AUDITS AND ATTITUDES: IS THE IRS HELPING OR HURTING SMALL BUSINESSES?

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#### Questions for the Record:

None.

#### Answers for the Record:

None.

#### Additional Material for the Record:

None.
AUDITS AND ATTITUDES: IS THE IRS HELPING OR HURTING SMALL BUSINESSES?

WEDNESDAY, JUNE 22, 2016

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX AND CAPITAL ACCESS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building, Hon. Tim Huelskamp [chairman of the Subcommittee] presiding.

Present: Representatives Huelskamp, Chabot, Radewagen, and Chu.

Chairman HUELSKAMP. Good morning. Thank you all for being with us today. I call this hearing to order.

Whether we want to or not, each and every one of us has a relationship with the IRS. Benjamin Franklin famously said, “In this world, nothing can be said to be certain except death and taxes.”

In the administration of the tax code, the IRS has dual roles, collection and enforcement. Small businesses have a right to be treated fairly on both counts. Unfortunately, that is not always the case. Many can appreciate that the IRS is a tough job to do; however, the best outcomes will result from the IRS and taxpayers working together to improve voluntary compliance and efficiently allocate resources.

The Small Business Committee has heard from a number of small businesses that have been harmed in one way or another by the IRS. In at least two cases, aggressive audits have resulted in these companies actually closing their doors.

Today’s hearing will focus on some of the ways the IRS can proactively work with small business taxpayers to improve communication and compliance, as well as on some things the IRS needs to do differently.

I would like to thank our witnesses for coming today. I look forward to your testimony.

I now yield to the ranking member for her opening remarks.

Ms. CHU. Thank you, Mr. Chairman.

One of the focuses of this Subcommittee is to ensure that small businesses are given the tools to comply with regulations without increasing their costs. This is particularly true when it comes to taxes and interacting with the Internal Revenue Service.

In the past, when small businesses have testified before the Committee, they have told us that complexity and uncertainty create difficulty when filing tax returns. Many business owners worry
that one simple mistake can lead to a costly and timely audit, and at a time when many businesses are striving to expand and hire additional employees, every hour and dollar counts.

As a result of IRS procedures and administrative challenges, small firms must devote greater resources towards accounts and lawyers to properly report income and pay taxes. Over a quarter of small businesses in the 2015 National Small Business Association’s Taxation Survey stated that they spent over $10,000 on tax compliance, and another 8 percent stated that they employ an outside tax expert to handle tax issues.

Unlike larger, multinational corporations, the time spent by small businesses in complying with tax laws is much more costly, impacting business expansion, job growth, economic prosperity, and growth of small businesses. They should not also have to face intense scrutiny from the IRS through business audits and inadequate IRS compliance with the Regulatory Flexibility Act. Nevertheless, small firms cite filing hardships, aggressive auditing, and collection procedures as confusing as to how a new regulation will affect their business.

Seeing as our nation’s fiscal constraints are an ongoing priority, I understand that closing the $450 billion tax gap is critical to our long-term prosperity, but so are small businesses. Any effort to increase tax compliance must be done in a way that is responsible, fair, and not disproportionately burdensome to small firms.

Today’s hearing will give us a better grasp of the scope and collection techniques regarding small business audits. This hearing also allows us to examine what is being done to minimize IRS regulatory procedural burdens for small entities. I believe that this information is even more important right now as the agency seeks to be more efficient due to financial realities. The fact of the matter remains that the IRS cannot review and modify the procedures impacting small businesses if Congress continues to cut their budget every year. These actions have weakened the IRS’s ability to enforce the nation’s tax laws while also providing sufficient customer service for our small businesses. With the proper tools, America’s small firms can sustain the economic growth currently underway by investing in their operations without fear of an audit and confusing regulations.

With that, I would like to thank the witnesses for being here today. I yield back.

Chairman HUELSKAMP. Thank you for that opening statement.

A quick summary again on timing. First, if Committee members have an opening statement prepared, I ask that it be submitted for the record.

I would like to take a moment to explain the timing lights for you. You will each have 5 minutes to deliver your testimony. The light will start at green. When you have 1 minute remaining, the light will turn yellow. Finally, at the end of 5 minutes it will turn red. I ask that you kindly adhere to that time limit.

Our first witness this morning is Mr. Pete Sepp, president of the National Taxpayers Union here in Washington, D.C. Mr. Sepp first started with the NTU in 1988. Currently, he supervises their government affairs, public relations, and development activities. Mr. Sepp has testified before Congress on a wide range of tax-related
issues and has also been a guest on several nationally broadcast radio and television programs.

Mr. Sepp, you have 5 minutes, and you may begin.

STATEMENTS OF PETE SEPP, PRESIDENT, NATIONAL TAXPAYERS UNION; LEE DAVENPORT, MEMBER, ELECTRONIC TAX ADMINISTRATION ADVISORY COMMITTEE; ROGER HARRIS, PRESIDENT AND COO, PADGETT BUSINESS SERVICES; EMILY PETERSON-CASSIN, PROJECT COORDINATOR, BRIGHT LINES

STATEMENT OF PETE SEPP

Mr. SEPP, Mr. Chairman, Madam Ranking Member, I am honored to be here to discuss a central feature of our tax system, the examination process. Back in 1988, my organization, National Taxpayers Union, led a bipartisan coalition, which included American Civil Liberties Union and National Council of La Raza, business organizations, taxpayer groups, all on behalf of a taxpayer bill of rights. There have been subsequent coalitions, subsequent pieces of legislation, but one interesting facet of this process has been a lack of focus on improving examinations. They tended to focus instead on making reforms to the collection process. There is a wide range of problems that have been identified in the small business community that still need to be addressed, particularly pertaining to examinations.

I call them “fear factors.” One major fear factor has to do with the complexity of the tax system itself and the uncertainty that brings. The Ranking Member of the Full Committee, Congresswoman Velázquez, said this very eloquently in 2013. I quote, “Many business owners worry that one simple mistake can lead to a costly and timely audit and at a time when many businesses are striving to expand, every dollar and hour counts.” Quite true.

I also think we have to worry about intimidation tactics used against small businesses. We are witnessing right now a counter and paradoxical trend of speed up audits where businesses are getting audit notices and being asked to respond almost immediately to whether they want to even appeal. They do not even have time to consider the central issues of the audit itself. On the other hand, there are “slow-down” audits where the procedure drags on and on. Interest keeps accruing through no fault of the taxpayer and abatement of that interest is a very difficult matter to resolve indeed.

We also have the question of opportunity costs. When you look at very small businesses, under $100,000 in receipts, they tend to have a tax liability after examination, an additional tax of less than $10,000. They could easily rack up that much in legal and audit representation costs. Many if not most of them decide, in my opinion, not to fight it. That is why the audit appeal rate is so low. It hovers between 5 and 7 percent annually.

When they have these problems, the remedies in court remain pitifully small. The cap on attorney fees that they can recover if they prevail in court nowhere near matches the amount that they actually need to spend to prove their position.

There are other problems on the horizon. We are part of a coalition called the Coalition for Effective and Efficient Tax Administra-
tion involving more than a dozen associations representing thousands of businesses. We are identifying problems in the large business and international division with issuing designated summonses and designating cases for litigation, tactics which are normally supposed to be reserved for a very small number of uncooperative taxpayers or broad ranging, and they are being applied in consistently greater fashion and with more force, and the threat is being wielded to compel taxpayers into accepting the IRS's position. That is going to be a major problem for smaller businesses down the road. Taxpayer experts and litigation representatives, like Daniel Pilla, who has been before Congress in the past, has said he fully expects those kinds of tactics to migrate into the small business area and the self-employed area sooner or later.

There is the issue that is being discussed in Committee markup for the Financial Services and General Government Bill. One of your colleagues, Congressman Katko, is offering an amendment to block the IRS from hiring private outside counsel to participate deeply in the examination process. Essentially, farming out audits. Now, this is currently applying to large business, the IRS hiring thousand-dollar-an-hour attorneys. You could easily see $300, $400 an hour attorneys working on small business liabilities. It happens because the IRS may consider the hazard of litigation in an appeal situation. They do not have to consider the cost of that litigation versus the tax due. So we have a volatile situation here.

We need to enact reforms ranging from S. 2809 by Senator Portman, which would address some of the CEETA Coalition's concerns, and the Small Business Taxpayer Bill of Rights, H.R. 1828, to reviewing the taxpayer advocates' most serious problems affecting small businesses, and coming together in a bipartisan fashion to address the factors of lack of trust, lack of certainty, and lack of remedies for small businesses in the audit process. We did it in 1988 and 1998. We can do it again. Thank you.

Chairman HUELSKAMP. Thank you, Mr. Sepp. We appreciate your testimony.

Our next witness is Mr. Lee Davenport, member of the Electronic Tax Administration Advisory Committee here in Washington, D.C. Mr. Davenport is in his third year as a member of the Advisory Committee, which serves as a public forum to discuss electronic tax administration issues. He is principal of Davenport Consulting, which provides business consulting and private financing services. He was also the architect of Myfreetaxes.com, which assists those who earn less than $62,000 per year to file their state and federal taxes for free.

Mr. Davenport, thank you for being here today. You may begin.

STATEMENT OF LEE DAVENPORT

Mr. DAVENPORT. Thank you. Chairman, I thank you for holding today's hearing on how the IRS could help small businesses. Twenty-eight million small businesses in America are a cornerstone to our economy. Small businesses account for over half of all U.S. sales and 55 percent of all jobs, and they pay significant amounts of income, employment, and excise taxes into the U.S. Treasury.
Helping small businesses easily file and pay their taxes is a critical mission of the IRS Electronic Tax Administration Advisory Committee, ETAAC. ETAAC was formed by law in 1998 to make strategic recommendations to Congress on how to improve tax administration and better serve taxpayers, including small business taxpayers through electronic means. In short, we are objective, digital, strategy consultants to the IRS.

The Committee believes that modernizing the IRS taxpayer service communication platform is an urgent and strategic priority for the IRS. In the 2015 tax season, the IRS was in its fourth consecutive year of budget reductions and IRS service levels plummeted. IRS answered only 38 percent of its calls from taxpayers. IRS has been unable to modernize its tax service platform to move away from traditional paper and phone interactions. A current phone and paper taxpayer service platform is also not the preferred choice of the IRS or the many taxpayers who expect secure online services.

Along with this issue is a lack of transparency with the IRS. For most taxpayers, the information the IRS has about them is a complete mystery. It is not easy for taxpayers to access and understand their tax information on file with the IRS, their previous tax-related interactions, or their tax compliance obligations.

For small business taxpayers, this issue is even more critical because small businesses are more likely to complete multiple year-round transactions with the IRS. In many cases, when there is a compliance issue, small business taxpayers find out through a surprising IRS notice after they file, or even more stressful, an audit that can take months or years to resolve. For all types of taxpayers, accessing and using their information to proactively comply is almost entirely out of the question in our current system.

The Committee believes that a key solution to these problems is a more digitally-enabled, modernized IRS that better equips taxpayers with information on how they can proactively comply, rather than solely focusing on detecting and enforcing compliance.

In the past 3 years, ETAAC has provided recommendations based on a simple vision of how the IRS could serve taxpayers. The vision allows taxpayers to fully understand their tax obligations, to have transparent access to their tax information status with the IRS, and effectively and securely interact with their tax administrator on the way they want to be served, in the way they want to be served.

The end state is a tax system that is less burdensome. It is a tax system that relies less on reactive measures, such as audits, and more on preventative and educational measures for taxpayers to remain proactively compliant. There are two challenges the IRS faces in achieving this vision.

First, the current tax system is designed to be reactive. It does not leverage tax information to help taxpayers meet their obligations.

Second, the IRS cannot quickly develop and implement its digital roadmap, including online accounts to address the needs of preferences of taxpayers. Our last two reports to Congress explain this dilemma and provide recommendations to overcome these challenges. In our 2015 report to Congress, we recommended that the IRS accelerate its digital taxpayer service strategy; that is, develop
and implement secure online accounts for all business and individual taxpayers. We know that businesses are much more likely to use a tax professional for tax filing compliance needs. Online accounts for these tax professionals should be a priority. ETAAC advocates for the IRS to commit to quickly developing online accounts for business taxpayers and the tax professionals who serve them, and we encourage the Committee to do the same.

In our most recent 2016 report, which actually comes out today, ETAAC addresses the lookback tax system that centers on post-filing programs that detect current noncompliance. We challenge Congress and the IRS to move to a system that verifies taxpayer identities and tax return information before accepting the return.

A system that uses information statements, such as forms 1099 and W-2 to verify taxpayer tax return information is essential to fighting fraud and reducing the taxpayer burden. The IRS should support taxpayers in filing accurate returns, giving them full electronic access to their tax account information at the time of filing. This proactive system would verify accuracy upfront and reduce audits, particularly those on small businesses.

ETAAC is pleased with the IRS's first steps in its digital service plans. IRS released an initial draft of the Future State Initiative in January of this year that specifically incorporated ETAAC recommendations from the past 3 years. The initiative specifically contemplates small business taxpayers and their needs. ETAAC endorses this digital service component of the Future State plans, and we clearly identified the urgent need for small businesses. The IRS needs to accelerate online accounts for businesses and tax professionals.

On behalf of the entire ETAAC, I thank you for inviting us to testify on this important topic.

Chairman HUELSKAMP. Thank you, Mr. Davenport. We appreciate your testimony and your service on the Advisory Committee.

Our third witness this morning is Mr. Roger Harris, President and COO of Padgett Business Services in Athens, Georgia. Mr. Harris has served twice as Chairman of the Internal Revenue Advisory Council, and has previously testified before this Committee, as well as before the Senate Small Business Committee. He has been named one of Accounting Today's Top 100 People. Mr. Harris, you have 5 minutes.

STATEMENT OF ROGER HARRIS

Mr. HARRIS. Thank you, Mr. Chairman, and Ranking Member Chu. It is a pleasure to be here today.

To give you a little background, Padgett Business Services provides accounting, tax, and payroll services to small businesses. We are currently celebrating our 50th year and have over 200 offices throughout the United States.

We define a small business as someone with less than 20 employees. Now, a lot of people consider that to be a “mom-and-pop” type business, but I would remind those people that almost 90 percent of people who have employees would fit that definition, so it is a very powerful part of our economy.

Our history and our relationship with our clients gives us a good perspective to comment on the interactions that small businesses
have with the IRS and, in our case, their representative. Specifically as it relates to audits, no taxpayer, be it an individual or small business, ever wants to receive a notice that they are being audited. But in a voluntary tax system like we have, there is an element of enforcement that must be present. So, if you are successful and stay in business long enough, there is a good possibility you are going to interact with the IRS in some form of audit or some sort of correspondence.

Currently, the IRS really executes two different types of audits on small business. The one that seems to be most prevalent and continues to increase over the years is the correspondence audit. Now, the idea behind a correspondence audit is that some computer or some person somewhere in the bureaucracy selects what appears to be some simpler issues and the small business owner is notified by mail, as the name indicates, and they are to respond to that notice about the specific issues in question. In theory, this is a very good system and I think it is partly the reason that we are seeing more and more of these is for the better use of IRS resources. It eliminates face to face, which is intended, again, I think, to minimize the cost and burden that a small business owner or their representative might face.

