Missouri. Mr. Smith is certified in fire and water restoration, mold remediation, door and window installation. He is also a certified restoration, remediation, and recovery instructor.

He is a non-combat disabled veteran. Mr. Smith served six years in the United States Navy. He has been an entrepreneur and owner of his own small business since he was 16 years old.

Mr. Smith, thanks for coming. We want to welcome you to the Committee, and we appreciate your coming here to Washington to tell us your story.

STATEMENT OF CHRISTOPHER "KIT" SMITH, S.T.O.P.—NORTHLAND, LLC

Mr. SMITH. Chairwoman Velázquez and Ranking Member Graves, my name is Kit Smith, and I am owner of a small business in Pleasant Valley, Missouri. I am pleased to be here today to testify of the burden of tax compliance for small businesses.

My company has been battling with the IRS since 2007 on a matter that generated an audit going back to 1989. It started because an employee had embezzled $58,000. She was trying to hide this by switching my EIN numbers around and making deposits with them to the State of Missouri and the IRS. This encompassed a sole proprietary, a corporation, and two LLCs.

The deposits owed for the taxpayer in question were, in fact, paid. The IRS person who received the deposits placed the money where they deemed needed and not where it was supposed to go per the forms that the deposits accompanied. The agent and I proceeded to uncover the fact that the payments were made. They

were misplaced, and the agent would locate and identify where to correctly put the payments.

After a short period of 30 to 45 days, I received a call from the agent and was informed that there was a small refund from past years and that the payments would need to be placed correctly if I agreed, and of course, I did.

I was then informed that there was a slight overpayment on my part and did I wish a refund or place it on account. I chose the refund.

After about a month or so I received a call from the agent stating that there was a mistake by them in the calculations placement of the funds, and I needed to repay approximately $2,300. I gave the agent the check number and wrote the check for the amount and put it in the night mail.

When we thought the audit was about done, up pops a new IRS agent on the phone stating that I owed approximately $2,300. I disagreed, and after two to three minutes on the phone, I asked if the phone agent could give the particulars to my office staff so that we could again research this.

To my complete amazement, my office staff came in and proudly proclaimed she had my amount reduced to approximately $1,800. How on earth can an employee negotiate with an IRS agent the amount of a tax due when during an audit they ask specific questions to qualify you as the appropriate person to be liable?

I just paid this tax for the third time. The tax advocate informed me of information that contradicted the supervisor's statement made to me via my message machine. I informed the tax advocate that they were hiding a big mistake. The agent was no longer to speak with me, and I was informed this matter was closed.

Who regulates this arm of government? What oversight do they have? How far can they go? Why do they have immunity from repercussions? They need checks and balances, one, to insure the tax due is paid, but, two, that when they are wrong they do not cover it up, destroy lives or businesses.

The burden placed on my business alone was over 150 hours of my personal time at $175 an hour to keep my doors open. Well over 100 hours of my staff time. The reams of paper and phone bill time. I cannot even think of the amount of business I lost focusing on this instead of my company. I will never get over this loss.

We as small businesses need a flat tax so we can plan for what tax is due instead of wondering what will be due. This would take the unknown out of taxes. It's funny, but not too long ago I had an IRS agent on the phone. She stated to me, "Mr. Smith, the IRS does not make mistakes." And I still have that tape! Can you believe the audacity? We are all human. Heck, I may have made a mistake coming here.

The stimulus package: There is nothing in the stimulus package for my business. I cannot afford to go further in debt, period! Buy equipment? Get an SBA loan for 35,000? No to further debt.

What the small businesses need , the available loan opportunity to lower their loan payments. Lower taxes to be able to afford and retain good employees instead of having to lay them off. Lower taxes to afford to give themselves a raise, I have not had one in five years. Lower taxes to insure the benefits package available

matches the larger institutional ones. Lower taxes to be able to afford, without a loan, improvements to facilities and equipment.

The stimulus package should not help mega companies that affect our economy. They need to fail just like if I failed no one would help me except me. If the big dogs fail, let them. Then smaller entrepreneurial companies will sprout up and take over where they failed. That is the spirit of America, freedom and hard work!

The stimulus package should not be for earmarked projects. They don't help small business. The package is wild spending of money that is not even printed yet. We need Congress to control spending and lower taxes. Small business will help pull us out of this faster.

Government is in place to keep peace, not to create jobs! They implement laws and govern, not dictate how much someone can make. The government can help create jobs by helping people who create jobs, us, the small business people of America who give every day!

In my State of Missouri, 90 percent of the employed people are employed by companies with fewer than 25 employees, small businesses! Unbridle the small business community. Give them the ability to rebuild the economy, and watch what we're capable of, but do not give us more burden, more taxes, and more administrative burdens such as more COBRA regulations.

Thank you for the opportunity to testify today.[The prepared statement of Mr. Smith is included in the appendix at page 35.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Smith.

Mr. Graves.

Mr. GRAVES. Thank you, Madam Chair.

I actually brought up a Syracuse University study that small businesses are targeted because they do not have the ability to hire expensive counsel or expensive representation to work on the audit, and I was just curious if you were able to do that and if you have heard of other small businesses that have been targeted by audits who are not able to hire counsel or get the expensive resources to be able to represent themselves before the IRS.

Mr. SMITH. Mr. Graves, with the amount of burdens placed on by local taxes, increased property taxes, and the tax burden that we already have, I couldn't afford an attorney. I hired an attorney in the first place, and it came to no resolve. It was not worth the money that I was spending. So I opted to go through this myself with the agent, and it was successful.

And I know of other gentlemen and women in business who have had this similar type of situation, not to this complete amount, but they have had the same situation where they have had employees that are embezzling, whether they have a gambling problem or whatever it is, that embezzle money, and now we are at a disadvantage because we do not have the capital to fight the IRS.

Ms. CLARKE. In your opinion, was it a situation where one agent did not know what the other agent was doing, the left hand does not know what the right hand is doing, or is it a situation of as far as they were concerned you were guilty until proven innocent, in your opinion at least?

How did you feel? You know, what could have made it a whole lot more user friendly, I guess, approach, you know, in working

with you in this? What would you have done different if you were on the other side?

Mr. SMITH. I really appreciate that question. The original agent that came into my office and flipped their badge was awesome. She went back to 1989 like my testimony said, and she uncovered where these payments went. She found them. She was diligent in her job, and she did it well.

Where the breakdown came was when we got the phone call from an agent on the phone that said mysteriously we owed this money again, and I went and said, "What is going on here?"

I tried to talk to that agent. I was not allowed to. I went to the tax advocate, thanks to your office, and that is an oxymoron because she is an employee of the IRS. Through her we contacted this department again, and I was given conflicting stories. I did talk to the agent very shortly and very briefly, and I was told I had to go to the supervisor.

