IRS PUTS SMALL BUSINESSES THROUGH AUDIT WRINGER

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#### Questions for the Record:
- None.

#### Answers for the Record:
- None.

#### Additional Material for the Record:
- None.
The Committee met, pursuant to call, at 11:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Luetkemeyer, Hanna, Huelskamp, Gibson, Hardy, Kelly, Davidson, and Adams.

Chairman CHABOT. Good morning. The Committee will come to order. We thank everyone for being here. Special thanks to our witnesses who have taken time away from their busy schedules to be here with us today.

We are here today to follow up on the June hearing held by our Subcommittee on Economic Growth, Tax, and Capital Access. In that hearing, we laid out many systemic problems within the IRS that are harming small businesses, including burdensome regulations, poor communication, and overly aggressive audits. Today, we are focusing specifically on IRS audits and how small businesses are treated, and often mistreated, during that process.

Members of this Committee regularly hear from constituents about the IRS, and these constituents are not calling us to tell us what a great job the IRS is doing generally. They are calling because they are desperate and frustrated, and they have good reason to be oftentimes. I know members of this Committee have heard from constituents who were audited so aggressively by the IRS that they had to actually close their doors. Others are engaged in protracted audits that seem like vague fishing expeditions with no end in sight. Most are hindered in their ability to actually run their businesses because endless document demands from the IRS require so much of their time and resources. In many cases, small businesses simply cannot afford to hire a professional to deal with the demands of an audit.

The IRS has an obligation to provide small businesses with clarity and to treat all taxpayers with fairness and respect. The agency has failed repeatedly in meeting this obligation to the people it is supposed to be serving.

I do not need to tell you that a business forced to close its doors can no longer pay taxes. It also cannot hire employees and create economic growth in that community. Our current system is working oftentimes against small businesses when it should be working for them. The IRS must do better.
Today, we will be examining some of the issues and problems with the current exam process. We will also be exploring some possible solutions.

I am looking forward to hearing from all of our witnesses here today, and I would now like to yield to the ranking member, Ms. Adams, for her opening statement.

Ms. ADAMS. Thank you, Mr. Chair, for holding this valuable hearing, which follows up on the Subcommittee on Economic Growth, Tax, and Capital Access hearing held in June. During that hearing there was testimony from several witnesses about the difficulties associated with a tax audit. While tax audits serve an important purpose in the IRS’ role to enforce and collect taxes, the auditing process can be confusing and intimidating for small business owners.

As we all know, our tax code is complex, resulting in simple and innocent mistakes, mistakes that should not be met with a time-consuming and costly audit. However, audits do serve an important purpose. They are the primary tool used by the IRS in its effort to reduce the tax gap, which is caused by nonfiling, underreporting, and underpayment. In total, the gap is over $450 billion, even with voluntary compliance at 84 percent. This lost revenue is unacceptably high, but because of IRS enforcement actions, like audits, an additional $50 billion is recovered. The recovery of this amount proves just how important audits can be, but it should not come at the expense of our Nation’s job creators. Rather, the IRS should be tasked with doing all that they can to improve voluntary compliance before audits are required.

Working with the taxpayer to correct mistakes is quintessential to a thriving tax system. Accordingly, the IRS has made strides to improve its relationship with taxpayers through increased customer service and outreach. Yet improvements can always be made.

Today’s hearing will give us another opportunity to learn what enhancements can be performed and modifications made to auditing techniques to reduce the burden on small business owners. These recommendations are critical to improving tax compliance and closing the tax gap. They also serve a very important purpose in assisting small firms. We often hear reports of small employers closing their doors due to an audit. They just could not recover from the process or the expense. In many cases, the owner’s energy is shifted from maintaining or growing the businesses toward meeting IRS demands to substantiate records. This problem is compounded by that of the great financial cost of hiring an outside professional, which many businesses do when facing an audit. Such burden makes it essential to understand how the IRS’ primary collection tool, audits, impact a small business who is attempting to comply with complex rules. While a small employer has a duty to pay taxes and keep an efficient recordkeeping system, the IRS also owes a duty to that taxpayer to conduct the audit in a manner which is clear, ensure the employer understands his rights or her rights during an audit, and to prevent harming the small business from aggressive tactics. So I look forward to learning more about the auditing process and what we can do to help both the IRS mod-
ify and update its practices and small business taxpayers do a better job by complying and recordkeeping.

So I would like to thank the witnesses today for the time that they are taking out from their busy schedules to testify.

Thank you very much, Mr. Chair. I yield back.

Chairman CHABOT. Thank you. The gentlelady yields back.

And I would now like to explain our timing rules here. And before that, Committee members who may have opening statements, we would ask that they submit them for the record.