Unfortunately, it does not work always as intended. First and foremost, sometimes the tax code is a little more complicated than it might seem, and what looks like a simple issue that can be very easily dealt with through correspondence really has more complicated pieces in it than may be on the surface. Sometimes that lack of face-to-face is a disadvantage, not an advantage, because the small business owner or their representative may feel like they are just talking to the bureaucracy and they do not really know where their information is and what is being done with it, and if there is something that needs to be questioned explained, there is not a real convenient process to do that.

The thing that we probably hear the most as a criticism of correspondence audit through our company and our experiences, is that there is an inconsistency in the quality of this unknown person responding from the IRS. In many instances it is almost as if they do not know the issue as well as the representative or the taxpayer does. Eventually, you really do need to move to a face-to-face environment to get the issue resolved. So, in many instances, what starts as a correspondence audit can only be resolved if it moves to some sort of face-to-face contact.

We understand that correspondence audits are probably going to continue to be the preferred method of auditing small businesses, but if that is the case, I think there are three areas that the IRS needs to focus on and address.

First of all, they need to do a better job of selecting the issues that work in this type of environment, so if it is going to be done through correspondence, it is an issue that can be resolved through correspondence. Secondly, they need to have more consistency and better training of their employees. And finally, I think something that is very important is they need to develop a tracking system. It is interesting to us that FedEx or UPS can track packages all the way through the delivery process, but the IRS cannot allow a taxpayer or a representative to track the status of their informa-
tion in their audit. There needs to be better tracking of the information as it is submitted and as it is going through the process. The audits that I think we all associate with the IRS are field audits where people come out and spend time either at the small business owner's place of business or the representative's place of business. The good news for that is you tend to get a more trained and better qualified IRS representative. The bad news is those audits can last days, weeks, months, and sometimes years, and the cost of those are almost exclusively the burden of the small business owner. Again, they are necessary evils because they can be very costly and very expensive.

I agree almost completely with some of the comments of Mr. Davenport as we move forward with online accounts. The IRS is setting up individual accounts, which I commend them for. However, there is a vast need for business accounts and practitioner accounts. Currently, about 70 percent of small business owners have some sort of relationship with a practitioner, and, therefore, you need to give access to accounts to the people who would be most likely to use them. Unless you operate as a Schedule C, if you are a partnership or a corporation, there are no accounts right now, but I think we need those accounts as well.

Finally, even on the individual accounts, which I think are a step in the right direction, and I certainly understand the challenges of identity theft that the service is facing, but right now the service says that the way to authenticate those accounts today, by their own admission, are only successful 30 percent of the time. If we are going to have individual accounts, they need to be something that the average person can actually access when needed.

So with that, I see my time is up, again, thank you for allowing me to being here, and I look forward to your questions.

Chairman HUELSKAMP. Thank you, Mr. Harris, we appreciate your testimony.

I now yield to our Ranking Member for the introduction of the final witness.

Ms. CHU. It is my pleasure to introduce Ms. Emily Peterson-Cassin. Ms. Cassin is the Coordinator of Public Citizen’s Bright Lines Project. The Bright Lines Project was founded in 2008 and worked to change the big test that currently defines political activity for nonprofits. Before joining Public Citizen, she worked as an attorney in ERISA litigation and in indigent representation. She received her juris doctorate from Georgetown University Law School.

Welcome, Ms. Peterson-Cassin.

Chairman HUELSKAMP. I thank the Ranking Member for that introduction.

Ms. Peterson-Cassin, you may begin.

STATEMENT OF EMILY PETERSON-CASSIN

Ms. PETERSON-CASSIN. Thank you. Mr. Chairman, Madam Ranking Member, thank you for the opportunity to testify today.

My name is Emily Peterson-Cassin. I am the Bright Lines Project coordinator at Public Citizen Congress Watch. Public Citizen is a national, nonprofit, public interest organization, with more than 400,000 members and supporters.
For 45 years, we have successfully advocated for stronger health safety, consumer protection, and other rules, as well as for a robust regulatory system that curtails corporate wrongdoing and advances the public interest. My own work at Public Citizen is to coordinate the Bright Lines Project, an expert team of attorneys and nonprofit partners working for an improved definition of political activity for all nonprofits.

I do not need to tell this Committee how important small business is to our economy and our society. Congress can, and should, protect small business by ensuring a clear, predictable framework of tax rules and regulations. Rules that are easy to follow and enforce allow small businesses to thrive, while minimizing opportunities to abuse the tax system.

The IRS should be doing more to ensure that small businesses can easily comply with the regulations already in existence, and work to improve its ability to provide accurate and timely guidance. The Bright Lines project focuses on nonprofits, advocating for a definition of political activity that increases civic participation and creates objective standards for the IRS to follow when enforcing the law. Clear rules are just as important for a small business. Indeed, nonprofits can be likened to small businesses with a social mission. At the same time, it is important to recognize the benefits to small business and our society of having a safe and healthy workforce made possible by sensible government regulation.

Regulation is also essential for opening up new markets for small businesses and helps incentivize innovation in safer and cleaner technologies. Regulations make our country stronger, safer, cleaner, healthier, and more fair to small business.

The regulatory system must not operate to give large corporations an unfair advantage by delaying important regulations or muddying the rulemaking process. Making the rulemaking process too complicated for commonsense regulations harms small businesses rather than helps them. The analysis required under SBREFA, for example, can delay the already laborious rulemaking process for months. A recent GAO report, which investigated the slow process of rulemaking at OSHA, found that it takes 8 extra months of work for OSHA to prepare for the SBREFA panel. In addition, small business analysis should be narrowly targeted to benefit small business.

Though the advisory panel component of SBREFA legislation often results in unnecessary delays to needed regulations, other aspects of the law do help small businesses comply with regulations and could be expended to be even more helpful. Supporting and expanding the Small Business Ombudsman and Compliance Assistance programs is a sensible way to give direct, tangible help to small business.

The information the IRS provides to business taxpayers is essential to increasing compliance and decreasing hassle for small business. However, funding cuts to the IRS in the past few years has made that assistance more difficult to provide. Since fiscal year 2010, the IRS's funding has been drastically cut again and again. Consequences of those cuts have led to reductions in staff available to assist taxpayers and in the training available to that staff. An IRS staff that is adequately knowledgeable and available to small
business taxpayers makes filing taxes easier and prevents compliance problems from compounding. Yet, over and over, the IRS is unfairly attacked and prevented from fulfilling its mission. Therefore, it is essential that the IRS is fully funded.

It is in our nation’s interest that small businesses are able to grow and thrive in a society that protects health and safety and ensures that the market operates fairly to businesses of all sizes. Small changes to SBREFA, fully funding the IRS, and ensuring a predictable rulemaking process will ensure that the playing field is level for small business.

Again, it is an honor to come before you today, and I look forward to your questions.

Chairman HUELSKAMP. Thank you, Ms. Peterson-Cassin. I appreciate your testimony. We will begin with questions.

I would first like to direct a question to Mr. Harris. I appreciate your experience as a practitioner. Looking at this and after a correspondence audit, what do we really know how the IRS determines who is going to be audited? The New York Times article contends they have a secret algorithm. What is your experience or your best guess in what is occurring over there?

Mr. HARRIS. They have what they call a DIF score. Tax returns are scored and compared to some norms of other returns and their prior returns, which, I guess, is the most common way. They also at times target specific issues where they see problems either in a tax part of a law or taxpayer behavior. Sometimes they are just random. They do some audits that are for research purposes, and those are done randomly and are done in great depth and detail. Quite honestly, sometimes you just do not know why you are selected. You see some returns that you think, wow, I do not know why that one is not getting an audit and one that looks fairly simple gets one, so, I think there are a lot of different reasons. I am not sure anybody knows them all.

Chairman HUELSKAMP. Another question for Mr. Sepp about the auditors. How are they currently held accountable when they make errors that might cause a catastrophic result for taxpayers and/or small businesses?

Mr. SEPP. There are some methods by which taxpayers can see redress if the IRS either loses documentation or if, perhaps, a math error on an examiner’s part is discovered. That was something brought up to me in an interview I conducted with a tax professional. Interestingly, the IRS issues millions of math correction error notices on its own. Sometimes the IRS’s own staff make mistakes in the calculation of a tax. The problem is, beyond going to appeals, and assuming the taxpayer even understands his or her appeal rights, getting into tax court or district court is a very expensive proposition. One of the elements of H.R. 1828, the Small Business Taxpayer Bill of Rights, would begin a pilot program for alternative dispute resolution in small business tax cases. That was an idea that had been developed by an IRS Reform Commission some 30 years ago, or 20 years ago I should say, and it is a good idea now. I think we should move forward with it.

Chairman HUELSKAMP. With a tax appeal rate of 5 to 7 percent, is this because businesses are a function of being scared as well as not knowing, or not worth the price of entry? There is a
lot of discussion about large corporations that will draw audits for years. For a small business with 20 folks or less a couple days is a major crippling factor on their business if they are shut down or have to spend all their time with an auditor on an appeal.

Mr. SEPP. Yes, absolutely. Some professionals have reported to me, just the basic misunderstanding, that when taxpayers receive the so-called 30-day letter with an RAR, the report of the examiner, as to the issues and the position of the IRS, they think it is a bill. They think they have to pay it.

Chairman HUELSKAMP. Who would they call?

Mr. SEPP. It is very difficult sometimes. That is a problem the Taxpayer Advocate has pointed out, that there needs to be a single point-of-contact with a phone number that a citizen under examination can get in touch with. The IRS has interpreted that mandate in a very fluid fashion, and that is not very helpful.

Chairman HUELSKAMP. Mr. Davenport, what is your sense of volume of audit activity? Could that be diminished, and more targeted, and more efficient? You filed recommendations for the council you are on. Can you describe that a little bit more, how we could actually make it more efficient and better allocate the resources? Thoughts on that?

Mr. DAVENPORT. I do not know if I can speak to the volume of the audits and their current status. I think that they would be increased. You would have more efficiency in the system if you allowed the small businesses to transparently see information that is on file. If the IRS presented to you an electronic account or a format, that they could say this is what we have for you. These are the kinds of things we are going to be talking about.

As was previously mentioned, they could track the audit process, the paperwork through the entire cycle of the audit. Their interactions are, as I mentioned, largely unaccountable for, so you can change hands of the audit process several times. You can speak with people on one issue or event in the IRS and then speak with another person in another department. They do not have a way to be able to speak knowledgeably about all the information held in one place at one time, and I think it would improve dramatically.

Chairman HUELSKAMP. They have, certainly, some type of internal processes, but are taxpayers not privy to those? Or if they ask who is looking at it next or who looked at it, where it is, what do they tell a small business man or woman that is appealing? Where is the appeal? Will they even answer that question?

Mr. DAVENPORT. I think it would require several lengthy responses back and forth. I think putting all the information we have into the same place and having an important and dynamic conversation about the information that we have at the same time would be fair and transparent for both the filer and the service.

Chairman HUELSKAMP. Well, thank you. I appreciate that.

Next, I would like to recognize the ranking member for her 5 minutes of questions.

Ms. CHU. Thank you, Mr. Chair.

Ms. Peterson-Cassin, the Regulatory Flexibility Act, or RegFlex, was passed by Congress and mandates that Federal agencies consider the potential economic impact of Federal regulations on small entities. In fact, it was this Committee that created the RegFlex
Act over 25 years ago. How can the lack of RegFlex compliance from the IRS impact the ability of small businesses to adjust according to a new regulation?

Ms. PETERSON-CASSIN. Well, clarity and predictability are essential to a good regulatory system to any regulation that comes out. It makes compliance easier and it makes enforcement easier. Small businesses want to comply with regulations, and when they do not know when the regulations are coming out, what the regulations will be, whether the regulations are going to affect them, it is impossible to comply. Furthermore, compliance problems, once they start, have a tendency to compound, which leads to a lot of the problems with difficult audits that we have been discussing previously.

Ms. CHU. Well, this Regulatory Flexibility Act, RegFlex, and the Small Business Regulatory Enforcement Fairness Act, were designed with small business compliance in mind. What are the most advantageous aspects of these laws and could these tools be extended to further assist small firms?

Ms. PETERSON-CASSIN. Absolutely. The best thing these laws do is to provide direct tangible assistance to small businesses, including creating small business ombudsmen. Most agencies already have one, including Treasury. Those ombudsmen are there to answer questions, provide guides, and help small businesses comply with existing procedures. But the program should be expanded to include more outreach, make sure that small businesses know that those resources are available and can be found easily. There should also be best practices guidelines on how to do that outreach. More compliance assistance and making that assistance meaningful will have enormous benefits, and remove burdens also to small businesses.

Ms. CHU. Absolutely. Now I would like to ask you about the significant budget cuts at the IRS. The IRS has had significant budget cuts and it has resulted in limited resources. Is it realistic to think that the IRS can appropriately and efficiently perform all the duties it has been tasked to do while also reviewing the modified problem areas, like the price of audit on taxpayer accounts? How can increasing the IRS budget, and therefore increasing personnel, address many of the problems we are hearing about today?

Ms. PETERSON-CASSIN. An answer to your first question, unfortunately, I do not think it is realistic at all to expect the IRS to carry out its vast mission of enforcing the tax code with the cuts that have been in place. Since 2010, as Mr. Davenport mentioned, the IRS has lost about 17,000 full-time employees, including 5,000 from enforcement. As we have been hearing, audits are an imperfect tool. Increasing compliance assistance and guidance, before the problems compound, makes those audits easier, and increasing the training available to staff through adequate funding would decrease the problems that those audits cause as well.

Ms. CHU. How about increasing personnel and increasing the budget? What could that do to address these problems that we are hearing about?

Ms. PETERSON-CASSIN. That is exactly right. I mean, the most obvious thing that the IRS can do to increase its compliance is answer their phones. As Mr. Davenport mentioned, he cited the sta-
tistic that the IRS has a 38 percent service level on their phones. That is obviously unacceptable. When they do get more funding, as they did, they got a little bit of funding in 2015 to address that problem, the service level goes up. In fact, when that extra funding came up, they were able to hire 1,000 temporary workers and increase the phone level service to about 70 percent. Now, that is not even talking about the first thing I do when I have a problem or I have a question, which is go to the internet. The IRS needs that extra funding in order to create easy-to-find compliance guides so that small businesses do not have to wonder what they are supposed to be doing. They should be able to find those answers right away. More funding will make sure that happens.

Ms. CHU. Thank you. I yield back.

Chairman HUELSKAMP. Thank you. Next, I would like to recognize Mrs. Radewagen for her 5 minutes of questions.

Mrs. RADEWAGEN. Thank you, Mr. Chairman. I, too, would like to welcome the panel. Thank you for appearing today.

Mr. Davenport, you talk about a system that verifies taxpayer identities and tax return information before the IRS accepts a return. How would this work in practice?

Mr. DAVENPORT. In my mind there are a few things that would have to change. There are some regulations in place now to bring in information returns in earlier, much earlier. Information now from the 1099s and the W-2 passes through Social Security and then gets to the IRS sometime around the summer or late summer. If information was to arrive earlier and it would be usable by the IRS, searchable and cross-matched, we could better identify information that was included on those information statements, like W-2s and 1099s, and use it to verify, authenticate the individual.