The supervisor told me that I had to go to the tax advocate, and I told the tax advocate this, and she said, no, that is not what he said, and he left a contradictory response to that on my answering machine. So I could not figure out.

I am thinking, okay, why doesn't the IRS just, and I asked them, "Why don't you just bring this file that the original agent did, let's sit down at a table, and let me see what you have so that I can see where she went?"

And all they would divulge to me was this unknown, unbeknownst jumble of figures that unless I was an IRS agent I would not know how to discern what was there. But she went back all the way to 1989 and covered money that they owed me from a long time ago, but they did not give that up! But she found out where I made the payments and where they were sidelined because this person was trying to throw a smoke screen, and she found that we, in fact, did make the payments, and then I found out I had to do it again.

So I would say that in this case that they should have brought the file, sat down with me and said, "Mr. Smith, this is what we found." They would not do it. They said you are not allowed to talk to the agent and this matter is closed. And I think that's wrong.

Mr. GRAVES. Thanks, Madam Chair.

Chairwoman VELÁZQUEZ. Ms. Clarke, no questions?

Okay. So we have got some stuff here from the IRS, and I guess there are some pending issues. We could use that opportunity after the hearing to continue the conversation.

With that I ask unanimous consent that members will have five days to submit a statement and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

Thank you.

[Whereupon, at 3:14 p.m., the Committee meeting was adjourned.]

NYDIA M. VELAZQUEZ, NEW YORK
CHAIRWOMAN

SAM GRAVES, MISSOURI
RANKING MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business

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STATEMENT
of the
The Honorable Nydia Velazquez, Chairwoman
House Committee on Small Business
"IRS Oversight: Are Tax Compliance Costs Slowing the Economic Recovery?"
Wednesday, April 1, 2009

Every American circles April 15th on their calendar. But outside of a few over-eager CPA's, most people don't look forward to tax day. While this time of year brings an annual headache for us all, it is especially daunting for our nation's entrepreneurs.

Historically, tax code complexity has been the greatest source of frustration for small businesses. No surprise there-- the tax code contains over 200 small business provisions. Simplification is key, and this committee has held hearings on the issue. But today, in light of historic economic challenges, that matter has taken a backseat to more immediate concerns.

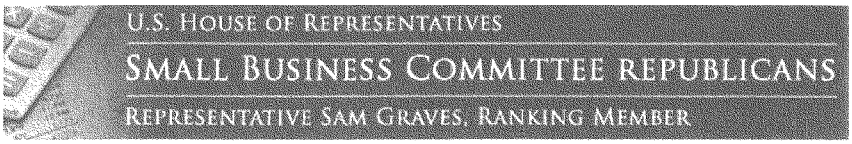
This afternoon, we will explore ways in which the IRS can help entrepreneurs meet tax obligations during a recession. We will also discuss the role of the agency in handling incentives within the stimulus.

In February, small businesses finally got their stimulus. Within that bill were critical tax incentives, from Bonus Depreciation to Net Operating Loss extensions. This is the kind of relief entrepreneurs need. But, like most tax policies, these initiatives are complex. The IRS needs to ensure their meanings are clear. Before small firms can take advantage of incentives, they need to understand how they work. Otherwise, the benefits of these provisions-- and of the stimulus overall--may be diminished.

Unfortunately, clarification has never been an IRS strong point. After all, we are talking about the agency that handles the 54,000 page tax code. But with new stimulus policies on the books, the IRS will have to improve communications. Part of that improvement process should include increased outreach, and enhanced client services. Entrepreneurs need to know they can count on the IRS to answer their tax questions quickly and accurately. In an era of growing uncertainty, those kinds of resources are critical. Especially considering recent increases in small businesses audits.

Unlike big businesses, small firms don't have an army of tax attorneys and accountants. As a result, they are largely defenseless against the IRS, making them easy targets. In the two years between 2005 and 2007, small business audits shot up 41%. Meanwhile, investigations of the biggest companies plummeted 40%.

It doesn't matter who you are or how big your businesses is-- no one has the right to skirt their taxes. But at a time when small business audits are up, and big business audits are down, you have to wonder-- where are the priorities? Small firms have been battered enough by the recession. The last thing they need is the added nightmare of an IRS investigation. In the face of a deepening recession, tax policies should be a means for small business growth, and *not* the straw that breaks the camels back.



Opening Statement of
Ranking Member Sam Graves
House Committee on Small Business
Hearing: "IRS Oversight: Are Tax Compliance Costs Slowing Economic Recovery?"
April 1, 2009

Madam Chairwoman, thank you for calling this hearing on tax compliance costs for small businesses. I would like to extend a special thanks to our witnesses, Commissioner Shulman, and the witness from our second panel, Kit Smith, a constituent from Missouri who I will introduce later.

Every day, it seems we hear more bad news for entrepreneurs: the faltering economy, federal bailouts of big companies that owe back taxes, studies showing that small companies are increasingly targeted for audits. Our nation's small company owners are in the trenches, day in and day out, working hard during a recession to keep their businesses afloat, contribute to the economy, purchase equipment, create the majority of new jobs and, of course, pay their taxes.

According to the Internal Revenue Service's National Taxpayer Advocate, tax issues present the single most significant set of regulatory burdens for small firms. The Small Business Administration's Office of Advocacy reports that firms with less than 20 employees spend more than $1200 *per employee* to comply with tax paperwork, recordkeeping and reporting requirements. This is twice the cost of compliance for larger firms. And Surveys by the National Federation of Independent Business consistently rank federal taxes among the top five issues of greatest concern to entrepreneurs.

Small businesses have good reason to be concerned. Most of them pay their taxes and on time, and want others to do so, as well. We have heard about the "tax gap," the difference between what is legally owed, and what is actually paid voluntarily and on time. One prong of the IRS' strategy to reduce the tax gap is increasing enforcement. And it appears the IRS has small businesses in the crosshairs. A 2008 Syracuse University study revealed that small businesses were 41% more likely to be investigated than large ones, while the audit rate for the nation's largest corporations fell to the lowest level in twenty years. One can only surmise that this is because small firms are less able to hire high priced attorneys and accountants to fight back. Today we will hear from my constituent, Mr. Smith, who will describe the horrific IRS audit of his small business.

If small firms didn't have enough stress trying to run a small company in a recession, we burden them with countless laws, regulations, reporting requirements, and continue to do so every year. We must simplify our tax code and require the IRS to do a better job of helping small businesses to comply. Small businesses deserve better.

Madam Chairwoman, thank you for calling this hearing, and I look forward to the testimony. I yield back.