I think there is some movement in the spending bill this year, the IRS will start issuing refundable credits on February 17th this year. This has some negative impacts for the system, but if you move back the date the refunds come out and you move up the date information comes in, you have a better chance of matching that information, and then knowing who the individual is and if they are getting the right number.

This is not to stop me stealing his information at a coffee shop; this is to stop the 500,000 returns and refunds that are issued improperly to people who do not exist. They are phantom corporations that have filed for millions of people.

Mrs. RADEWAGEN. Given the IRS cybersecurity challenges, as well as those of taxpayer identity theft and refund fraud, how do we ensure that the taxpayer online portals you recommend are secure?

Mr. DAVENPORT. Security is an evolving thing. Even 3, 4 years ago, we thought security questions were lightyears ahead of where we are. Now you can find that stuff on Ancestry.com and this is a pretty common thing that we think the status of evolving authentication, for me knowing who an individual is, the computer must be smarter than we are and those are powered by people and people have to make the decisions, and cybersecurity is a big deal. Right? So if we can improve that, if we can know who they are and if we can master information, we will have a better chance of making those payments correctly.
The thing is now I can choose to interact with the IRS on the schedule I want. I can come in and out of the system at any point. I can file and not file next year and no one will know the better. We will know later, years later, but if we were to create an online system that I could match my information the employer sent me. I am a small business owner, if I got 1099s in the mail, as did the IRS, and if I could actually see what was there, what they had, what I had, in a prefiling season I could know my compliance was going to be right and I was going to file the right return. I could submit my return through an online account. They would send me a note, we received your return today. Thank you very much. We are going to drop your refund in your account today. Is that okay? Well, if it was not me or that was not my return I would say no and we would stop immediately.

I think there are some security concerns around how to do it, but does it need to be done? It absolutely has to be done.

Mrs. RADEWAGEN. Okay, I am running out of time here.

I wanted to ask Mr. Sepp, the current audit process seems to be a bit of a mess based on a number of issues you identified: lack of centralized management, lack of transparency, flawed IDR process, et cetera. But it appears that many of these issues could be resolved administratively within IRS. What recommendations would you make to the agency to make the process work as intended?

Mr. SEPP. Some of these recommendations are being made by the Coalition for Effective and Efficient Tax Administration, but I think they apply not only to the large business and international division but small business and self-employed. There needs to be more centralized case management and points of contact. There needs to be much more consultation between the auditors and the audited about deadlines for information document requests, about timelines for completion of the audit, and about issues identified in the audit. I would echo the testimony of those here who say we need better training of IRS staff to focus more intently on the issues and to refrain from tactics such as designated summons or threatening to designate cases for litigation or hiring outside firms. Those kinds of issues, again, are eventually going to migrate into the small business community in some form or another. We need to address those now.

Mrs. RADEWAGEN. Thank you, Mr. Chairman. I yield back.

Chairman HUELSKAMP. I have a feeling we may have some members streaming in from other committees, and I have a couple of additional questions and the members will have another round of questions.

Mr. Sepp, you did mention the option of farming out audits, which is a new concept to me. I understand the current system where we actually do in most States, if not all, participate in assisting the IRS in tax administration. But the current system, farming out audits to hire private companies are perhaps conflicts of interest? Describe why that should be allowed or your opinion on the IRS doing that. Apparently, it is doing it on a number of cases.

Mr. SEPP. Well, certainly, National Taxpayers Union has in the past supported allowing the private sector to deliver services more efficiently and effective than government, but you have to draw a
line. This is an inherently governmental function involving sensitive information and very sensitive issues. When a business is involved, of course, anything that gets made public can affect the reputation of the business, its ability to attract capital and the like.

This issue was first raised when the Internal Revenue Service retained Quinn Emanuel in an investigation, an audit of a very large firm, and this has led to concerns on the Senate Finance Committee side of all kinds of things. We have privacy issues, we have whether this is worth the expense. We also have the issue of whether this is something that reinforces the intimidation factor when you have attorneys at over $1,000 per hour participating in the examinations. We are not talking about appearing as expert witnesses about issues that the examiners within the IRS might need help with, but rather, deposing witnesses. That could be very troubling.

Chairman HUELSKAMP. Is this a new route for the IRS? Or have they been doing this for a long time?

Mr. SEPP. No. It is very recent. Very recent. We are essentially ahead of the curve here in our ability to curtail this practice before it becomes commonplace. As I mentioned, one of your colleagues, Congressman Katko, is already offering an amendment regarding this. Senator Portman’s legislation has a somewhat different approach to curtailing the practice, but we need to get on this as quickly as possible.

Chairman HUELSKAMP. It seems very shocking to me and I was actually in a different type of regulatory setting of environmental regulations with the idea we would bring in a competing firm to help enforce or decide what permits their competitive firm gets and it is just beyond unbelievable the IRS would do this as well.

Ms. Peterson-Cassin, you said you had experience in the nonprofit world as well, and there have been a lot of discussions in the last few years in trying to figure out who gets targeted for audits or selection of special scrutiny, which has come under a lot of discussion lately. Can you provide an insight? Should the IRS be using special words they target, or how do they pick these out in the nonprofit world for this tax-exempt status, which of course raised plenty of concerns, I think, by many folks. Can you describe what they should have done, what you think they did?

Ms. PETERSON-CASSIN. Absolutely. What happened in that case is that the laws governing what political activity is for nonprofits are so vague that they are not only hard for nonprofits of all stripes to comply with, but they are also very, very difficult to enforce. This is exactly the discussion we have been having. Compliance and enforcement are two sides of the same coin.

So I liken it to a speed limit sign that says do not go too fast. When the rule is that vague, there are going to be plenty of people who do go too fast for whatever reason. Then there are going to be even more people, in fact, the most common thing we hear from nonprofits is they just do not engage. They restrict themselves from things that they could be doing, could be participating in, could be furthering their mission, and they say we are too afraid. We are too afraid and we are not going to do it. The Bright Lines project exists to make that clear so that everyone can be on the same page.
Chairman HUELSKAMP. In my conversations with the Commissioner, there are things that he told me they could do that no one in their right mind in the nonprofit world would even try to do because they know they are going to be hit on the wrist or even worse. How do you know what you know? How do you find out? Now we are in the middle of just trying to figure out what exactly they were doing in Cincinnati, which is the subject of other hearings of other committees, so I appreciate that insight.

Ms. Chu, did you have any additional questions?

Ms. CHU. Yes. Mr. Davenport, I was intrigued by the recommendations of the Electronic Tax Administration Advisory Committee. Electronic signatures is just such a basic common sense idea and would allow small business owners to save time and money when filing their taxes electronically. How could such a simple administrative change create efficiency for small businesses and the IRS?

Mr. DAVENPORT. You hit on a multiyear problem and I think this has come out of ERSAC before as well, but it is the way the form line 40-ES, the employment form for small businesses, it is a form that is filed quarterly and their employment taxes paid. It is administratively much easier to go to the form, print the form itself, sign it, and then scan it back than it is to create an electronic account to do this. It is a simple fix, but, you know, if we talk about the 80 percent goal to get electronic filing above 80 percent, which is going to charter ETAAC in 1998, we are close in most categories: individual filings, 87 percent of individual taxpayers; businesses are below 80 percent, just below 80 percent, because the 94X series, which there are 20-something million of these forms that come in every year, only about 37 percent of them come in electronically. It is something that the IRS has formed a working group on, they did that when I was in my first year in ETAAC. They formed a working group in e-services. They will make recommendations, and they expect to implement those recommendations in fiscal year 2018. And so you can see the arc for change is not as agile as you would expect in the private sector, but I do think that we are going to see some changes in that soon because it is honestly just an easier thing to do than not to do.

Ms. CHU. What makes implementing these changes so difficult for the IRS? Why is it taking so long? Also, are there any downfalls to allowing electronic signature, such as fraud or ID theft?

Mr. DAVENPORT. I think one of the things they are dealing with is that an individual must authenticate for a business, on behalf of a business, and as a Schedule C filer. There are millions of Schedule C filers, it is no problem for me to authenticate myself with my own social, but to do so on behalf of a business, you have to share your own personal identity on behalf of a business as a business owner, and sometimes as businesses grow, that information then has to pass to internal accounting services or external folks.

Again, it may just be an administrative thing that can change, that we can fix the system and make it easier, but I think they have to think about authentication as a whole strategy. That is just kind of wound up in it. I would probably defer to Mr. Harris, he may have strategies.
Mr. HARRIS. No, I think your comments are true. We need to move to more electronic filing capabilities, and I think the service, if I was going to be critical, it is the old saying, “The enemy of good is perfect.” At some point we need to begin to allow businesses—there is always a reason not to do something. We need to start trying to find a reason to do something.

Ms. CHU. Mr. Harris, collecting tax debt is possible through flexible collection tools and can be an efficient way of helping these individuals, yet these tools are rarely utilized by the IRS and instead tax liens, levies, and seizures are used. What makes liens and levies, which are much harsher points of collection, the preferred method for IRS agents?

Mr. HARRIS. I really have no idea why it would be the preferred method because it is the most cumbersome method. It creates the most difficulties. I guess if you have exhausted every other tool. As you said, there are plenty of opportunities through any collection process through the use of installment agreements or offers in compromise or just paying the tab, it should be in all cases the place of last resort. If it moves up anywhere beyond that, then something in the system has not gone as intended because, again, that should be the last thing anyone gets to because that has the most severe impact of all on a small business owner.

Ms. CHU. I yield back since I think votes have been called.

Chairman HUELSKAMP. Are there votes this early? I did not know that, so I appreciate that. We got sidelined with another Committee, so I would like to thank all of you witnesses for participating today. You have raised a number of issues and potential solutions—I like hearing solutions—that require some serious attention at the IRS. It seems we have a lot more work to do in this area but this hearing is a good start.

I know the Full Committee and this Subcommittee will follow up with the IRS and other stakeholders on the issues raised today. You have not heard the last from us. It is important that these issues and other related concerns are identified, addressed, and corrected.

I ask unanimous consent that members have 5 legislative days to submit statements and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned.

[Whereupon, at 11:28 a.m., the Subcommittee was adjourned.]
APPENDIX

Statement of
Pete Sepp
President
National Taxpayers Union

Prepared for
The Subcommittee on Economic Growth, Tax, and Capital Access
Committee on Small Business
United States House of Representatives

Regarding the Subcommittee’s Hearing on

“Audits and Attitudes: Is the IRS Helping or Hurting Small Businesses?”

Submitted June 22, 2016

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**Introduction**

Chairman Hultskamp, Ranking Member Chu, and Members of the Subcommittee, it is a great honor for me to provide comments today for your hearing, “Audits and Attitudes: Is the IRS Helping or Hurting Small Businesses?”

My name is Pete Sepp and I am President of National Taxpayers Union (NTU), a non-partisan citizen group founded in 1969 to work for less burdensome taxes, more efficient, accountable government, and stronger rights for all taxpayers. In 1997, NTU’s then-Executive Vice President David Keating was named to the National Commission on Restructuring the Internal Revenue Service (IRS), a federal panel whose recommendations later became the basis for the most extensive IRS overhaul in a generation. More about our work as a non-profit grassroots organization, and the thousands of members we represent across the nation, is available at www.ntu.org.*

Throughout our 47-year history NTU has held a special concern for small business and self-employed taxpayers, who make up a somewhat larger proportion of our membership than would be represented in the general working population of the United States. Although we advocate for many structural changes to the tax system, from the comprehensive to the incremental, one common aspect on which NTU often specifically focuses is the administrability of such proposals. As policymakers define the rates, bases, deductions, credits, and other features of a tax system, what will the practical impact be on taxpayers’ lives and their rights?

It is particularly fitting that your Subcommittee preside over this discussion of small business tax audits, because the conduct and outcomes of IRS examinations directly impact not only the rights of business owners, but also their ability to contribute toward economic growth, to comply with tax laws in the future, and to obtain the capital needed to expand.

**I. Small Businesses and IRS Enforcement: A Troubled History**

In our experience, IRS treatment of the small business community has historically served as a barometer for systemic reforms of the tax laws as well as tax administration. Many of the first Americans to approach NTU’s advocacy staff and share “horror stories” of harsh treatment by the Internal Revenue Service were small business owners.

A 1987 Senate Finance Committee hearing, for example, focused in part on the plight of Thomas Treadway of Pipersville, Pennsylvania, who lost his trash-management business after an IRS audit resulted in a $247,000 assessment (including penalties and interest) against him. The assessment was later thrown out in its entirety, but Treadway’s livelihood was severely impacted due to overly aggressive IRS collection tactics (including a $22,000 seizure of his girlfriend’s bank account). In a 1990 Finance Committee proceeding, Kay Council (an NTU member) described how her husband, Alex, was driven to suicide after an IRS audit of the Councils’ real estate development business disallowed a tax shelter. The tax agency never contacted the Councils or their accountant about the deficiency until four years after the fact, at which point the tax bill had soared to nearly $300,000. The IRS’s destroyed their business, and Kay Council only prevailed after spending some $70,000 on legal fees drawn partially from the life

*As a matter of organizational policy National Taxpayers Union neither seeks nor accepts any kind of grant, contract, or other funding from any level of government.

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insurance policy of her deceased husband. Tragically, this suicide over a mishandled tax audit was not the only incident of its kind. Subsequent hearings and media accounts in the mid-1990s uncovered harsh tactics against small business owners. Armed raids of IRS agents on establishments such as the Jewish Mother restaurants in Virginia and the Kids Avenue clothing stores in Colorado highlighted how tax enforcers could effectively ruin a small business's reputation with its customers ... and, in turn, its viability.

Ultimately stories such as these led Congress to enact comprehensive taxpayer rights safeguards in 1988, 1996, and 1998. Those laws have all worked to curb some of the agency’s worst excesses, provide limited remedies for wronged taxpayers, and introduce new layers of accountability through the IRS Oversight Board and the National Taxpayer Advocate.

Yet, further challenges have arisen. In 2013, for example, The Wall Street Journal revealed that the IRS was targeting small businesses for heightened scrutiny over their cash transactions. The article described how the agency’s initiative, which included sending owners “Notification[s] of Possible Income Underreporting,” left many small business people feeling intimidated.

Hearings held in April of last year and May of 2016 by your colleagues on the Ways and Means Committee have uncovered another wrinkle to the government’s apparent suspicion of cash-intensive businesses that deal in cash. Despite some embarrassing revelations several years prior in The New York Times, the IRS has been teaming up with the Department of Justice in pressuring asset forfeitures among small business owners dealing in cash. The Committee revealed more than 600 cases involving over $40 million of seized funds from “individuals and families who have been forced to forfeit their assets even though they have not been proven guilty of any crimes.”

Although Congress took the commendable step last year of codifying the “Taxpayer Bill of Rights” principles promulgated by the National Taxpayer Advocate, the job of protecting taxpayer rights will never be finished. As the Tax Code, the economy, and technology are all constantly evolving in new directions, so must the laws designed to prevent abuse of authority and provide appropriate remedies when such abuse occurs.

The following testimony is intended only to provide highlights surrounding tax administration issues for small businesses, especially in the areas of tax examinations. Its recommendations should be considered as part of a broader effort that is needed to update protections and procedures for all taxpayers. In April of 2015 I was asked to testify before the full Committee on Small Business at a hearing entitled, “Tax Reform: Ensuring that Main Street Isn’t Left Behind.” Several sections of my testimony for that hearing continue to have relevance, and have been updated or modified for inclusion in various portions of this document.

II. The “Fear Factors” of Audits

In late November 2001, a McKenna Research poll of 500 respondents reported that by a 50 percent – 32 percent margin, more Americans worried about “receiving an audit notice from the IRS in the mail” than “receiving anthrax in the mail.” These results reflect a degree of gallows humor. However, McKenna’s findings – at the height of the nation’s concern over terrorism – also reflect how deeply-seated Americans’ fears of the tax agency were, even three years after adoption of the IRS Restructuring and Reform Act of 1998.
Fast forward to 2013, when a Gallup Poll found that 62 percent of those surveyed felt the IRS had “more power than it needs to do its job,” and it is clear that the public has remained anxious over the tax man’s ability to pry into Americans’ daily lives.

IRS examinations, whether in the form of field or correspondence audits, must be viewed with other interrelated pieces of the tax administration puzzle to gain a full appreciation of problems and solutions. Document matching and math error correction are among the other tools the IRS employs to oversee and ensure compliance in the tax filing process.

Yet the fact remains that some of the most contentious issues surrounding tax administration center upon, or are a consequence of, audits. These matters range from the clarity and content of the laws themselves, to appeals of audit results, to IRS employee conduct, and to remedies in the courts.

From the view of the small business person immersed in an audit, such matters of policy seem academic. What, therefore, are the more palpable “fear factors” foremost in business owners’ minds when undergoing this process? Based on NTU’s review of research literature, statistical analysis, oversight reports, and hundreds of anecdotes over the past several decades, we believe the following are most pertinent.

**Uncertainty.** Audits can be a direct consequence of complexity in the tax laws themselves. Some examinations involve straightforward questions such as whether a taxpayer can provide support for claiming deductions. In other situations, however, the questions revolve around a taxpayer’s application of often-confusing laws to his or her unique situation … an application that clashes with the IRS’s own interpretation.

Ranking Member Velázquez of the full Committee eloquently summed up the problem in an opening statement from 2013, when she observed that, “In the past, small businesses have told us that complexity and uncertainty create difficulty when filing tax returns. Many business owners worry that one simple mistake can lead to a costly and timely audit. And, at a time when many businesses are striving to expand, every hour and dollar counts.”

For businesses, those dollars and hours add up quickly. An annual study published by our research affiliate, National Taxpayers Union Foundation (NTUF), calculated that for this year the federal personal and corporate tax system extracted 6.1 billion hours and $234.4 billion out of the economy in 2016 (a trend that has been worsening). Other analyses suggest that two-thirds or more of these sums would be attributable to the business sector, including corporations, partnerships, and sole proprietorships.

The complexity load that businesses bear has been a longstanding malady. NTUF reported that General Electric’s 2006 tax return, would have amounted to over 24,000 pages had it been printed on paper. GE’s tax return may be even longer today. When NTUF’s researchers contacted GE’s media relations staff in 2010, they were told that the firm’s tax department had stopped counting after the filing documents routinely exceeded the 24,000-page mark every year.

A small firm may not face as daunting a tax filing scenario as GE, but it could quite conceivably contend with a return involving dozens of forms, schedules, and worksheets backed up by the equivalent of hundreds or thousands of recordkeeping transactions.

Companies such as GE, with entire departments laboring to fulfill tax requirements, are forced to pass along their costs in the form of higher prices, lower shareholder returns, or fewer employment opportunities. Yet, it is clear that even in tax compliance, economies of scale can sometimes occur,
making the chore of meeting tax obligations disproportionately more difficult for small businesses and self-employed individuals. At the same time, their ability to exercise “pass along” options is more limited.

This disparity is measurable. A September 2014 report for the National Association of Manufacturers calculated that the regulatory cost per worker for all tax compliance activities in firms of any size was a whopping $960 (using 2012 data and expressing in 2014 dollars). For companies with fewer than 50 employees, the tab was much worse — over 50 percent more, at $1,518 per worker.

Unfortunately, these considerable outlays and resources do not buy peace of mind for small business owners who, as Ranking Member Velázquez stated, often operate in fear of vague laws being used against them.

Uncertainty has also crept its way into the audit selection process itself. A Government Accountability Office (GAO) report issued in January of this year on the Small Business/Self Employed (SB/SE) division of the IRS concluded that the “lack of strong internal control procedures” in the agency’s 33 workstreams for identifying and reviewing returns for possible audit “increases the risk that the audit program’s mission of fair and equitable application of the tax laws will not be achieved.” The term of “fairness” in selecting returns was unclear or even contradictory in how it was defined among IRS staff, while “documentation and monitoring procedures were inconsistent” for ensuring that selection procedures met internal controls. Flawed inputs like these could have real-world consequences in terms of the effectiveness of audits for the government and equitable treatment for taxpayers.

Intimidation tactics. Previous taxpayer rights laws have certainly improved audits and auditor behavior. Those under examination have prerogatives due to those laws, such as recording audit proceedings and having some flexibility to determine the location where an audit will take place. Furthermore, thanks to the IRS Restructuring and Reform Act, auditors (like other IRS employees) are managerially evaluated on providing fair and equitable treatment of taxpayers. The Internal Revenue Manual has been updated to describe the sorts of behaviors that represent such treatment.

Still, members of the tax representation community have observed that the conduct and attitudes of audit personnel have not been subjected to the same level of regulation as personnel involved in collection. A passage from a 2012 article appearing on AOL, News by Ross Kenneth Urken, personal finance editor for TheStreet.com, is particularly illuminating:

In response to the ‘storm trooper’ reputation, the IRS publicly tried to clean up its act during the Clinton administration. Yet most of the changes it made had to do with collections, according to Anthony Parent, the founding partner of IRS Medic, a law firm oriented toward those with tax troubles. There was a lot of congressional testimony about revenue officers’ abuses, but there was no censuring of abusive auditors, nor were any concrete limitations placed on their powers.

IRS veterans refer to this period as ‘Rah Rah ’98.’ Parent said – a mocking cheer that represents the emptiness in the push for audit reform. …

Given that the typical auditor today was just a kid during the Clinton administration, Parent says, the public can still expect ‘skittish’ auditors who ‘if pushed into a defensive position, will lash out at a taxpayer.’

To this day, taxpayers and advisers continue to report on troublesome developments in IRS audits that range from isolated cases to broader policies. Here I am indebted to Daniel J. Pilla (an author and tax litigation expert), Leonard Steinberg, E.A. (a New York area tax representative), NTU’s members, and
others for providing me with background information on their challenges:

- Some auditors continue to ignore or deny protocols in the Internal Revenue Manual, including “audit reconsideration” procedures when, for instance, an individual files an amended return that could obviate the need for continuing an examination.
- IRS delays in resolving some cases allow the statutory clock to keep ticking on interest that is almost never abated, even though the agency’s own lack of follow-up may be to blame.
- In other areas, however, “Speed Up Audits,” brought on by what some say is a reduction in IRS enforcement resources, may be leading taxpayers to a financial dead end. Writing in The New York Times last year, Dave Du Val of TaxAudi.com explained that, “Examiners for the I.R.S. are giving taxpayers and their accountants much less time to respond to certain audit letters. … An initial request for an appointment is followed quickly – in some instances, on the same day – with a follow-up letter that states that the requested information has not been received.” That second letter contains a threat that failure to respond to the first notice could result in loss of appeal rights. A taxpayer in this situation has little, if any, time to consider even a basic response, much less an appeal.
- The IRS “rounds up” in making its case against taxpayers. Restaurants, for example, become targets through no fault of their own because of the IRS’s fixation on credit-card transactions as part of the audit determination process. These transactions include taxes and tips, generating an artificially larger cash-flow than records which would reflect only actual sales of menu items.
- Innocent “chit chat” between auditors and taxpayers can become the basis for wider investigations. An auditor might innocently raise the topic of where the citizen might have last gone for vacation, or ask for advice on buying a car based on what the taxpayer owned.

Correspondence from the IRS can intimidate as well, whether intentionally or not. In the 2013 Wall Street Journal article cited above that explored the IRS’s crackdown on cash-intensive businesses, one owner remarked, “There’s an emotional thing when you get an ominous-looking letter from the IRS.” Another noted, “There are so many reasons why even if you’re the most honest taxpayer, you’re not going to match a given business’s credit-card record sales records with non-card transactions.

Even routine audit correspondence can have this effect. According to Daniel J. Pillia, who has decades of experience in helping thousands of clients, the Revenue Agent’s Report (RAR) mailed with the post-audit “30-day letter” can be misunderstood. As he wrote in his recent book, How to Win Your Tax Audit, “Citizens commonly mistake the RAR for a bill, which it is not. They do not understand that it is merely a proposed change, which they can appeal.”

The National Taxpayer Advocate (NTA) of the IRS has also identified subtle but important flaws in IRS correspondence audits that contribute to the intimidation effect. In her latest Annual Report to Congress “report card” (which evaluates follow-up on NTA’s “Most Serious Problems” (MSPs) in tax administration), the Advocate determined that the IRS has “overlooked the Congressional mandate to assign a specific employee to correspondence examination cases, thereby harming taxpayers.” The agency fails even to provide a telephone number or employee identification code on audit notices generated by individual tax examiners. Depriving audited taxpayers of this information leaves them feeling even more isolated.

Some potentially intimidating IRS actions aren’t revealed until the taxpayer is placed in a nearly untenable position. Despite their questionable intersection with taxpayer protection laws, “parallel investigations” involving the criminal and civil arms of tax examination have continued. An August 2015 article appearing on the American Institute for Certified Public Accountants’ “Tax Adviser” website describes the “gradual evolution” of this technique. Whereas traditionally a civil proceeding would be “frozen” if the tax examiner thought the case should be referred to authorities in the criminal sphere, more
and more cases “over the past decade” have been marked by “extensive interaction between criminal and civil enforcement personnel.”

According to Justin J. Andreozzi, Randall P. Andreozzi, and Arlene Hilschweiler, who authored the article, the IRS cannot intentionally portray a criminal investigation as civil to the taxpayer involved. The IRS, however, “does not have an affirmative obligation to disclose the existence of a criminal investigation … IRS civil examiners are instructed not to disclose that a criminal investigation has been opened, and, if asked, only to state that any information obtained in a civil examination can be shared with criminal investigators.” The resulting fallout could, they write, “range from trivial inconveniences to much more serious landmines such as a tax adviser’s unwittingly waiving a client’s constitutional rights.” Currently parallel investigations are employed most forcefully in abusive tax shelter transactions, and the chances of an innocent business owner encountering them are low. But as the recent asset forfeiture debacle has shown, powers intended for use in one capacity can be wielded in others.

**Deadweight losses.** By its very nature, any IRS examination involves a considerable expenditure of time, effort, and money on the part of the business owner and the owner’s professional advisors. Substantiating deductions or reconciling income often requires gathering or producing copious records. The owner’s mental energy is shifted away from maintaining or growing the business and toward meeting what can seem like an endless list of IRS demands. And of course, the out-of-pocket expense for financial and legal advisors can take on enormous dimensions, sometimes out of proportion to the amount of tax at issue. With so much at stake, one would be led to believe that most small businesses would appeal adverse IRS determinations. This is not the case, and the reasons merit further analysis.

According to the most recent *IRS Data Book*, 29 percent of all field audits and 57 percent of all correspondence examinations of small corporations in Fiscal Year 2015 involved no proposed change to the taxpayer’s liability. Among 1040 returns reporting business income, the percentages were generally smaller, although those with business receipts above $200,000 subject to correspondence audits had a no-change rate of above 50 percent.

It is clear that the number of small business taxpayers who actually appeal their audits is quite low. There are several ways of measuring the appeal rate, but *Data Book* presentations show that 6,291 taxable nonfarm 1040 returns with business income of under $200,000 involved “unagreed recommended additional tax” out of 191,501 returns in that category examined. Even after throwing out “no change” returns and recommended decreases in tax liabilities, from these statistics alone the rate of appeals in audit situations appears to be paltry, hovering somewhere below 5 percent.

Is this apparent low frequency of disputes simply attributable to the IRS being correct in the position it takes from the vast majority of examinations? Numerous authorities, from prominent members of the tax advisory community, to the Government Accountability Office, to the National Taxpayer Advocate, would answer, not at all.

In fact, there are many reasons why small business owners do not appeal audit determinations. As explained earlier, the very content of IRS correspondence can be unclear about a taxpayer’s right to contest the tax agency’s recommendation. There is also another consideration at work.

Many business people told lawmakers in hearings during the 1980s and 1990s that they believed the cost of disputing an IRS tax bill — even if they knew the agency was wrong — simply became too prohibitive. To be sure, there are appeal and abatement processes for audits that have improved over time in terms of accessibility and affordability for taxpayers without extraordinary means. Unfortunately, even into the mid-1990s, many Americans facing IRS demands felt helpless.
According to a 1995 study by Daniel J. Pilla:

The average individual face-to-face tax audit led to the assessment of $4,780 in additional tax and penalties, not including interest. However, just 5 percent of those found to owe more money appealed [Pete Sepp comment: note 2015 statistics above showing how little this figure seems to have changed]. The 5 percent number is significant in this way: the GAO has proven that the IRS’s computer notices are wrong 48 percent of the time. Still, 95 percent of the public is persuaded that IRS audit results are correct or not worth fighting. That testifies to the degree to which the IRS has the public convinced that it cannot win when challenging an audit.

In short, all too many Americans thought it was cheaper to pay what the IRS said they owed rather than fight.

Consider, for example, the average additional recommended tax in 2015 resulting from field audits of business 1040 tax returns with receipts between $25,000 and $100,000 – a total bill of $9,947 per return. Imagine the decisions this audited business owner – the very definition of “the little guy” – would face. If he or she hires a tax professional for representation, the average fee, according to the National Society of Accountants’ most current public data, would be $144 per hour. It would not be unusual for the accountant to spend 10 hours on this stage of the audit. Should the initial examination go against the owner, he or she could choose to retain the accountant for the administrative appeals process, perhaps involving an additional 10 hours of time. Meanwhile, the owner could have easily spent 10-20 hours of time gathering records, reviewing paperwork, etc., at an average compensation amount (according to the National Association of Manufacturers study mentioned previously) of $48.50 per hour.

To get this far into the audit process, the owner could have already spent close to $3,900, more than one-third of the contested bill. Should the administrative route fail, the owner then has broad options to file a Tax Court petition or try to litigate in federal court. While many Tax Court petitions never advance, and often lead to settlements, this process could easily consume another 10 hours of a legal professional’s time (at likely a higher rate of compensation). Should litigation actually take place, a qualified tax attorney might demand $300 per hour or more. If the owner prevails, his or her ability to recover the entirety of fees like these remains doubtful. The maximum amount that can be awarded is barely $200 per hour, and only if the court determines the IRS’s position was not “substantially justified.”

All along this difficult road, the owner must also take account for the damage that eventual liens or levies could have on his or her business reputation, not to mention lost productivity diverted from keeping the company profitable.