WRITTEN TESTIMONY
OF
DOUG SHULMAN
COMMISSIONER
INTERNAL REVENUE
BEFORE
THE HOUSE SMALL BUSINESS COMMITTEE
"IRS OVERSIGHT: ARE TAX COMPLIANCE COSTS SLOWING THE ECONOMIC RECOVERY?"
APRIL 1, 2009

Introduction

Chairwoman Velazquez, Ranking Member Graves and members of the Committee, thank you for this opportunity to testify on the Internal Revenue Service's efforts to assist America's small businesses, particularly during the current economic downturn. As President Obama recently observed: "Our recovery in the present and our prosperity in the future depend upon the success of America's small businesses and entrepreneurs."

The IRS has two important goals – service and enforcement. We need to provide world class service to the vast majority of taxpayers trying to pay their taxes and wrestle with a complex tax code. And we need to carry out rigorous enforcement programs for those who do not meet their legal obligations to pay taxes. This isn't an either/or proposition. We need to do both.

However, the IRS is acutely aware of the many problems confronting small businesses today – from struggling to make their payrolls, securing lines of credit, meeting their pension plan obligations and paying their taxes.

As the financial crisis deepened, the IRS took deliberate and focused action to provide assistance to individual and business taxpayers in distress while also preventing others from straying into non-compliance.

It is inevitable that during times of economic downturn, taxpayers may fall behind in paying their taxes. As IRS Commissioner, I am committed to striking the right balance between collecting the revenues needed to fund the government, and using all the tools we have available to us to work with small businesses who find themselves in difficult times.

This is a very fine line. On the one hand, as basic matter of fairness we need to ensure that American taxpayers pay their fair share and are compliant. On the other hand, we need to take taxpayers as they come, and ensure that we are treating people fairly and compassionately in these difficult times. In the end, we need to be flexible, principled, and to empower our employees to use judgment.

Assisting Small Business Taxpayers

As the economy worsened last summer, I believed it was imperative to get out in front of the changes before they overwhelmed us. We had to respond to an evolving crisis in real time and help get the nation back on the road to recovery. I pulled together my senior team to discuss and review programs that would be stressed in a deteriorating economy. Let me highlight some that affect and can benefit the small business community.

- **Offering Installment Agreements:** We have reminded examination employees of their responsibilities to consider collectability during the pre-audit phase. They were also reminded of their ability to offer installment agreements at the end of an audit when taxpayers are having difficulty satisfying their obligations immediately, thereby enabling them to minimize interest and penalty charges.

- **Postponement of Collection Actions:** IRS employees may suspend collection actions in certain hardship cases where taxpayers are unable to pay. This includes instances when the taxpayer has recently lost a job, is relying solely on Social Security or other assistance or is facing devastating illness or significant medical bills. If an individual has recently encountered this type of financial problem, IRS assistors may be able to suspend collection without further documentation to minimize the tax burden on the taxpayer.

- **Added Flexibility for Missed Payments:** The IRS has flexibility in working with previously compliant individuals in existing Installment Agreements who have difficulty making payments because of financial hardship. The IRS may allow a skipped payment or a reduced monthly payment amount without automatically suspending the Installment Agreement.

- **Prevention of Offer in Compromise Defaults:** Taxpayers who are unable to meet the payment terms of an accepted OIC will receive a letter from the IRS outlining options available to help them avoid default.

- **Expedited Levy Releases:** The IRS will speed the delivery of levy releases by easing requirements on taxpayers who request expedited levy releases for hardship reasons.

- **What If Scenarios:** The IRS recently added a special area on its web site focused on the financial downturn. Taxpayers with financial problems who discover they can't pay when they file their 2008 tax returns have options available. IRS.gov has a list of "What If?" scenarios that deal with payment and other financial problems. These scenarios, in question-and-answer format, provide information on specific actions taxpayers can take. Taxpayers unable to pay in full can contact the IRS to discuss additional options to pay.

American Recovery and Reinvestment Act: Net Operating Loss Guidance

Madame Chairwoman, the American Recovery and Reinvestment Act of 2009 (ARRA) is also providing some valuable tools to help small business in this difficult economic climate.

On March 16, 2009, the IRS announced that small businesses with deductions exceeding their income in 2008 can use a new net operating loss (NOL) tax provision to get a refund of taxes paid in prior years. The new net operating loss provisions could throw a lifeline to struggling businesses, providing them with a quick infusion of cash. Moreover, the IRS wants to make it as easy as possible for small businesses to take advantage of these key tax benefits.

The new provision, enacted as part of ARRA, enables small businesses with an NOL in 2008 to elect to offset this loss against income earned and allows a carryback of five years instead of the normal rule of two-years. The IRS released legal guidance in Revenue Procedure 2009-19 on March 16, 2009, outlining specific details.

With the economic downturn and the new law, the IRS expects record numbers of small businesses to be eligible for the refunds. The IRS is taking special steps to ensure timely processing of these refunds to help small businesses during this difficult period.

Small businesses with large losses in 2008 may be able to benefit fully from those losses now, rather than waiting until claiming them on future tax returns.

To qualify for the new five-year carryback provision, a small business must have no greater than an average of $15 million in gross receipts over a three-year period ending with the tax year of the NOL. Businesses with more than $15 million in gross receipts still qualify to carry back their 2008 NOL for two years.

Generally small businesses that are not corporations (including sole proprietorships filing schedule C with their Form 1040) may accelerate a refund by using Form 1045, Application for Tentative Refund.

The IRS has ensured proper staffing for expedited refunds; will be closely monitoring these filings; and will provide additional staff as needed to process these forms. The IRS will work to issue refunds within 45 days or even earlier to the degree possible.

In addition, Questions and Answers have been posted on the IRS Web site. Small businesses that file Form 1040 can also call 1-800-829-1040 with NOL questions. Corporations can contact 1-800-829-4933 with NOL questions.

Improving the Small Business Taxpayer Experience

The IRS is always looking for ways to better serve the small business/self employed taxpayer – from setting up their businesses to staying compliant. For example, the IRS

Small Business Examination group has a monitoring tool in place to capture taxpayer feedback on our examination process. We use taxpayer satisfaction information as an overall gauge of how the IRS is performing and to reduce taxpayer burden during the audit process.

Within the survey, we look to specific issues or factors which have a negative impact on our examinations – and ultimately on tax compliance. Some of these include the length of the audit process or taxpayers not fully understanding the audit outcome or adjustments made. Utilizing the periodic feedback, we analyze these issues and trends and use them as opportunities for improvement, such as training.

The IRS has also undertaken several initiatives to address the quality of the examination process, such as the Exam Process Improvement Challenge (EPIC). Other initiatives that help provide a seamless taxpayer experience include:

- **Fast Track Settlement**: The IRS is also vigorously pursuing Fast Track Settlement (FTS) for field cases. FTS is designed to settle cases more quickly than is possible with traditional Appeals procedures. This process is especially beneficial to taxpayers who have a tax liability in dispute that is greater than $25,000. In FTS, the examiner brings in an Appeals official to facilitate settlement while the case remains at the group level. FTS is being piloted in eight cities throughout the country.