Confronted with this type of calculus, it is little wonder that many businesses are forced into either conceding completely to the IRS’s position or making a compromise that substantially weakens their balance sheets. The latter course can actually backfire on the government, should the business become so infirm that it no longer is able to deliver receipts to the Treasury.

Existential threats. Some small businesses clearly do owe major tax liabilities as a result of a civil examination or investigation, to the point of their very existence being endangered. For criminal enterprises or “shell” firms, this is no real loss to the economy or society.

But what of legitimate business owners who are innocent of wrongdoing, or have simply made some honest mistakes? Their worries over the very survival of their companies should be our worries as well – on them depend not only the entrepreneurial spirit, but the practical benefits of economic activity and revenue generation. Jordan Markson’s experience is just one of many illustrative examples.
An entrepreneur who has been involved with half a dozen startups, Markuson co-founded a company in 2003 that bought and sold online domain names. The highly successful firm was subject to an IRS audit in 2011 and Markuson’s excellent recordkeeping gave him little to fear from IRS requests to document his firm’s well-flowing revenues. Unfortunately, the agency did flag him on home business expenses, eventually disallowing three years of write-offs.

In an interview accessed in 2016, Markuson told Lisa Ferguson of Bplans.com that “the additional liability and accounting costs were equal to one-third of the following year’s total revenue. Paying it back becomes an uphill battle because IRS back payments are not expenses, so they are coming directly for your profit.” Markuson’s business failed as a result of this quandary, but fortunately he was able to apply his talents to another business and maintain a positive attitude. Yet, was it truly in the government’s interest to bleed a taxpaying business to death, rather than allowing the business to function as it paid its way out of a tax bill?

Other stories have a less optimistic ending. Paul Hatz, a taxpay from Boston, had to shutter his company (and lay off more than a dozen employees) because of an auditor’s error in attributing income from his corporation to him personally. Hatz had a $110,000 tax lien entered against him, and spent several years and $60,000 in representation costs clearing up the problem. The final actual tax bill was reduced to $5,000, but Hatz declared personal bankruptcy as well as losing his business. In a 2012 interview with TheStreet.com’s Ross Kenneth Urken, Hatz said, “I never want to start a business again. … If you get the wrong auditor and are a small business struggling to make ends meet, you are done – out of business regardless of whether you did anything wrong or not.”

Another example was brought to my personal attention from an owner of a technology consulting business, who has asked me not to reveal their identity.* After an IRS audit of the business’s tax returns, a net operating loss carryback was accepted for two years of returns but denied for the third year, triggering a large tax liability. This problem was unknown to the owner until the individual discovered a tax lien had been entered on the business’s assets. The owner did not agree with the IRS’s position, but on the advice of an attorney entered a payment plan for the liability “to un-restrict growing my … small business.” The owner was led to understand that the liens would be released after demonstrating consistent payments on the back taxes, but even after the liability was satisfied, the liens remained. This fact, still true today, has in the owner’s words “resulted in me being denied a Small Business Administration backed Working Capital Line of Credit.”

The owner concluded a summary of the case sent to me by writing:

The IRS can simply say you are guilty and you either agree to make payments or they will ruin you. Of course as a taxpayer I could potentially take the IRS to court to prove my innocence but that isn’t the way the system of jurisprudence is supposed to work. The taxpayer is assumed guilty even though after many years you can prove you were right.

Will this taxpayer’s business survive, to continue contributing to the economy and therefore the Treasury? Only time will tell.

Lack of remedies. Prior to reforms enacted in the 1988-98 period, taxpayers had only a few options in disputing an IRS assessment that did not involve considerable expense and time. Even if they decided to go to U.S. Tax Court or a Federal District Court, the most citizens could recover if they were victorious was $75 an hour in attorney fees. The 1988 law allowed taxpayers to sue for damages if they

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*NTU can put Subcommittee staff members into contact with this business owner upon request.
could prove an IRS employee “recklessly or intentionally” disregarded the law. The cap on attorney fees was raised to $125 per hour. Yet, these provisions were still relative pittance to a taxpayer, especially a business owner contemplating months or years of lost time, a large up-front out-of-pocket expense, and a tax bill that kept accruing interest and penalties.

In a 2013 *Wall Street Journal* article, respected tax lawyer Robert Wood estimated that over the past decade, he identified at least 22 taxpayers involved in IRS disputes who received some kind of attorney compensation or litigation costs from courts, “although some rewards may later have been reduced.” Other award cases may exist but their prevalence remains rare.

On the other hand, the IRS’s litigation resources against small businesses are formidable. Over the past ten Fiscal Years, the IRS Chief Counsel’s Office has typically closed some 70,000 “tax enforcement and litigation” cases per year. Roughly ⅓ of those cases fell under the category of “Small Business and Self-Employed.” No other area of practice – large businesses, criminal issues, or even general legal services – comes close.

Granted, IRS reforms have expanded both the number and the usability of appeals avenues to taxpayers, the availability of Taxpayer Assistance Orders, as well as safeguards against hasty or capricious liens and seizures. Nonetheless, the IRS recently came under new scrutiny last fall regarding its collection policies, amidst revelations from *The New York Times* that the agency had made hundreds of tax-related seizures in 2012 by creatively employing civil asset forfeiture laws. As the *Times* observed (with historical relevance in my opinion), “The government can take the money without ever filing a criminal complaint, and the owners are left to prove they are innocent. Many give up. . . . The median amount seized by the I.R.S. was $34,000, according to [an] Institute for Justice analysis, while legal costs can easily mount to $20,000 or more.”

One such individual who decided to capitulate in the face of these odds was Calvin Taylor, a business owner on Maryland’s Eastern Shore. During a recent hearing before the House Ways and Means Committee, he eloquently summed up his own situation as well as that of many fellow business people:

I had no choice but to agree to the DOJ and IRS keeping our legally earned money. I faced potential criminal charges for crimes I did not know I had committed, but that a U.S. Prosecutor had nonetheless threatened to bring against me. . . . The potential cost of defending myself was astronomical, and it greatly exceeded our family’s resources. Settling was an obvious and sensible business decision in the circumstances, made under duress in order to avoid prosecution and potentially, a long jail term.”

Rights without remedies are meaningless. Congress should address this contradiction in short order.

### III. Shared Concerns with Large Businesses

Small business owners are adding another set of audit fears to the top of their list, and they stem, ironically, from the reorganization of the Large Business and International (LB&I) division of the IRS. The sweeping LB&I restructuring is still not sufficiently detailed for private sector experts to pinpoint the entirety of its impact. Nonetheless, overall the IRS envisions shifting its examination focus away from industry-specific clusters and toward nine practices areas, four of which are geographically oriented and the remaining five subject-oriented (e.g., enterprise activities, pass-through entities, cross-border activities, withholding and individual international compliance, and treaty and transfer pricing.)
operations). In February of 2016 the IRS elaborated upon the new LB&I audit approach, which is to be issue-based, outcome-driven, collaborative, and transparent.

Last year, National Taxpayers Union enthusiastically joined as a member of the Coalition for Effective and Efficient Tax Administration (CEETA), which was formed to constructively engage both the Treasury and Congress on audit process issues as the LB&I reorganization takes place. CEETA is comprised of more than a dozen trade associations and citizen groups, including: Council for Citizens Against Government Waste, Council on State Taxation, National Association of Manufacturers, Retail Industry Leaders Association, Small Business and Entrepreneurship Council, Software Finance and Tax Executives Council, and the U.S. Chamber of Commerce.

Because it is so remarkably broad, this coalition has been able to gather the experiences of numerous companies and unify them around several themes embodying opportunities to improve the way business (and in some aspects individual) tax audits should be conducted. These themes follow.

Lack of centralized management and accountability in audits. Under the new LB&I auditing process, more than one practice area (e.g., a regional area and an expertise area) may be assigned to a single audit. In addition, the IRS’s chains of command for domestic and international audit issues are split. How will the IRS’s personnel lines of reporting and most importantly, decision-making authority, be allocated in such a situation? Furthermore, the LB&I Examination Process has been established to invite open collaboration between the taxpayer and the exam team on process matters such as a timeline and how changes to the exam plan are to be communicated.

“Without centralized management or clear responsibility for an audit, it is difficult for taxpayers to seek assistance when an audit is not conducted in accordance with best practices such as the QEP [Quality Examination Process],” an extensive November 2015 CEETA memorandum to IRS officials noted. Nor does this problem facilitate the resolution of complex audit issues.

Lack of transparency. Nowhere is greater transparency more urgent than in the way official guidance over highly complex issues raised in audits is promulgated through the IRS Chief Counsel. CEETA has determined that over the past 15 years, there has been a dramatic shift toward relying upon less formal Chief Counsel Advice (CCAs), which generally have no taxpayer participation, and away from Technical Advice Memorandums (TAMs), which require agreement between the taxpayer and the IRS on the facts surrounding a given question. In the period of 2000-2004, for example, the IRS issued 928 CCAs and 393 TAMs, a ratio of less than 2-1/2 to 1. A decade later, in the 2010-2014 timeframe, 1,530 CCAs were issued, compared to just 53 TAMs—a ratio of roughly 29 to 1.

This development has serious downstream effects. CEETA noted in its November 2015 communication, “The lack of taxpayer involvement is bound to result in a less robust consideration of the facts and the issue. The use of CCAs can also hinder the resolution of cases in the Office of Appeals because Appeals officers may be disinclined to engage on an issue” after a CCA has been disseminated.

Breakdowns in the information document request (IDR) process. Through peer review, the IRS’s own staff have acknowledged that IDRs are a major impediment to the workflow of audits. In 2013 LB&I clarified procedures for all IDRs going forward, requiring them to be issue-focused, discussed with the taxpayer prior to issuance, and guided by a deadline negotiated between the taxpayer and the agency. A subsequent IRS directive in early 2014 created detailed instructions on how IDRs would be issued and how they would be enforced.

Unfortunately, the execution of these otherwise sound procedures has been uneven and erratic. Problems have been reported such as IDRs with overbroad issue focuses, or “kitchen sink” IDRs for all types of irrelevant information before the initial audit conference has begun. Moreover, examiners have
issued multiple IDRs with the same deadlines, or have requested information for tax years or entities not under audit. No guidance is available to examiners on how to establish an IDR deadline or grant an extension. These problems and others can make the new process chaotic.

**Delays in closing cases and honoring estimated completion dates.** As noted previously, businesses have been experiencing both frustrating delays and demanding accelerations of audits at the hands of the IRS. In the case of LB&I, the prospects for resolving or appealing audits are less tenable. Increasingly, taxpayers are receiving multiple requests for extending the statutory period of examination, while estimated completion dates established in audit plans have become less meaningful.

The Catch-22 becomes evident in the Appeals division’s policy requiring that 12 months always remain in the statutory examination period; this becomes a justification for the IRS to continue the audit rather than conclude the case. Taxpayers can never actually avail themselves of an appeal, and are forced into Tax Court. Some of these delays are blamed on IRS resource constraints and turnover of qualified personnel, but CEETA contends, “Issue selection and resource availability should go hand-in-hand, with issues only pursued if there are qualified and dedicated resources available.”

**A litigation mentality as opposed to an issue resolution mentality.** In some instances, CEETA members have observed that IRS exam teams seem more occupied with “preparing for litigation rather than ascertaining the correctness of a return and resolving issues.” This mentality manifests itself in various ways, including IDR interviews and requests that have the effect of pre-trial discovery. Other developments are discussed below, but the end result “negatively affects the cooperative relationship, impedes transparent interaction, decreases efficiency, increases costs, and delays certainty for both taxpayers and the Service.”

The coalition has made dozens of recommendations that the IRS could implement administratively in conjunction with the LB&I reorganization. However, CEETA has also identified four key matters that should be addressed through legislation in this Congress – while prudent inputs and adjustments can still be most effectively absorbed into the IRS’s LB&I audit strategy. They are:

**Properly limiting the designated summons.** Although the IRS has the conventional power to summon testimony and documents in examinations, the designated summons is a special authority intended, according to a top IRS audit official, for situations “only after the taxpayer under examination refuses to extend the statute of limitations … and the examiner has exhausted all other means to obtain the needed information.” The designated summons, unlike conventional summons, will act to suspend the assessment period when a court proceeding is brought to enforce or quash it. As a consequence, the designated summons can, if employed improperly, compel taxpayers into nearly endless extensions of the statutory examination period. In fact, so potent is this weapon that Congress required, by statute, a report on its frequency of use (a report whose issuance we cannot verify).

Until quite recently, designated summons enforcement was quite rare. But as CEETA’s memo warns, “current and former IRS officials have publicly commented that designated summons will become a more frequent IRS management tool.” Indeed, the National Taxpayers Advocate confirmed that summons enforcement (non-designated in most cases) was one of the most litigated issues in 2015, and taxpayers rarely prevail in attempting to challenge them.

It bears mentioning here that like many weapons, the designated summons can be effective when employed as a threat, not just a reality. Shrewd IRS personnel can, at an appropriate moment in the audit process, simply mention that the designated summons is available to them as a “last resort” if a taxpayer does not capitulate to their demands for yet more time to complete their examination.
Better defining circumstances for designating cases for litigation. Just as the designated summons was designed to be used only under special circumstances, the IRS has given itself the authority – when approved by high-level agency and Chief Counsel officials – to force a case or audit issue into the courts. This power has never been authorized by Congress; it is not based on legislative authority, but is an administrative power the IRS has granted to itself. It is again, intended to be wielded infrequently because doing so strips a taxpayer of the right to an administrative resolution unless the taxpayer unconditionally surrenders their position on the issue. IRS guidelines indicate that cases suitable for designation are those that “present recurring, significant legal issues affecting large numbers of taxpayers … and there is a critical need for enforcement activity with respect to such issues.” Specifically, the guidelines note, the cases designated for litigation should be selected with an eye toward “judicial precedent [that] may provide guidance for the resolution of industry-wide, tax shelter or other issues.”

In theory this power, carefully employed, could function effectively. But as CEETA notes, when used with less circumspection, or even threatened, designation has raised “concern [among taxpayers] regarding the predictability of their own audits and in particular the availability of Appeals.”

Ending the improper use of private contractors in examinations. Last year, Senate Finance Committee Chairman Orrin Hatch made an important inquiry to Commissioner Koskinen regarding a $2.2 million contract extended to a private law firm in a large corporate audit; this contract permitted examination activities on the part of the firm best described as overhearing and harsh. Chairman Hatch stated:

The IRS’s hiring of a private contractor to conduct an examination of a taxpayer raises concerns because the action: 1) appears to violate federal law and the express will of the Congress; 2) removes taxpayer protections by allowing the performance of inherently government functions by private contractors; and 3) calls into question the IRS’s use of its limited resources.

From NTU’s standpoint, the IRS’s action is fraught with additional risks. Allowing more entities access to confidential taxpayer information only raises the likelihood of additional data security breaches in the future, on top of several recent hacking incidents and a continuing plague of tax-related identity theft. Furthermore, if the agency is allowed to continue this practice, by issuing a “temporary regulation” without a comment period or notification, the door will be open for other grave trespasses against taxpayers’ rights affecting many constituencies.

All of these factors, and more, combine to undermine taxpayer rights to appeal. The Office of Appeals is approaching its 90th year of service, while the IRS Restructuring and Reform Act of 1998 created “firewalls” between Appeals and compliance functions as well as directed the Commissioner to ensure availability of impartial appeal options. Most recently the 2015 taxpayer rights legislation affirmed that a taxpayer should be able to disagree with the Service’s positions.

Yet, these assurances are becoming eroded in a number of ways, from informal threats by auditors to the actual issuance of designated summons and designating cases for litigation. Taxpayers need, and deserve, definitive statutory protections that provide, in crystal-clear detail, their right to appeal an audit without the duress of capitulating.

All of CEETA’s observations and recommendations should be familiar to small businesspeople. In NTU’s opinion, they are emblematic of the very same uncertainty, intimidation, deadweight losses, existential threats, and lack of remedies outlined earlier in my testimony.

Daniel J. Pilla was among the first members of the tax representation community to recognize the danger that LB&I’s approaches would pose to other types of taxpayers. In his 2014 book, How to Win
Your Tax Audit, Pilla devoted considerable discussion to the revised IDR process and how, improperly executed, it could harm ‘the little guy’. He wrote:

At the time of issuance, the memo was pointed at only large businesses. However, it is clear that the agency will push the practices ‘more deeply’ into the system, exposing more taxpayers to their pitfalls. I fully expect the IRS to utilize ‘strong arm’ tactics more often in pressing for documents in all audits, particularly those related to business income and particularly with respect to computerized recordkeeping systems. . . . I fully expect [the policy] to migrate deeper into the IRS sooner rather than later.

More recently, in an April 19th 2016 endorsement letter, the Small Business and Entrepreneurship Council (SBEC, a CEETA member) expressed just how relevant CEETA’s stance was to its many thousands of supporters across the country:

Small business owners do not have the resources to endure audits without end. They certainly do not have the resources to go up against a powerful $1,000-an-hour legal team in a tax dispute.

Indeed, it’s not hard to see how powerful, private attorneys doing the most complex and sensitive work of the IRS could lead to abuse and harassment, not to mention expensive legal bills.

Those who believe the IRS would never hire such “big guns” to pursue smaller businesses’ tax liabilities should bear in mind that decisions by auditors and Appeals officers are guided first and foremost by the facts and the law. While the agency will weigh the danger of setting an adverse precedent for the government if a case might wind up in court, the “nuisance cost” is not a formal determinant. Even so, the opening given the IRS by this questionable practice could easily permit private attorneys commanding somewhat lower rates to routinely involve themselves in cases involving smaller liabilities.

There is a larger point to be explored here. How meaningful is the distinction between small and large businesses for the purposes of audits? Of course, there are practical considerations that tend to categorize these entities. Larger businesses tend to have more globalized operations, more complex tax returns, and a somewhat greater base capacity to at least cope with compliance burdens than smaller firms. Tax laws and regulations can also define different treatment and processes for large and small businesses (e.g., expensing and depreciation rules).

Still, there are many instances where the line between “large” and “small” business becomes quite subjective, such as audit rates. For example, the IRS Data Book indicates that the examination rate for all “large corporation” tax returns was 11.1 percent in Fiscal Year 2015, compared to 0.9 percent for “small corporations.” On the other hand, businesses declaring income through the 1040 tax return instead of a corporate form do have much higher rates than the general filing population. Depending on the income level of the business, the rate can be three times higher than that of all individual tax returns, or even eight times higher than nonbusiness returns without Schedules C, E, F, or Form 2106.

But it is also important to remember that the LB&I’s jurisdiction encompasses a wide range of entities called “large corporations,” including not just major multinational firms but companies with assets at a minimum level of $10 million. Granted, the latter entities can hardly be described as “mom and pop” concerns, but neither are they massive conglomerates. They could be “hometown” companies employing several dozen, rather than thousands, of individuals. The Data Book reports that more than one-fourth of the “large corporation” returns the agency selected for examination last year reported assets of between $10 million and $50 million.

The Transactional Records Access Clearinghouse (TRAC) has often contended that insufficient numbers of businesses, especially large ones, are being audited, thereby imperiling compliance with the law. NTU does not necessarily agree with this conclusion, because many other parts of the tax system,
such as complexity in the laws themselves, drive compliance problems. Nonetheless, in a recent data release, TRAC noted that even in the LB&I division, an increased emphasis was being placed on examining returns of Subchapter S Corporations – which are not archetypical multi-billion-dollar operations. For Fiscal Year 2016, the IRS had, according to TRAC, set a goal of increasing audits of these entities by 20 percent. It is not known if the agency will reach this goal.

Thus, the audit policies of LB&I – even if they are not immediately adapted for use in other divisions – already directly touch some companies that would not be considered massive in size. For instance, Members of this Subcommittee are well aware of the Small Business Administration’s (SBA) criteria under the Code of Federal Regulations for contracting. A commonly held assumption is that a business must have fewer than 500 employees to meet SBA’s standard definition, yet this is by no means uniform. According to SBA’s summary of size standards online, nearly half of all qualifying small businesses in manufacturing employ between 1,000 and 1,599 workers. A small business involved in heavy construction may have up to $36.5 million in average annual receipts, while those engaged in mining, transportation support activities, or publishing may, in certain circumstances, reach as high as $38.5 million in average annual receipts.

Furthermore, Census Bureau statistics released in February show that an establishment of any type reporting receipts of between $35 million and $39.99 million had a payroll averaging 43 employees. Even those establishments in the $10 million-$14.99 million receipt category, an amount that still seems quite large, employed an average of just 34 people.

Assets and annual receipts are two different statistical snapshots, but they are often closely related parts in the nural of a company’s finances. It would not be unusual for a firm with $20 million or $30 million in yearly receipts to have $10 million or $20 million of assets on its books.

Finally, audit and enforcement actions pursued against the very largest American businesses have “ripple effects” in the small business community that works with them. Large multinationals tend to have supplier, distributor, or contractor networks numbering hundreds or even thousands of member businesses. These often-small entities suffer adverse consequences to their own bottom lines when their larger customers must alter expansion plans or reconfigure business models due to tax concerns.

The bottom line: administrative exigencies might recommend that the IRS divide itself into divisions such as SB/SE and LB&I, but ultimately the tax system must be viewed holistically. Otherwise, the rights of individual and business taxpayers become categorized, divided … and conquered by bureaucratic overreach.

IV. Overcoming the Fear Factors: Recommendations for Reform

Small businesses finding themselves in an examination or in other portions of the IRS administrative system could benefit tremendously by concerted action in the executive branch and in Congress. It cannot be overstressed that the leadership of this Subcommittee can make a genuine, salutary difference to the millions of people in the entrepreneurial community, many of whom will at some point in their businesses’ evolutions will interact with the tax agency in some fashion beyond filing a return. On behalf of NTU and its members, we offer the following recommendations.

To reduce uncertainty, start small. As this testimony has indicated at length, simplifying the tax laws themselves has numerous advantages to small businesses, from reducing wasted expenditures, to increasing compliance, to making the examination process less uncertain for both the taxpayer and the IRS. Obviously, a comprehensive replacement of the entire tax system, which reduces rates, broadens the base, and streamlines filing, would be ideal.
Yet, federal officials need not remain idle while a sufficient consensus builds to move a tax reform package forward. One intriguing possibility was mentioned by the National Taxpayer Advocate: the IRS Restructuring and Reform Act of 1998 required the tax agency to report to Congress each year on “sources of and ways to reduce complexity in tax administration.” Only two such documents were ever issued, none since 2002. Since Congress actually enacted legislative responses to the findings of those reports, Members of this Subcommittee should collaborate with Ways and Means and other panels to ensure that the complexity reports are regularly issued. Small business owners could see short-term improvement to some of the thorniest parts of the law (which can give rise to examination issues).

In addition, the Subcommittee can add an authoritative voice on behalf of reconstituting the Internal Revenue Service Oversight Board. Also a product of the 1998 restructuring law, the Board’s purpose was “to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction.” The Board’s members often brought years of experience in the private sector to bear on some of the agency’s most intractable bureaucratic processes, but unfortunately a quorum does not exist for the entity to function. Congress and the Executive Branch should work together to rectify this situation.

Follow through on existing audit process flaws. The quality of information available to policymakers on taxpayers’ experiences with the IRS has certainly improved over the past two decades. The National Taxpayer Advocate’s Annual Report to Congress, with its Most Serious Problems facing taxpayers, has provided a wealth of actionable information to improve tax administration. In the 2015 Annual Report, many of these MSPs touched upon small business, such as:

- The Appeals Judicial Approach and Culture (AJAC) project, designed to build more firewalls between the Appeals office decision-making function and investigations conducted in the Examination and Collection arms, is backfiring. The Advocate believes AJAC, in conjunction with other policies, is “being used to intimidate taxpayers and deny their right to an administrative appeal” by encouraging curtailed appeals evaluation periods and causing cases to wind up in administrative limbo.
- The IRS may not have adequately tested information reporting data for certain parts of the Affordable Care Act (itself a major compliance challenge for small businesses). The potential result could be more extensive and expensive examination procedures.
- The IRS’s “Future State” plan has been developed without significant input from the Taxpayer Advocate or public comment. A major concern is that the IRS’s intent to interact with taxpayers mostly in an online setting overlooks the potential continuing demand for face-to-face service or telephone inquiries from taxpayers with complex or highly specialized issues (among them small businesses).

The latter MSP prompts an important question about the value of online and automated service options. Clearly, small business owners accrue considerable time and expense savings by being able to conduct many tax transactions online. NTU has supported a number of the recommendations from the Electronic Tax Administration Advisory Committee (ETAAC) regarding e-filing and other issues. We have also advocated for the availability of more convenient services online; during the Senate Finance Committee’s markup of taxpayer protection and security legislation in April, we urged adoption of a provision directing the IRS to create a fully-functioning online platform for filing 1099 forms by 2020.

We have cautioned, however, that sufficient consideration needs to be given to the ability of small businesses to absorb e-compliance mandates from the tax agency. Not only will the specialized issues referred to above necessitate continued access to more than “FAQs” on a website, but other
problems such as identity theft and the IRS’s own porous information security will erode the “trust factor” among business filers.

State as well as federal experience in this area commands particular attention to the plight of small businesses. One example was brought to our attention through the Mackinac Center’s Michigan Capital Confidential newsletter. Senior Investigative Analyst Anne Schieber recounted the technical difficulties experienced by small businesses forced to use Michigan’s “Systems, Applications, and Products” (SAP) online portal for processing sales, use, and payroll taxes. Some users reported that the SAP registration process alone consumed hours, if not days, of time. Others complained of being unable to obtain timely assistance from state tax officials when they encountered payment problems.

The matter of cost-benefit analysis behind mandates and rules brings another consideration to the fore: IRS compliance with the Regulatory Flexibility Act (RFA). Now past its 35th year of operation, RFA demands that all federal agencies “fit regulatory and informational requirements to the scale of the businesses, organizations, and governmental jurisdictions subject to regulation.” Agencies must also “solicit and consider” alternatives that can meet a given regulatory requirement in a flexible manner. The Small Business Regulatory Enforcement Fairness Act of 1996 provides for judicial review of compliance with RFA and empowers the Small Business Administration (SBA) to advocate on the laws’ behalf. This type of scrutiny is greatly enhanced when Congress and the Small Business Administration evaluate in detail the IRS’s responses to the safeguards that are supposed to be provided by RFA.

Also, in 2002 the Treasury established Taxpayer Advocacy Panels (TAPs) with volunteers from all 50 states, the District of Columbia, and Puerto Rico who “are dedicated to helping taxpayers improve IRS customer service and responsiveness to taxpayer needs.” In our experience, TAPs have provided valuable suggestions at the most granular level that could, if fully adopted by the IRS and Congress, make the taxpayers experience of all Americans (including small enterprises) less troublesome. TAP’s most recently released annual report submitted 42 recommendations from its project committees. Many of these touched upon small business and self-employed taxpayer concerns, among them improving communication to taxpayers about the new simplified home office deduction, and expansion of free online filing options for more business tax forms, such as those involving moderate-income truck drivers.

Unfortunately, progress in getting the IRS and Congress to act on TAP and NTA recommendations has been uneven. NTU reviewed the last three years of the Advocate’s report cards on implementation of the recommendations contained in her Annual Reports to Congress. Although many of these suggestions are broad-based in that they would benefit all taxpayers, we could identify more than half a dozen key MSPs specifically pertaining to or citing small businesses, each of which contained multiple parts. MSP Topic #12 from the 2013 report card noted that “IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue,” primarily because the IRS has shunned a “proactive service-oriented approach” that would involve employees capable of quickly resolving trust fund tax delinquencies. The Advocate’s 2012 report card examined the IRS’s response to MSP Topic #20, the “Diminishing Role of the Revenue Officer,” explaining that “particularly with tax debts involving small business taxpayers, the Revenue Officer’s skill set should be used as critical to case resolutions that are in the best interests of the taxpayers and the United States.”

These and other MSPs remain entirely or partially unfulfilled. The recommendation made earlier in this section on IRS annual complexity assessments appeared in the Advocate’s 2014 report card, and remains in stasis. The problems with IRS examination correspondence, noted in Section II, also came from the 2014 report card.

This Subcommittee could provide a vital contribution to the development of good policy in all of the areas mentioned here, from resolution of outstanding MSPs to implementation of TAP findings, to compliance with RFA in ETAAC and other matters. Even a letter of inquiry from this Subcommittee to
the IRS could be helpful in jumpstarting the complexity report process. Quarterly or semi-annual hearings about these matters, with structured review agendas, could go a long way toward ensuring follow-up.

**Continue to Measure and Refine Audit Strategies.** The 2015 Taxpayer Advocate’s Report contains an interesting analysis on the impact of audits on Schedule C filers with incomes below $200,000. Its findings are indication of how difficult attaining the balance between tax compliance and taxpayer rights remains.

The Advocate’s study, drawn from a random sample of filers who were audited after submitting Tax Year 2007 returns, found a definite tendency of noncompliant taxpayers to report more income after being “caught.” Even three years after the audit, a filer whose audit resulted in recommended additional tax reported on average 120 percent more income than before they were subject to examination. However, “compliant” taxpayers whose audits resulted in no change reported, on average, 35 percent less income on their returns. The Advocate noted the need for a “better understanding of the psychological impact of audits on compliant taxpayers [which] may lead to enhanced examination approaches that mitigate the erosion of tax morale and maintain their incentives to comply.”

An earlier study released by the Advocate in 2013 attempted to correlate factors involved in small business tax compliance among the ten deciles of Discriminant Index Function (DIF) scores of returns for audit selection among Schedule C filers. These taxpayers were then surveyed about their attitudes toward compliance based upon factors such as societal norms, their own “tax morale,” trust of the IRS and the government, complexity and convenience of the laws, and the influence of preparers.

Although there were variations based on income, DIF scores, and other variables, the overall conclusion was that access to IRS help was key:

The factor that explains the most statistical variance in responses to the questionnaire on voluntary compliance by small proprietors is taxpayer service, which contributes to trust in government. At the same time, factor analysis disaggregated fairness as a separate factor, related to trust as described in the literature. Similarly, tax policy appeared as a distinct factor in this analysis, suggesting that agreement or disagreement with legislative design influences compliance. Likewise, the tax policy factor may be another aspect of trust in government.