- Offer-in-Compromise – The IRS is studying a simpler case resolution process for taxpayers who file related OICs (e.g., joint filers filing separate OICs on joint liability).

- Cross-IRS Study – The IRS Small Business and Self Employed and Wage and Investment divisions and the Taxpayer Advocate Service are working together to identify opportunities to resolve taxpayer collection issues earlier and provide for operational improvement opportunities.

- Lien Assistance – We have changed our procedures to better assist taxpayers with lien releases. When a taxpayer cannot pay the full amount on a lien where there is a pending real estate transaction or refinancing, we provide them information about partial discharges and subordinations, a reference to the publications, and the telephone number to call.

General Outreach to Small Businesses

The Internal Revenue Service is dedicated to helping small businesses owners – primarily Schedule C filers – especially those facing hardship as a result of the economic downturn. Eighty percent of small businesses use professional return preparers, and many of these taxpayers belong to industry and small business organizations and associations.

Our outreach and education strategy relies on critical third-party relationships with preparers and the organizations that assist and represent small business owners. We work with thousands of industry and small business organizations, tax professional and payroll associations, women and minority-owned business associations and government agencies to leverage our outreach and education efforts to small business owners.

As a result, we are able to provide small business owners with the information they need to avoid compliance problems and relieve burden, and to keep them informed of legislative changes that can affect their tax responsibilities, such as the American Recovery and Reinvestment Act.

We use a number of methods and channels to get our message out to small business owners, provide guidance and answer their questions. In FY 2008, IRS participated in over 2,600 meetings, symposiums and seminars attended by over 162,000 small business owners and tax professionals. For example in FY 2008, IRS held 135 Small Business Forums which provide an open avenue of communication between IRS and trade and industry groups.

Our stakeholders alert the IRS about issues that are a burden to their members, provide feedback on policies, practices and procedures and learn new ways to assist small businesses in navigating through the IRS. The Forums also allow members to receive the latest small business information from IRS and provide an opportunity to share feedback and concerns on behalf of their members.

At the local level, we have special units dedicated to conducting similar meetings attended by representatives of organizations that assist small business owners, such as trade and professional associations, chambers of commerce, small business development centers, and Better Business Bureaus.

By working with these organizations through the Forum process, we are able to communicate to thousands of small business owners. These groups get the word out in a variety of ways, such as through their national and local chapter meetings, on their websites, in articles in newsletters and magazines, and at continuing education programs.

Our strong third-party relationships also enable us to provide quality education to small business owners through our Small Business Tax Workshop program. IRS facilitated 410 of these structured workshops in FY 2008 which cover tax topics from starting to closing a business. Industry groups provide classroom venues and tax professionals provide instructors. These workshops are advertised on IRS.gov and are held all over the country.

In addition to working with industry and tax professional organizations, our Governmental Liaison division helps us develop productive relationships with other national and state governmental agencies to provide outreach and education to small business owners. For example, we work closely with the Small Business Administration. As a result, we recently held joint agency "Webinars" for small business owners covering

timely economic downturn topics, such as identity theft and IRS relief for taxpayers in difficult financial situations.

The IRS also holds National Phone Forums on a regular basis, advertised on IRS.gov. These free seminars typically include thousands of participants covering topics of interest to small business owners and the tax professionals who assist them, such as "Correspondence Examinations – Understanding the Process and Working Together," "Recordkeeping for Small Businesses," "How to Navigate IRS.gov," "Identity Theft," "Choosing a Preparer in English and Spanish" and "Disaster Assistance Information."

Our website, IRS.gov, is also one of the best resources for small business owners. It has a comprehensive section devoted to small business and self-employed taxpayers, including a companion website just for this community, called the Small Business Resource Guide. We know that the economy has presented many challenges to small business owners, and our website addresses a number of job, debt and tax-related questions, as well. The Business and Specialty Tax toll-free number is dedicated to answering tax questions for small business owners.

Finally, we publish several helpful products for small business owners who may not have access to IRS.gov, including the Tax Calendar which notes key filing and payment dates, and the Virtual Small Business Workshop DVD. Industry groups and tax professionals order these products from us, and make them available to small business members and clients.

The IRS is also dedicated to providing taxpayers with correct information the first-time asked, and to provide quick resolutions for unanswered questions. We use an Issue Management Resolution System (IMRS) to collect questions/issues that are raised by our stakeholders, and send them to subject matter experts throughout the IRS to be resolved.

Not only does this system allow us to respond in a timely manner to our stakeholders, it also allows us to track trends where taxpayers may misunderstand procedures and law, and to develop new outreach products and programs to improve understanding and relieve burden. We expect IMRS to play a large role in resolving questions that arise about the ARRA.

Indeed, the IRS is taking extraordinary efforts to publicize the ARRA's tax relief provisions. Again, because we have such an extensive network of third-party relationships with national and local industry and tax professional organizations, we have contacted over 2,600 of them to provide initial guidance on the new legislation.

Since enactment, we have provided ARRA information at many venues all over the nation, including Small Business Forums and industry, payroll and practitioner meetings, seminars and symposiums. We continue to provide more information as it becomes available to these partners, and to provide explanations and guidance on IRS.gov.

IRS Compliance and Examination Programs

The IRS continues to administer its examination programs within today's difficult economic climate where balance and judgment become all the more important. The economic downturn has left many small businesses in a precarious position.

We have also communicated to our small business examination employees the importance of recognizing that individual taxpayers or businesses being audited may be experiencing hardships as a result of the current economic conditions. As I noted in the introduction to my testimony, we need to take taxpayers as they come, and ensure that we are treating people fairly and compassionately in these difficult times. In the end, we need to be flexible, principled, and to empower our employees to use judgment.

Additionally, IRS operating divisions that interact with small businesses are coordinating issues more than ever before. Our Small Business Examination group is working with Appeals to provide a more expeditious resolution of audit issues which may have reached an impasse. Our Fast Track Settlement initiative process allows the taxpayer/ representative to meet with our Examination and Appeals personnel to discuss unresolved issues, explore alternative resolutions to achieve consensus which brings closure to the issue. This approach decreases the amount of time the audit is open and reduces the overall burden on the taxpayer.

Asset Smoothing

IRS efforts to assist small businesses also extend to their retirement plans. Asset smoothing is a good example. The Pension Protection Act of 2006 (PPA) mandated significant changes in the rules for determining minimum funding contributions for qualified defined benefit pension plans. In general, the minimum contribution to a plan for a plan year depends on a comparison of the value of the plan's assets as of the beginning of the plan year with the plan's "funding target" (i.e., the present value of all benefits accrued as of the beginning of the plan year) and the plan's target normal cost (i.e., the present value of benefits expected to accrue or be earned during the plan year).

In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. In such a case, the minimum required contribution for the plan year generally is equal to the sum of the plan's target normal cost for the year and a portion of the funding shortfall for that year and prior plan years.

PPA provided that the value of plan assets generally is the fair market value of the assets. However, the value of plan assets may be determined on the basis of the *averaging* of fair market values under certain circumstances. PPA also provided that any averaging must be adjusted for contributions to the plan and distributions to participants.

The Department of the Treasury and the IRS proposed regulations in 2007 that permit the value of plan assets to be determined on the basis of averaging. Under the proposed regulations, the average value of plan assets generally is increased for contributions that

are included in the last valuation date during the averaging period, but that were not included in the prior valuation dates during the averaging period. Similarly, the average value generally is decreased for distributions included in the last valuation date during the averaging period, but that were not included in the prior valuation dates during the averaging period.

Due to some issues raised by the pension plan community in interpreting the legislative intent of the provision, smoothing was specifically permitted as part of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), in accordance with Treasury guidance.

On March 16, 2009, the IRS issued guidance interpreting the asset smoothing provisions in WRERA. It allows actuaries to take advantage of asset smoothing in 2009 without redoing their asset calculations for the 2008 plan year.

Additional Pension Guidance, Assistance and Education

In addition to the asset smoothing regulation, the IRS provides other guidance and assistance to small businesses and entrepreneurs concerning setting up and maintaining pensions under normal circumstances and also in today's difficult economic climate.

- Pension funding waivers for "temporary substantial business hardship". A waiver of a year's minimum funding requirement is authorized by Internal Revenue Code § 412(c)(1) in cases where compliance with the funding requirement would impose a temporary substantial business hardship on the employer. Factors taken into account in determining such hardship include whether:

  - The employer is operating at an economic loss.
  - There is substantial unemployment or underemployment in the trade or business and in the industry concerned.
  - The sales and profits of the industry concerned are depressed or declining.
  - It is reasonable to expect that the pension plan will be continued only if the waiver is granted.
- Automatic 7-year schedule to fully fund a year's shortfall. If a plan's benefit liabilities exceed its assets in a year, the Code does not require the employer to fully fund the shortfall that year. Rather, pursuant to Code § 430(c)(2), the amount of the funding shortfall may be contributed to the plan in 7 installments over that year and the next 6 years.

Public Outreach and Education

- Publications. The IRS publishes numerous publications of interest to small business pension plan sponsors. For example, Publication 560, *Retirement Plans for Small Business*. This IRS publication provides a plain-English discussion of the key features of pension plans and other types of retirement arrangements for small businesses. Specifically, this publication covers:

-What type of plan to set up.
-How to set up a plan.
-How much to contribute to a plan.
-How much of the contributions are deductible.
-How to treat certain distributions.
-How to report information about the plan to the IRS and employees.
-Basic features and rules that apply to pension and other retirement plans.

This and other retirement plan-related publications are available online at http://www.irs.gov/retirement/sponsor/index.html or by calling 1-800-TAX-FORMS.

- Newsletter. Since 2004, the IRS Employee Plans Division (TE/GE) has published the *Retirement News for Employers* newsletter – a free, periodic publication with retirement plan information of interest to employers, including small businesses. The Winter 2009 issue is available here: http://www.irs.gov/pub/irs-tege/rne_win09.pdf.

- IRS Website. The "Retirement Plans Community" is one of the six key links on IRS's home page. Inside the link, the site map identifies information and helps direct visitors to the pension-related features they are seeking. For example, at http://www.irs.gov/retirement/sponsor/index.html, employers can find plain- English discussion and information regarding the tax rules, filings, and correction of mistakes that apply to pension plans.

- Email. Since 2002, the IRS has maintained an email address -- RetirementPlanQuestions@irs.gov -- that anyone (including small businesses and their owners and employees) may use to ask questions related to proper operation and tax-qualification of their pension plan. In 2008, the IRS responded to 1,991 such emails.

- Employee Plans Toll-Free Telephone "Hotline". Since 1999, the IRS's Employee Plans Division (TE/GE) has operated a toll-free hotline that anyone may utilize, on an anonymous basis, to seek immediate answers to questions related to their pension plan. The hotline received approximately 75,000 such calls in FY 2008. The phone number is 1-877-829-5500.

- Speeches and Webcasts -- Employee Plans Customer Education and Outreach. Pension experts in the IRS's Employee Plans Division (TE/GE) participate each year in over 300 retirement plan-related public speeches and webcasts in locations throughout the United States (and on the Internet), with a total audience of over 120,000. The IRS website posts a schedule of upcoming presentations: http://www.irs.gov/pub/irs-tege/upcoming_confs.pdf.

Tax Gap

Madame Chairwoman, the last subject I would like to discuss is the tax gap. In 2006, the IRS updated its estimate of the overall gross tax gap for Tax Year 2001 – the difference

between what taxpayers should have paid and what they actually paid on a timely basis – to be $345 billion. IRS enforcement activities, coupled with other late payments, recover about $55 billion of the tax gap, leaving a net tax gap of $290 billion for Tax Year 2001.

As with prior estimates, the updated estimate of the tax gap shows that the largest component of this gap – more than 80 percent – comes from underreported taxes. Underreported *income* tax is the largest component of this; non-filing and underpayment of tax comprise the rest of the tax gap. Clearly we must do a better job to get taxpayers to report their income.

Conclusion

Madame Chairwoman, I want to thank you again for the opportunity to testify today on what the IRS is doing to help small business owners on the road to economic recovery. We have made some progress but more needs to be done. We look forward to working with you, the Committee and staff to make sure that this great engine of economic growth and prosperity continues to operate at its full potential.

Testimony of

Kit Smith
S.T.O.P. – Northland LLC
Pleasant Valley, MO

Before the
House Committee on Small Business

Hearing: "IRS Oversight: Are Tax Compliance Costs Slowing Economic Recovery?

April 1, 2009

Chairwoman Velazquez and Ranking Member Graves,

My name is Kit Smith and I am the owner of a small business in Pleasant Valley Missouri.
I am pleased to be here today to testify about the burden of tax compliance for small businesses.

My company has been battling with the IRS since early 2007 on a matter that generated an audit going back to 1989.
It started because an employee had embezzled $58,000.00.
She was trying to hide this by switching my EIN numbers around and making deposits with them to the State of Missouri and the IRS. This encompassed a Sole proprietor, a corporation, and two LLCs.
The deposits owed for the tax periods in question were in fact paid. The IRS person who received the deposits placed the money where they deemed needed, and not where it was supposed to go per the forms that the deposits accompany.