The debate will continue over how big the deterrent effect of audits and other enforcement techniques might be on taxpayers, which is why this Subcommittee should continue insisting upon quality research from the IRS, SBA, and other entities into these areas.

**Embrace the audit reforms in S. 2809.** One of most important recommendations NTU can make in this communication is that Members of the Subcommittee support a House companion to Senator Portman’s legislation to improve taxpayer safeguards in the examination process. S. 2809 would stipulate:

- The IRS cannot interfere with a taxpayer’s right to an impartial hearing before the IRS Appeals division. The procedures for appeals and “triggers” for the process by which taxpayers may access them would be clarified and strengthened (with exceptions for frivolous tax positions);
- The agency is more restricted in its use of designated summons and in designating cases for litigation to their original intended purposes. One exception is that “listed transactions” (e.g., tax shelter schemes) would still fall under special discretion for cases designated for litigation; and
- The IRS could not contract with private law firms to conduct examinations.

The Chairman’s Modification of the Senate Finance Committee Chairman’s Mark of the Taxpayer Protection Act of 2016 contained the provision of S. 2809 pertaining to hiring outside counsel.
However, at the time this testimony was submitted to the Subcommittee, introduction of a House companion bill to S. 2809 was imminent. The Subcommittee’s vigorous support for the entirety of S. 2809’s House companion, in standalone form as well as amendment language, would be helpful toward getting these reforms enacted in the 114th Congress. There are several legislative vehicles, besides the Taxpayer Protection Act, which could afford opportunities for doing so.

Time for a Small Business Taxpayer Bill of Rights. Eighteen years after the IRS Restructuring and Reform Act’s passage, Congress has amassed a considerable body of experience and advice on potential improvements from sources such as the National Taxpayer Advocate, professional practitioners, and small businesses themselves. Future tax administration maladies could be prevented by enacting reforms like these:

- Creating an Alternative Dispute Resolution (ADR) program for audits that will permit neutral third-party mediation in a cost-effective manner. Meanwhile, small case procedures and access to installment agreements without fees should both be expanded, thereby providing taxpayers with more low-cost options for solving tax problems. Many business owners are already familiar with some form of ADR in mediating issues with customers, so this process would not be as intimidating to them as Tax Court or District Court venues.
- Strengthening safeguards against taxpayer abuses, such as a ban on ex parte communications between IRS case employees and Appeals officers, and a prohibition on new issues being raised during a taxpayer’s appeal process.
- Providing more avenues for redress when the IRS recklessly or intentionally disregards the law, including increases in the cap on damages and more options to recover attorney fees.
- Delivering additional opportunities for spousal relief, such as more time for filing petitions and clarifying that Tax Courts must follow applicable appellate procedures when reviewing such petitions. For over two decades NTU has sought more equitable tax treatment for “innocent spouses” (usually divorced) who are wrongfully being pursued as “responsible and willful” parties to tax controversies involving the other spouse. This scenario is not entirely foreign to small businesses, which are often begun and conducted by married couples who might strictly segregate their roles in the company’s operations. Furthermore, divorced spouses must often reconfigure their professional as well as their personal lives, and doing so can mean becoming self-employed. Making updates to this area of law would help many people in such a situation.

These types of changes are thoughtfully incorporated in legislation known as the Small Business Taxpayer Bill of Rights, introduced in the House as H.R. 1828 by Rep. Thornberry. The legislation has, in various forms, been introduced in several Congresses now.

NTU’s members were elated to see lawmakers come together in a bipartisan fashion last year in enacting a statutory codification of NTA’s version of the Taxpayer Bill of Rights, via the extenders legislation. But H.R. 1828, as well as other reforms being developed in the Senate Finance Committee (and discussed during an April markup) merits the Subcommittee’s attention. Among these was an amendment developed by Senators Grassley, Thune, and Cardin to tax identity theft legislation. Although it was authored prior to the extenders legislation’s codification of the Taxpayer Bill of Rights, the remainder of this amendment could still answer to many purposes under discussion in today’s hearing. Highly desirable elements include clarified lien notice filing procedures, expedited “hardship” relief for businesses subjected to levies, and a new consultation requirement that will ensure that the IRS bureaucracy seeks early, systematic input from the Taxpayer Advocate before new regulations are published.

Finally, I must remind the Subcommittee that there are still judicial areas to explore in the quest to improve taxpayer rights. Although the laws provided for certain exceptions, citizens still generally
cannot enforce their rights in court until after they have been violated. Under Section 7421 of the Internal Revenue Code, no lawsuit can be brought by any person in any court for the purpose of restraining the assessment or collection of a tax, except under limited circumstances. The case law around the Anti-Injunction Act further impedes the ability to restrain the collection of the tax. Moreover, the Declaratory Relief Act, which allows citizens to file a suit that can persuade a court to declare their rights, indicates that the law applies “except with respect to federal taxes.” The Federal Tort Claims Act presents additional barriers to tax-related controversies.

It is critical to move as many of these reforms as possible to the President’s desk quickly; they need not, and should not, languish until the next Congress.

Conclusion: Diverse Businesses, Common Concerns

Small business owners and self-employed individuals have varying reactions to the examination process, from relative calm, to annoyance, to great apprehension. I have even made the acquaintance of a writer – Stanley Rich – who staged a theater production parodying his own audit experience, entitled “Taxpayer! Taxpayer!” But across this emotional gamut, there are substantive policy matters that both Congress and the Executive Branch should address now. Members of the Subcommittee should be at the center of this effort, and can have a tremendously positive influence on behalf of small business taxpayers. NTU’s staff and supporters stand ready to assist you.

I am most grateful to all of you for engaging in this hearing and for devoting so much attention to these lengthy remarks.
Chairman, thank you for holding today’s hearing on how the IRS can help small businesses. The 28 million small businesses in America are a cornerstone to our economy. According to the Small Business Administration and the IRS, small businesses account for over half of all US sales and 55% of all jobs. They pay significant amounts of income, employment, and excise taxes to the US Treasury.

Helping small businesses easily file and pay their taxes is a critical mission of the IRS Electronic Tax Administration Advisory Committee, or ETAAC. ETAAC was formed by law in 1998 to make strategic recommendations to Congress on how to improve tax administration and better serve taxpayers—including small business taxpayers—through electronic means. In short, we are objective digital strategy consultants to the IRS. Recently, the committee has sharpened its focus on how the IRS could make the tax system less reactive and intrusive by providing taxpayers with digital access to their tax information and a better understanding of their compliance requirements.

The committee believes that modernizing the IRS taxpayer service platform is an urgent, strategic priority for the IRS. In the 2015 tax season, the IRS was in its fourth consecutive year of budget reductions, and IRS service levels plummeted. The IRS answered only 38% of its calls from taxpayers. The IRS has been unable to modernize its taxpayer-service platform to move away from traditional paper and phone interactions. The current phone and paper taxpayer-service platform is also not the preferred choice of the IRS or the many taxpayers who expect secure online services.

Aligned with this issue is a lack of transparency with the IRS. For most taxpayers, the information the IRS has about them is a mystery. It’s not easy for taxpayers to access and understand their tax information on file with the IRS, their previous tax-related interactions or their tax compliance obligations. For small-business taxpayers, this issue is even more critical, because small businesses are more likely to complete multiple year-round transactions with the IRS. In many cases, when there is a compliance issue, small-business taxpayers find out with a surprising IRS notice after they file, or—even more stressful—an audit that can take months or years to resolve. For all types of taxpayers, accessing and using their tax information to proactively comply is almost entirely out of the question in the current system.

The committee believes that a key solution these problems is a more digitally enabled, modernized IRS that better equips taxpayers with information on how they can proactively comply, rather than solely focusing on detecting and enforcing compliance.
In the past three years, ETAAC has provided recommendations based on a single vision of how the IRS should serve taxpayers. This vision allows taxpayers to:

- Fully understand their tax obligations,
- Have transparent access to their tax information and status with the IRS, and
- Effectively and securely interact with their tax administrator in the way that they want to be served.

The end state is a tax system that is less burdensome. It is a tax system that relies less on reactive measures, such as audits, and more on preventative and educational measures for taxpayers to remain proactively compliant.

- First, the current tax system is designed to be reactive, and does not leverage tax information to help taxpayers meet their tax obligations, and
- Second, the IRS cannot quickly develop and implement its digital roadmap, including online accounts, to address the needs and preferences of taxpayers.

Our last two reports to Congress explain this dilemma and provide recommendations to overcome these challenges.

In ETAAC’s 2015 report to Congress, we recommended that the IRS accelerate its digital taxpayer-service strategy—that is, develop secure online accounts for all business and individual taxpayers. Taxpayers should have secure digital access to their tax information, and they should be equipped with comprehensive tools to interact effectively with the IRS online.

In the report, we directly addressed key problems in the IRS strategy that affect small businesses, and we advocated for an expedited release of online accounts and tools for businesses—still not a stated IRS priority.

Additionally, we know that businesses are much more likely to use a tax professional for tax filing and compliance needs. Online accounts for these tax professionals should be a priority. In the current IRS digital plan, online accounts for business taxpayers and their tax professionals arrive much later. ETAAC advocates for the IRS to commit to quickly developing online accounts for business taxpayers and the tax professionals who serve them, and we encourage this committee to do the same.

In our most recent 2016 report, ETAAC addresses the “look-back” tax system that centers on post-filing programs that detect and correct noncompliance. We challenge Congress and the IRS to move to a system that verifies taxpayer identities and tax return information before accepting a return.

A system that uses information statements, such as Forms 1099 and W-2, to verify taxpayers and their tax return information is essential to fighting fraud and reducing taxpayer burden. The IRS should support taxpayers in filing accurate returns by giving them full electronic access to their tax account information at the time of filing. This proactive system would verify accuracy upfront and reduce audits, particularly those on small-business taxpayers.
ETAAC has been pleased with the IRS' first steps in its digital service plans. The IRS released an initial draft of its Future State Initiative in January of this year. The initiative specifically contemplates small-business taxpayers and their needs. However, the delivery date of these digital capabilities is unknown.

Many of the ETAAC's recommendations from the past three years are incorporated into the IRS Future State Initiative's digital plans. ETAAC endorses the digital-service components of the IRS' Future State plan, and we have advocated to Congress that the IRS should accelerate these plans. Our recommendations clearly identify the urgent needs of small businesses. The IRS needs to accelerate online accounts for businesses and tax professionals.

On behalf of the entire ETAAC, thank you for inviting us to testify on this important topic.

For more information on ETAAC's recommendations to the IRS, and those impacting small businesses, please see the committee's recent reports at https://www.irs.gov/uac/electronic-tax-administration-advisory-committee-etaac-annual-reports.
Good morning, I am Roger Harris, President and Chief Operating Officer of Padgett Business Services. I have been a tax practitioner for over 40 years and have served on the Internal Revenue Service Advisory Council for four years and was its Chair for two of those years. I believe this experience gives me a balanced approach to small business taxation—I have had the opportunity to see what works and what doesn't work in the real world.
For nearly fifty years, Padgett Business Services has been providing accounting, income tax planning and preparation, payroll and payroll tax services to thousands of small business owners through our network of over 200 offices across the United States. Our clients generally have 20 or fewer employees and are what some people would consider “mom & pop” businesses; however, based on recent studies almost 90% of all firms that have employees operate in our target market.

**Internal Revenue Service Audits of Small Businesses**

Padgett’s business model brings us in contact with our clients throughout the year, not just during filing season. We assist our clients in establishing good accounting, recordkeeping and tax processing. This ongoing communication allows us to understand these small business owners well beyond just knowing their numbers. Our strong belief is the best way to survive an audit is to do everything within your means to never have one. Enforcement being a prerequisite for our tax system to work, there is a real possibility for all small business owners to one-day experience the pleasure of an IRS audit. Because of that possibility the second best way to get through the process is to have a clear, traceable record of financial transactions and of course to keep and organize receipts and invoices. A disciplined approach throughout the year generally results in less trouble with the tax man—local, state and federal.

In those occasions where audits do arise, either for established clients or individuals new to the small business world, it’s important to have a broad overview of the process.

In general, there are two kinds of audits: Correspondence and Field. According to IRS data for 2014, the IRS conducted just over 291,000 Field Audits and over 950,000 Correspondence Audits. Both of these numbers have dropped considerably since their peak in 2010 of 391,000 and 1.173 million, respectively. Because Correspondence Audits tend to focus on more moderate income tax returns, and more basic issues that should not require a face to face meeting, mom-and-pop small businesses are much more likely to experience these than actually sitting across from an IRS auditor.

Correspondence Audits, known within the IRS as Campus examinations, are the most basic type of audit and are conducted—as the name implies—by mail. They are usually triggered by software that compares returns against common trends and selects those that might be considered outliers.

Field Audits typically occur when the IRS suspects major violations or they are part of an IRS research program. IRS auditors may ask that taxpayers come to their offices, but they typically visit the place of business at least once during the process.

The vast majority of small business audits are Correspondence Audits. While they are intended to cover only simple issues, because of the IRS’s focus on efficiency, they can be frightening to small business taxpayers, as well as being time consuming and expensive. In some circumstances when things go wrong, they can be devastating to a business.
For a Correspondence Audit, the IRS will mail small business taxpayers either a Letter 566 or a CP 2000 notice. 566 letters advise taxpayers that their returns have been selected for examination and will list documents such as receipts needed to verify positions on returns. The CP 2000 notice will contain adjustments based on third-party documents associated with the return. A taxpayer typically must respond within 30 days.

If taxpayers agree with a notice, they simply sign the letter and return it with a check made out to the US Treasury; the problem arise usually when there is a dispute.

When responses from taxpayers arrive at the Examination center, they sit in a queue at the IRS processing center for weeks or even months depending on the backlog—causing great anxiety on the part of taxpayers. Eventually, files are assigned to auditors. If all goes well, taxpayers will receive letters thanking them for their responses and telling them nothing more is needed. Sometimes, for whatever reasons, taxpayers do not receive these acknowledgements, forcing them or their representatives to hunt down their case files or to keep resending them.

As expected a good number of these responses are denied by auditors due either to the quality of the records or because of a dispute over a matter of law. While many people believe tax law is black and white the reality is most areas are gray. This graying requires the law to be applied to the facts and circumstances that exist and are specific to that small business. Sometimes it is difficult to understand all of the facts and circumstances when the discussion is by correspondence.

Unfortunately, it is not uncommon for a small business taxpayer to fail to respond to the original correspondence from the IRS in a timely manner. If taxpayers do not respond, the IRS issues a second notice, and if there still is no response, it will issue statutory notices of deficiency, known as a “90-day letter.” At the end of that time, the IRS “assesses” the tax, including penalties and interest. Assessment establishes that taxpayers legally owe the amounts in question and then the cases are move over to collections.

The problems associated with the audit process for small businesses can range from the mundane to the Kafkaesque. First, even the simplest correspondence audits consume time and focus for business owners to find, gather and mail the requested records to the auditor. The IRS often states “but, it is up to taxpayers to keep proper records.” This is correct but it doesn’t make it any less burdensome. Even for the most organized among us, it takes time to locate and organize the correct documents. In addition to time requirements, the small business owner is usually under a great deal of stress. For many taxpayers this is their first dealing with the IRS in this way. Their minds wander to the horror stories they have all heard and they wonder how bad will this be and can I do this without help?