The agent and I proceeded to uncover the fact that the payments were made, they were misplaced, and the agent would locate and identify where to correctly put the payments. After a short period of 30-45 days, I received a call from the agent and was informed that there was the small refund from years past, and that the payments would need to be placed correctly if I agreed. Of course I did. I was then informed there was a slight over payment on my part, and did I wish a refund or place it on account, I choose the refund.
After about a month or so, I received a call from the agent stating that there was a mistake by them in the calculations/placement of the funds and I needed to repay aprox $2,300.00. I gave the agent the check number, wrote the check for the amount, and put it in the night mail.
When we thought this audit was done, up pops a new IRS agent on the phone stating that I owed aprox, $2,300.00.
I disagreed and after 3-4 mins on the phone, I asked if the phone agent could give the particulars to my office staff so we could again research this. To my complete amazement, my office staff came in and proudly proclaimed she had my amount reduced to approx 1800.00? How on earth can an employee negotiate with an IRS agent the amount of a tax due when during an audit they ask specific questions to qualify you as the appropriate person to be liable?

I just paid this tax the third time. The tax advocate informed me of information that contradicted the supervisors statements made to me via my message machine. I informed the tax advocate that they were hiding a big mistake; the agent was no longer to speak with me. I was informed this matter was closed!

Who regulates this arm of the government, what oversight do they have, how far can they go, why do they have immunity from repercussions?
They need checks and balances; One, to ensure that the tax due is paid, and two, that when they are wrong they do not cover it up, or destroy lives and businesses!

The burden placed on my business alone was over 150 hours of my personal time @ 175.00 per hour to keep my doors open. Well over 100 hours of staff time. The reams of paper and phone bill time. I cannot even think of the amount of business I lost focusing on this, instead of building my company. I will never get over that loss.

We as small businesses need a flat tax so that we can plan for what tax is due, instead of wondering what will be due. This would take the unknown out of taxes.

It's funny, but not too long ago I had an IRS agent on the phone and she stated "Mr. Smith, the IRS does not make mistakes", I still have the tape! Can you believe the audacity? We are all human. Heck, I may have made a mistake coming here!

STIMULUS PACKAGE:

There is nothing in the stimulus package for my business. I cannot afford to go further in debt, PERIOD! Buy equipment? Get an SBA loan for 35,000.00? NO to further debt!

What the small businesses need is available loan opportunities to lower their loan payments. Lower taxes to be able to afford and retain good employees instead of having to lay them off. Lower taxes to afford to give themselves a raise, I have not had one in 5 years. Lower taxes to insure the benefits pack available matches the larger institutional ones. Lower taxes to be able to afford, without a loan, improvements to facilities and equipment!

The stimulus package should not help mega companies that affect our economy. They need to fail, just like if I failed. No one will help me except me! If the big dogs fail, let them. Then smaller entrepreneurial companies will sprout up and take over where they failed! THAT IS THE SPIRIT OF AMERICA, FREEDOM, AND HARD WORK!

The stimulus package should not be for earmark projects! They do not help the Small business. The package is wild spending of money that is not even printed yet. We need congress to control spending, and lower taxes. Small business will help pull us out of this faster.

Government is in place to keep the peace, NOT to create jobs! They implement laws and govern, not DICTATE how much someone can make! The government can help create jobs by helping the people who create jobs, US, the SMALL BUSINESS PEOPLE of America who give every day!

In my state of Missouri, 90% of the employed people are employed by companies with fewer than 25 employees, SMALL BUSINESSES!

Unbridle the Small Business community, give them the ability to rebuild the economy and watch what we are capable of! But don't give us more burden, more taxes, and more administrative burdens such as more COBRA regulations.

Thank you for this opportunity to testify before you.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
TAX DIVISION
STATEMENT SUBMITTED TO
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
PUBLIC HEARING:
IRS OVERSIGHT AND TAX COMPLIANCE
April 1, 2009

The American Institute of Certified Public Accountants thanks the House Small Business Committee for the opportunity to submit this statement for the hearing on IRS oversight and tax compliance.

The AICPA is the national, professional organization of certified public accountants comprised of approximately 350,000 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, small and medium-sized businesses, as well as America's largest businesses. It is from this broad perspective that we offer our comments today.

Our comments focus on a number of significant issues involving IRS oversight and tax compliance. In section one on tax law complexity and simplification, the AICPA addresses: (a) the alternative minimum tax; (b) estate tax reform; and (c) the tax treatment of cell phones and personal digital assistants as "listed property." Section two, involving tax administration and compliance, focuses on: (a) the section 7216 regulations; (b) penalty reform; (c) the IRS's e-file strategy; (d) the tax gap and stakeholder outreach; and (e) offers in compromise.

SECTION ONE: TAX LAW COMPLEXITY AND SIMPLIFICATION

A. ALTERNATIVE MINIMUM TAX

Our tax laws give special treatment to certain types of income and allow special deductions for certain expenses. These laws enable some taxpayers with substantial economic income to significantly reduce or eliminate their regular tax. The alternative minimum tax (AMT) was created to ensure that all taxpayers pay a minimum amount of tax on their economic income.

The AMT is one of the tax law's most complex components. In fact, the AMT is a separate and distinct tax regime from the "regular" income tax. Internal Revenue Code sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions and credits under the AMT system. Taxpayers who own businesses must also maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Often, taxpayers cannot calculate AMT directly from information reported on their regular tax return, which makes the computations extremely difficult for taxpayers preparing their own returns. Including adjustments and preferences from pass-through entities also contributes to AMT complexity. This complexity also affects the IRS's ability to meaningfully track compliance with the AMT.

Although most sophisticated taxpayers are aware of the AMT and that they may be subject to its provisions, the majority of middle-class taxpayers have never heard of the AMT and are unaware that it may apply to them. Unfortunately, the number of taxpayers facing potential AMT liability is expanding exponentially due to: (1) "bracket creep;" and (2) classifying as "tax preferences" the commonly used personal and dependency exemptions, standard deductions, and itemized deductions for taxes paid, some medical costs, and miscellaneous expenses.

Approximately 4 million taxpayers were subject to AMT in 2007. "The Emergency Economic Stabilization Act of 2008," passed on October 3, 2008 included an AMT patch for 2008 to insulate middle class taxpayers from the reach of the AMT. On March 27, 2009 the Tax Policy Center released estimates of current individual AMT distribution and liability, including 10-year projections for the tax. Under current law, 43.1 million taxpayers would be subject to AMT by 2019.

Due to the increasing AMT complexity, the AMT's impact on unintended taxpayers, and AMT compliance problems, the AICPA supports repealing the individual AMT altogether. However, we recognize that simply eliminating the AMT would generate a new set of problems given the large loss of tax revenue that would accompany such a move. Consequently, the AICPA urges Congress to consider alternative solutions that we believe should reduce or eliminate most of the complexity and unfair impact of the AMT as currently imposed.

B. ESTATE TAX REFORM

The *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) phased out the estate tax over several years and completely in 2010; then in 2011, reinstates it back up to full pre-EGTRRA 2001 levels -- $1 million per person estate tax exemption and 55 percent maximum estate tax rate. Over the past few years, Congress has been considering possible transfer tax reforms to deal with the uncertainty and frustration of taxpayers and practitioners regarding the possible reinstatement of the estate tax in 2011.

As Congress considers various issues and alternatives with regard to estate tax reform in 2009, the AICPA encourages Congress to make permanent changes to the estate tax prior to the current law expiring in 2010 in order to provide certainty to taxpayers. The AICPA developed and sent to Congress in 2005, 2006, 2008, and most recently in January 2009, a priority list of suggested reforms of the current estate and gift tax system. Many of these suggestions were published and sent to Congress in 2001 as part of the AICPA's *Study on Reform of the Estate and Gift Tax System*. That study focused on the complexity of the current system, taxpayer planning and compliance burdens, ease of administration and revenue constraints. The AICPA study remains a timely and relevant analysis of the current transfer tax system. As Congress considers whether significant reform of the U.S transfer tax system is appropriate at this time, the study could serve as a valuable resource.

The AICPA recommendations include:

1) Increasing (and indexing for inflation) the exemption to eliminate the filing and tax burdens for all but the very wealthiest Americans;
2) Retaining the full step-up in basis for inherited assets and avoid the complexities of carryover basis;
3) Creating a uniform exemption amount for estate, gift, and GSTT purposes;
4) Making permanent the technical changes Congress made to the generation-skipping transfer tax (GSTT) in 2001;
5) Reinstating the full state estate tax credit, or provide another mechanism (such as a surtax) that would allow states to uniformly "piggyback" on the federal estate tax;
6) Providing broad-based liquidity relief, rather than targeted relief provisions;
7) Making the top estate tax rate no higher than the maximum individual income tax rate; and
8) Provide portability of the estate, gift and GSTT exemptions to a surviving spouse to simplify estate planning and estate administration for married couples.

The AICPA also co-sponsored the 2004 *Report on Reform of Federal Wealth Transfer Taxes*, developed by the Task Force on Federal Wealth Transfer Taxes, a joint effort of the AICPA, ABA, and several other organizations. Like the 2001 study, the 2004 report provides diverse views and perspectives on many issues concerning the current federal wealth transfer tax system and the changes made to that system by the *Economic Growth and Tax Relief Reconciliation Act of 2001*. The 2004 report suggests options for Congress to consider, but does not make specific recommendations for legislative or regulatory action.

C. REMOVE CELL PHONES AND OTHER PERSONAL DIGITAL ASSISTANTS (PDAS) FROM CLASSIFICATION AS "LISTED PROPERTY"

Congress created the listed property rules in 1984 to discourage the personal use element of certain property, such as luxury automobiles. Cell phones were added to the definition of listed property in 1989; at that time, the cost of such phones was relatively expensive and the use of such devices in daily business activities was far from the norm.

Including cell phones as listed property limits the use of accelerated depreciation and expensing of such phones unless the employer and employee substantiate a certain amount of business use of the phone through adequate records. Also, the value of personal use of the phones is treated as wages for employment tax purposes and reported on Form W-2. In order to quantify the personal use, the regulations require detailed records for every business call, including: (1) who was on the call; (2) their relationship to the organization; (3) the business purpose; (4) the date; (5) the time; and (6) the cost of the call.

Today's technology and business expectations are clearly different from that which existed when cell phones were classified as listed property. For this reason, we support H.R. 690 and S. 144, the MOBILE Cell Phone Act of 2009 (Modernize Our Bookkeeping In the Law for Employee's Cell Phone Act of 2009). The bill recognizes that cell phones and other PDAs cost a small fraction of what they did in 1989, and they are often provided at no cost when the buyer agrees to a multiple-year contract. Furthermore, most cell phone/PDA contracts now provide for unlimited minutes for a fixed fee. The use of cell phones and PDAs is expected by businesses as

the norm, for connecting to their employees 24/7. The prevalent use of these devices has made them the equivalent of a landline phone, for which detailed recordkeeping has never been required. According to a 2004 NFIB Small Business Poll, 78% of small business owners use a cell phone for business purposes. For further reference, see the House Small Business Committee report at: http://www.house.gov/smbiz/reports2008/embargoed-small-business-committee-tax-report.pdf.

By removing cell phones and other PDAs from classification as listed property, H.R. 690 and S. 144 alleviate the need for taxpayers to deal with the onerous recordkeeping requirements under the listed property rules in an area no longer considered potentially abusive. In this way, the bills lessen the possibility of penalties being imposed on taxpayers, tax return preparers, and tax exempt organizations.

SECTION TWO: TAX ADMINISTRATION AND COMPLIANCE

A. SECTION 7216 REGULATIONS

On January 1, 2009, new IRS regulations under Internal Revenue Code section 7216 became effective. Treas. Reg. section 301.7216 represents a modification of previous regulations that had remained largely unchanged for 30 years. The newly revised regulations attempt to address modern return preparation practices, including electronic filing and the cross marketing of financial and commercial products and services by tax return preparers.

Unfortunately, the regulations are having a significant impact on the office operations and procedures of tax return preparers. Many preparers label the regulations: (1) as very burdensome to implement; and (2) as having negative impacts on long-term client relationships. These preparers find the regulations challenging to the daily practices because -- absent a specific exception -- Treas. Reg. section 301.7216 generally prohibits the "disclosure" or "use" of tax return information without the client's explicit, written consent. In general, a "disclosure" of tax return information involves a disclosure by the preparer of a client's return information to a third party. A "use" of tax return information generally involves the use of the return information by the preparer potentially for the purposes of offering non-tax services to the taxpayer.

Preparers are very concerned about issues relating to their office operations and procedures, which to a non-tax professional might be considered small or mundane; but to a preparer (in a traditional practice) seem large and overwhelming due to the fact a violation of section 7216 involves criminal sanctions. Under section 7216, a tax return preparer is subject to a criminal penalty for "knowingly or recklessly" disclosing or using tax return information. Each violation of section 7216 could result in a fine of up to $1,000 or one year imprisonment, or both. Internal Revenue Code section 6713, the companion civil penalty, imposes a $250 penalty on a preparer for each prohibited disclosure or use of the return information.

Numerous scenarios exist in which preparers find the regulations impeding the delivery of services in normal client relationships. For example, even when a client calls a tax preparer to send the client's return to the local bank -- in order to facilitate a loan -- is seen as triggering the need for the client to sign a written consent prior to release of the return. In another example, it

is even unclear as to whether a preparer can send clients a newsletter containing both tax and non-tax economic/business information without first obtaining the client's written consent.

The AICPA and other tax professional organizations are consulting with the IRS on the impact of the regulations on the traditional practices of tax return preparers. We are seeking clarification and further guidance from Treasury and IRS to mitigate the burdens the regulations are placing on the office procedures of accounting firms. Additional guidance from the government might include (among other options) release of a notice, additional frequently asked questions (FAQs), and other administrative relief. We are hopeful that the tax preparer community's fairly intensive dialogue with the government will lead to such guidance once the current filing season is completed.