Second, over 70 percent of small business owners rely on enrolled agents, CPAs or attorneys when they are contacted by the IRS. Because of this, even mundane correspondence audits can have significant cost, even for small disputes the cost of representation can
easily exceed the taxes in question. Many business owners do the math and decide to just pay the extra tax instead of fighting it. For those instances when small businesses respond to correspondence audit notices and auditors reject their records or legal position, outside practitioner costs can quickly add up to thousands of dollars. Longer more complex field audits can be even more cost prohibitive for taxpayers.

Another problem area for taxpayers that cost both time and money is when responses are seemingly lost or delayed in the system. The deadlines come and go and taxpayers believe that they have responded. The nature of the Correspondence Audit process is that it is almost wholly automated. If the computer at the examination campus does not know taxpayers have responded it continues to send out notices, deadlines will continue to not be met, as the IRS claim marches inevitably into assessment and collection. The IRS seems to have gotten better over the years at tracking cases but approximately a million cases go through Campus Examination centers each year. Cases can either be lost, not processed correctly, or they are not submitted in a timely manner. It is important to keep in mind that there is no one point of contact taxpayers or their representatives can call at the center to track down a particular case. This lack of a responsible human being within the bureaucracy is often the most frustrating aspect of the Correspondence Audit.

A similar problem, except on the taxpayer side, is the non-receipt of notices because taxpayers have moved, or for whatever reason are not receiving them. Taxpayers are blissfully ignorant. And on top of that the computer processing correspondence audits is blissfully ignorant as well, belching out notice after notice until cases end up in collections. Taxpayers can first learn they have a problem when their business checking accounts are frozen or another collection action has been taken. Once again unwinding these cases can be particularly time consuming and expensive.

Finally, our franchise owners have experienced inconsistent quality in personnel. It is readily apparent that older more experienced auditors have the benefits of more training, a deeper understanding of the law, and more real life experience to guide them. Younger personnel only have a basic understanding of the law or do not have the experience that only time can provide. This lack of experience can cause delays, or even worse an incorrect determination. There has been a long term practice of allowing more complicated Correspondence Audits to be transferred to a local area office at the request of taxpayers. It has become very difficult to have these transfers approved. Similarly, requests to speak to managers and referrals to appeals can be ignored. The IRS is clearly experiencing a shortage of personnel and suffering from a lack of training.

The small business taxpayer is also at the mercy of the knowledge and experience of their tax preparer or representative. Additionally, a less qualified tax preparer may be the very reason the small business owner finds themselves in the mess they find themselves in.
At the end of the day no matter if it’s the small business taxpayer, the tax practitioner, or the individual from the IRS, the cost of an extended process will be paid by the small business owner.

So, what can the IRS improve even within the constraints of fewer resources? We believe they better facilitate the tracking of cases. If Federal Express can manage millions of packages all over the world, it seems that the IRS could come up with some sort of bar code or other tracking system that would allow both the IRS and the taxpayers to track correspondence responding to notices and the status of their cases. Most importantly, the IRS may need to be willing to assign cases earlier to an auditor or a team of auditors if the taxpayer believes such a request is in their best interest. And finally, leading to my next discussion, the IRS needs to drive a large part of the Correspondent Audit communications to the interest.

**IRS Future State Vision for Small Businesses and Practitioners**

The IRS vision for Future State could provide significant relief to many of the problems associated with Correspondence Audits. A taxpayer receiving one of these notices could simply activate an individual account through IRS.GOV, view their status online, scan the requested documents and email them to the examination campus, and respond to any follow ups. All of these communications would be done through a secure email system that would track all communications. If taxpayers are required to make payments, they can do so through their accounts or enter into installment agreements all online. We believe strongly that Future State accounts could provide their greatest return on investment in managing Correspondence Audits.

Unfortunately, like most things there is good news and bad news. First, IRS plans to roll out online applications for individual taxpayers over the next year or so. Similar accounts for practitioners, however, will not be available for at least a year or two beyond that. It is important to keep in mind that over 70 percent of small businesses choose to have an enrolled agent, CPA or lawyer deal with notices from the IRS. This means that most small businesses will effectively be stuck in the current snail-mail process.

Another considerable problem has to do with authentication. In order to access these accounts, taxpayers must provide information associated with their tax returns, their account numbers for a loan or credit cards, and cell phone numbers associated with their name and social security number. Unfortunately, for taxpayers who have not filed a tax return, or do not have loans or credit cards, or have cell phones provide by work or a family member, they will be effectively locked out of their own accounts. The IRS estimates that only 30 percent of taxpayers will be able to authenticate themselves and use their accounts. Currently, unlike a typical financial institution, there is no 800 line planned that taxpayers could use to authenticate themselves over the phone.

Additionally, the agency has no real plans for providing business level accounts. Luckily, most sole proprietors or LLCs filing a
schedule C will be able to use the individual accounts. More complex small businesses organized as C corporations or partnerships will not have access to these accounts.

Generally, because of the real threat of online hackers, the IRS is creating a very high authentication barrier to access online accounts. The reality is, however, that most taxpayers will rarely, if ever, need access to their accounts. They will try once, with 70 percent of the time failing to gain access, and then picking up the phone or using the U.S. Mail as their primary method of contact. While practitioners and businesses, both of whom have many more interactions with the agency, will do whatever it takes to go through the authentication juggernaut in order to access the accounts.

Additionally, in the case of practitioners, they are well known to the IRS, having registered for a PTIN and a Central Authorization File number. Further, if necessary, the IRS could require a one time in-person authentication similar to the FAA's PreCheck system.

In short, as the IRS moves forward with online accounts, it must include access by practitioners—enrolled agents, CPAs, and attorneys—and businesses in order for the strategy to be successful. The agency needs to find practical methods to authenticate Circular 230 practitioners and to authorize them to solve their clients' problems. Any solution that omits practitioners fails to recognize many taxpayers benefit from representation because they (a) do not want to represent themselves, (b) recognize they are not proficient enough to represent themselves, or (c) are afraid to engage with IRS enforcement staff. Forcing a portal to face taxpayers only will place taxpayers with practitioners at a disadvantage, as a result, practitioners will continue to be parked on phone lines, and it will significantly impede taxpayers' rights to be represented before the agency.

We urge the Internal Revenue Service to consider four important policies:

1. Develop robust individual and practitioner online accounts at the same time.
2. Allow Circular 230 practitioners to execute and file authorizations electronically and immediately represent those clients.
3. Allow the use of electronic signatures for all power of attorney and disclosure authorization forms.
4. More expeditiously to provide access to business accounts.

Thank you for this opportunity to testify today and Padgett Business Services looks forward to working with the Committee on this crucial area of tax administration.
Written Testimony of

Emily Peterson-Cassin
Bright Lines Project Coordinator, Public Citizen

Before the

House Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital Access

On

“Audits and Attitudes: Is the IRS Helping or Hurting Small Businesses?”
Dear Chairman Huelskamp, Ranking Member Chu, and Committee Members:

Thank you for the opportunity to testify today on the Internal Revenue Service’s (IRS) interaction with the Regulatory Flexibility Act (RFA) and the Small Business Regulatory Enforcement Fairness Act (SBREFA). I am Emily Peterson-Cassin, the Bright Lines Project Coordinator at Public Citizen’s Congress Watch. Public Citizen is a national nonprofit public interest organization with more than 400,000 members and supporters. For 45 years, we have successfully advocated for stronger health, safety, consumer protection and other rules, as well as for a robust regulatory system that curtails corporate wrongdoing and advances the public interest.

My own work at Public Citizen is to coordinate the Bright Lines Project, an expert team of attorneys and nonprofit partners working for an improved tax code definition of political activity applicable to all nonprofits. Clearer rules for the nonprofit sector will strengthen nonpartisan engagement in our democracy while curbing abuses of the nonprofit structure and making enforcement of the rules easier for the IRS and the Treasury Department.

I do not need to tell this committee how important small business is to our economy and our society. Protecting small business owners and employees is a paramount goal of our government. Congress can and should protect small businesses by ensuring a clear, predictable framework of tax rules and regulations. Rules that are easy to follow and enforce allow small businesses to thrive while minimizing opportunities to abuse the tax system. And the IRS should be doing more to ensure that small businesses can easily comply with the regulations already in existence, and work to improve its ability to provide accurate and timely guidance.

At the same time, it is important to recognize that rules intended to protect small businesses can have unintended effects. Laws that are intended to help small businesses, such as the RFA and SBREFA, in practice can allow large corporations to delay important regulations and thus harm small businesses rather than help them.

Finally, while fair enforcement of regulations is critical for small business success, it is also important that we ensure that the tax code itself provides a level playing field for small business. Currently, loopholes in the tax code allow multinational entities advantages that smaller players do not have, and prevent domestic businesses from being fully competitive in the marketplace. These loopholes allow tax-avoidance by large corporations, and small entities that would rather spend their resources on building their business than on elaborate avoidance schemes cannot take advantage of them. For example, reforming the code to remove the incentives that promote complex corporate tax-avoidance schemes like inversions would help small businesses by leveling the playing field, so that small, domestic businesses can compete more fairly with big international businesses.

1. **Delaying Appropriate Regulations Harms Rather than Helps Small Business.**
The benefits to small business and our society of having a safe and healthy workforce made possible by sensible regulations, including tax regulations, are tremendous. For example, in addition to improving the quality of life in our country, regulations in the areas of public health and environmental safety reduce time lost due to illness among workers and their families. The Environmental Protection Agency (EPA) estimated that the Clean Air Act prevented 13 million lost work days in 2010 alone. In addition, the costs of large-scale industrial catastrophes preventable by adequate regulation fall disproportionately on small business, for example when local tourism is affected. Regulations are also essential for opening up new markets for small businesses, and help incentivize innovation in safer and cleaner technologies. Regulations make our country stronger, safer, cleaner, healthier, and fairer to small business.

The RFA and SBREFA are intended to benefit small businesses by ensuring that the costs of these important regulations do not fall disproportionately on them. Paying for tax assistance, compliance, consultants, accountants, and others is easier for large corporations than for small businesses.

Unfortunately, SBREFA does not operate to support small business. Instead, SBREFA has provided an opportunity for large corporations to delay progress on important regulations. The SBREFA panels at the EPA, the Consumer Financial Protection Bureau (CFPB) and the Occupational Safety and Health Administration (OSHA) are good examples. The panels currently require massive government work and spending even on rules that will have no application on small businesses. The analysis required under SBREFA can delay the already laborious rulemaking process for months. A recent Government Accountability Office (GAO) report which investigated the slow process of rulemaking at OSHA found that it takes about eight extra months of work for OSHA to prepare for the SBREFA panel.

Because SBREFA operates to delay the regulatory process, pushing the IRS to apply SBREFA more broadly is not a good way to help small business. The IRS issues guidance in the form of revenue rulings, private letter rulings, and revenue procedures and announces updates on that guidance weekly. This up-to-date guidance helps practitioners understand the uniquely-demanding tax code. Requiring the IRS to do more analysis of their advice before publication will limit the amount of information available to small business and make compliance harder, not easier. In addition, unnecessary additional steps would cause pointless delay in the issuance of needed guidance. Subjecting the IRS’s guidance processes to superfluous analysis like a SBREFA process would render that guidance less useful and certainly less timely.

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4 The IRS weekly bulletin may be found at https://apps.irs.gov/app/picklist/list/InternalRevenueBulletins.html

5 Public Citizen takes no position on whether the IRS is correctly interpreting its obligations under RFA and SBREFA.
II. Finding the Balance: A Path to a Successful Regulatory Regime

Though the advisory panel component of SBREFA legislation often results in unnecessary delay to needed regulations, other aspects of the law do help small businesses comply with regulations, and could be expanded to be even more helpful. In addition to providing information on non-tax regulatory compliance, agencies with Small Business Ombudsman offices could expand their outreach and provide more education on tax issues in the industries the agency oversees.\(^6\) Congress should pass legislation that ensures those offices are conducting effective outreach and establishing “best practices” guidelines. Programs at the IRS itself could be expanded with adequate funding and direction from Congress as well. Such reforms would give direct, tangible assistance to small businesses.

In the IRS context and others, additional analysis on small business impacts for some rules may be useful so long as the delay in implementing a final rule does not give larger competitors an unfair advantage. Small business analysis should be narrowly targeted to benefit small businesses. When agencies, including the IRS, undertake an analysis specifically to determine the impact upon small business, care should be taken to ensure that the extra work is not wasted because the rule in question would not affect small business. By the same token, a good rule should not be delayed for all businesses because of an additional analysis applicable only to small businesses.

Even without these changes to SBREFA, there is much the IRS could do to reduce the compliance burden on small businesses. However, funding cuts to the IRS in the past few years has made that assistance more difficult to provide. Since fiscal year 2010, the IRS’s funding has been drastically cut again and again.\(^7\) Consequences of those cuts have been far-reaching, leading to reductions in staff available to assist taxpayers and in the training available to that staff.\(^8\) An IRS staff that is adequately knowledgeable and available to small business taxpayers is essential to answer questions as they arise and prevent compliance problems from compounding.

III. Loopholes in the Tax Code Hinder Small Business Success in the Marketplace

Finally, it is impossible to talk about whether the IRS helps or harms small businesses without acknowledging that the tax code which the IRS enforces stacks the deck in favor of large multinational corporations in a set of important ways. For example, the practice of inversion (merging with a foreign company and reincorporating in a tax-friendly nation in order to save money on taxes) allows companies with the resources to carry out a multinational merger to shift their tax burdens onto small businesses and individual taxpayers, while retaining unfettered access to the U.S. economy. Treating a larger number of inverted companies as domestic for tax purposes (as proposed by the Stop Corporate Inversions Act) would reduce the incentive for U.S. companies to invert.

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Other tax avoidance gimmicks like profit-shifting also stack the deck against small, domestic businesses. A recent random sampling of entrepreneurs found that nine out of ten small business owners agreed that the practice of U.S. corporations using accounting loopholes to shift their profits overseas and avoid taxes is a problem, and they support eliminating these tax breaks and providing incentives to bring production home.⁹

Well-resourced corporations have an unfair role in creating and keeping loopholes that benefit them at the expense of small business. Our current political spending system allows big-dollar political donations and expensive lobbying by corporations to preserve their favored status at the expense of small businesses unable to make the same expenditures. More than three-quarters of small employers say that big businesses have a significant impact on government decisions and the political process, while not even one quarter believe that of small businesses.¹⁰ To correct this imbalance, we need significant changes to the way our election campaigns are financed, including at the IRS. For example, the Bright Lines Project advocates for a better definition of political activity for nonprofits, which would operate to strengthen the nonpartisan role of nonprofits in our democracy while ensuring that voters have full information regarding the financing of their elections. Adopting such changes through rulemaking and new campaign finance laws would help small businesses play on a level playing field.

Conclusion

It is in our nation’s interest that small businesses are able to grow and thrive in a society that protects health and safety and ensures that the market operates fairly to businesses of all sizes. Small changes to SBREFA, fully funding the IRS, and closing unfair loopholes will ensure that the playing field is level for small businesses.

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