B PENALTY REFORM

According to the National Taxpayer Advocate[1], the number of civil tax penalties has increased from approximately 14 in 1954 to over 130 in 2009. As a result of this proliferation in penalties, the AICPA believes that, once again, there is a need for Congress to perform a comprehensive review of the penalty provisions in the Internal Revenue Code and to make necessary reforms to ensure that penalties are appropriately and fairly designed and applied to accomplish their purpose.

It has been 20 years since the AICPA worked with Members of Congress, the Internal Revenue Service, other tax practitioners, and business groups in connection with the last major reform of the federal tax penalty provisions. The result of those efforts was the *Improved Penalty Administration and Compliance Tax Act of 1989* ("IMPACT"). Since that time, a number of revisions to the penalty provisions have been made or proposed. Also since that time, questions have been raised regarding the appropriate administration of the penalty provisions.

The AICPA has recently formed its own task force to review the current penalty regime. We hope to share the results of our review with Treasury and the IRS and welcome the opportunity to work with Congress on any future efforts in this area. In the meantime, we urge Congress to stay true to the philosophy behind IMPACT (i.e., that the purpose of penalties is to encourage voluntary compliance) when drafting future penalty legislation.

C. IRS'S E-FILE STRATEGY

The AICPA appreciates: (1) the benefits electronic filing offers to tax administration and taxpayers; and (2) the successes the IRS has had with its electronic tax filing (e-filing) program during recent filing seasons, successes due in large part to the Service's vigorous efforts to gain the input and involvement of affected parties.

The IRS has closely collaborated with the AICPA since 2006 on the Service's rollout of the mandatory large corporate and exempt organizations e-file programs on the MeF platform; and also with respect to its rollout during the 2007 filing season of the large partnership e-file program on the MeF platform. With respect to these e-file programs, the AICPA played a

[1] See the National Taxpayer Advocate's 2008 Annual Report to Congress, December 31, 2008, page 414.

proactive role in surfacing issues and solutions that ultimately contributed to the success of e-file. We plan to continuing working closely with the Service to meet its expectations for these programs for the 2009 filing season; and with respect to its future rollout of the Form 1040 MeF program.[2]

We support using the AICPA/IRS collaborative model for e-file for other customer outreach initiatives involving the Service, especially from the perspective of encouraging voluntary compliance. In general, we wholeheartedly support efforts by the Service to reach out to the AICPA and other stakeholders as much in advance as possible prior to the Service's implementation date for a new program. By doing this the IRS will receive constructive feedback about the pending new program, input that will likely improve the program upon implementation; and such stakeholder outreach is likely to garner a higher degree of stakeholder "buy-in" or support for the program.

D. THE TAX GAP AND STAKEHOLDER OUTREACH

The AICPA supports the suggestion by National Taxpayer Advocate Nina Olson that the IRS place a significant effort on understanding the tax gap and the non-compliance rates associated with small business taxpayers. According to IRS statistics, non-compliance by small business is the single largest component of the tax gap, representing about 44 percent of the gross federal tax gap of $345 billion.[3]

While we support the concept of increased enforcement to address the tax gap, we recognize (like the National Taxpayer Advocate) that the IRS should increase its focus on educating small businesses as opposed to solely relying on its enforcement apparatus. Ms. Olson's 2006 report to Congress suggests increasing the scope and reach to the small business community of the Small Business/Self-Employed Division's Communication, Liaison, and Disclosure (CLD) function. We support an increase in resources for CLD, as well as enhancement of CLD's educational component.

CLD is doing a very commendable job in serving the small business and tax professional communities in terms of its stakeholder outreach efforts, despite the reduction in staff and resources that took place a few years ago. We do believe a further commitment to programs like the Service's Small Business Tax Workshops and its online resources such as the Small Business and Self-Employed Online Classroom, Small Business Resource Guide, and the Virtual Small Business Tax Forum are positive endeavors. In order to enhance further development of these types of products, it would be helpful for the SB/SE Division to study the market penetration and use of these programs by small firms.

The AICPA does recognize that the Service heavily relies on irs.gov and the Internet to accomplish much of its "customer outreach" to small business. We appreciate the Service's understanding that a substantial majority of small businesses rely on CPAs and other tax

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[2] See IRS Modernized e-File Form 1040 Status Report, dated January 2008, as provided by the IRS to the AICPA and posted to aicpa.org at URL: http://tax.aicpa.org/NR/rdonlyres/8F52D6AA-A50D-466D-BD91-2C62C73FB8BD/0/1040_MeF_Overview__AICPA_012008.ppt.

[3] See the National Taxpayer Advocate's 2006 Annual Report to Congress, December 31, 2006, page 174.

professionals to prepare their tax returns and provide professional advice. For this reason, the Service heavily utilizes the AICPA and other professional associations to assist the government in its outreach efforts to the business community on key tax administration issues.

E. OFFERS IN COMPROMISE

Under section 7122(c)(1) of the Internal Revenue Code, if a taxpayer submits a lump-sum offer in compromise (*i.e.*, an offer of payments involving 5 or fewer installments) to compromise a tax debt, the taxpayer is generally required to submit a payment of 20 percent of the offer amount to the Service upon submission of the offer application. Low income taxpayers (persons with incomes below 250 percent of the federal poverty thresholds) are generally exempt from the 20 percent payment requirement.

Resolving outstanding tax liabilities efficiently is necessary for good tax administration and reduction of the tax gap. The IRS should have the opportunity to review offers and determine whether accepting an offer is in the best interest of the government. The IRS should use offers in compromise as one of the many tools to collect the proper amount of tax. However, the 20 percent requirement of current law has discouraged taxpayers from seeking opportunities to settle tax liabilities with the government.

According to the National Taxpayer Advocate's 2007 Annual Report to Congress, in about 70 percent of the offers accepted by the IRS prior to implementation of section 7122(c)(1), the 20 percent payment amount was not available from the taxpayer's liquid assets. Thus, taxpayers are invariably forced to turn to family and friends to raise the necessary funds to cover the 20 percent payment amount otherwise required for submission of an offer application. Some commentators are concerned that, unfortunately, family and friends of the taxpayer may be reluctant to provide the taxpayer with the necessary funds for the partial payment amount, particularly when informed that the payment amount is nonrefundable, even when the offer is not otherwise accepted later (creating a situation that could be construed as a barrier to settling tax debts for many taxpayers).

Although proponents of the 20 percent partial payment amount under section 7122(c)(1) believe the partial payment amount is effective in eliminating the submission of frivolous offers, it appears that the real effect of the 20 percent requirement is to discourage the submission of a large number of legitimate offers.

Especially during a time of economic downturn, we urge Congress to repeal the 20 percent partial payment measure, as well as take other appropriate steps to increase the number of offers accepted.

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