We operate under the 5-minute rule. You will each get 5 minutes to testify. We take 5 minutes to ask questions, and there is a lighting system to assist you. The green light will be on for 4 minutes and then the yellow light will be on for a minute to let you know that you have got about a minute to go, and then the red light will come on. And if you can stop near that I will appreciate it. We will give you a little time, but not a whole lot.

And I would now like to introduce our very distinguished panel here this morning. Our first witness is Kathy Petronchak, who is director of the IRS Practices and Procedures for alliantgroup in Houston, Texas. In that capacity, she provides advisory assistance on a wide range of issues related to IRS procedures and represents clients before the IRS. Ms. Petronchak previously had a 29-year career with the IRS in various positions, most recently serving as commissioner for the Small Business/Self-Employed Division. We welcome you here and appreciate your testimony.

Our second witness will be Warren Hudak, president of Hudak and Company in Lemoyne, Pennsylvania. Hudak and Company is a small business that provides comprehensive tax services to other small businesses. Mr. Hudak is an enrolled agent and CPA and has owned Hudak and Company for the last 20 years. And we welcome and appreciate your testimony this morning, Mr. Hudak.

Our third witness today is Don Williamson, executive director of the Kogod Tax Policy Center, Kogod School of Business at American University. Professor Williamson teaches a number of subjects related to taxation. He is also a partner in LaMonaca and Williamson, a small Falls Church, Virginia, firm that specializes in accounting, auditing, and tax preparation for small businesses, and we thank you for being here this morning.

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

Ms. ADAMS. Thank you, Mr. Chair.

It is my pleasure to introduce Ms. Jennifer Breen. Ms. Breen is a partner at Morgan Lewis where she concentrates on tax controversy and planning matters with an emphasis on audits and IRS administrative proceedings. Before joining Morgan Lewis, she worked at Mattel, Inc., PricewaterhouseCoopers, and as a lawyer with the IRS Office of Chief Counsel. She received her juris doctorate from the University of Houston Law Center. Welcome, Ms. Breen.

Chairman CHABOT. Welcome, Ms. Breen.

And Ms. Petronchak, you are recognized for 5 minutes.
STATEMENTS OF KATHY PETRONCHAK, DIRECTOR OF IRS PRACTICES AND PROCEDURES, ALLIANTGROUP, LP; WARREN HUDAK, PRESIDENT, HUDAK & COMPANY; DON WILLIAMSON, EXECUTIVE DIRECTOR, KOGOD TAX POLICY CENTER, AMERICAN UNIVERSITY; JENNIFER E. BREEN, PARTNER, MORGAN, LEWIS & BOCKIUS LLP

STATEMENT OF KATHY PETRONCHAK

Ms. PETRONCHAK, Chairman Chabot and Ranking Member Adams, thank you for inviting me to testify. It is an honor to provide comments today for your hearing.

I interact with small businesses in my work with alliantgroup, a tax consulting firm that ensures small and midsize businesses are able to avail themselves of the tax benefits provided by Congress. I also spent almost 29 years at the IRS, and so this gives me a unique perspective into the examination process. My testimony focuses on challenges that small businesses face and what the IRS can do to improve the examination process.

Before I go into specifics, let me just say that much of the problem we see today is exacerbated by a lack of adequate funding for the IRS, a trend that needs to change. With respect to the IRS exam process, we believe there is some inconsistent treatment of small versus large businesses, as well as differing procedures being used in audits of these businesses. It is important to remember that America’s small businesses have needs, interests, and resources that may differ significantly from those of larger businesses. However, some of the procedures utilized in large business audits, as outlined in my testimony, provide added transparency that would bring greater fairness to the small business examination.

I raised five issues in my testimony. I would like to briefly focus on two of those issues: specialist assistance and third-party contacts.

With regard to the first issue of specialist assistance, in an IRS audit there are instances when specialists are needed. While this assistance is necessary, the process is often mysterious and the taxpayer is left in the dark regarding who is making decisions. Our experience includes situations where a revenue agent who lacks expertise may rely on a technical specialist to make the decision in an examination, and due to staffing levels, the specialist may not have adequate time to fully assist, so revenue agents have only consultations with them. In some cases, the taxpayer is not aware that this assistance happened until a FOIA request was made in preparation for appeals.

Another recent experience creates a greater concern. We recently encountered a case in which the agent told our client that he was going to sustain a majority of the tax credit at issue. However, the agent then told our client he had to have a technical specialist review his final report. Weeks later, the agent told us that the specialist had directed him to allow little of the tax credit. The agent’s manager informed us that he did not have the authority to reverse the specialist’s decision, and when a conference call was requested...
with these specialists, we were advised that they would not participate. This behavior is particularly troublesome if the specialist is making the ultimate decision. The ideal situation is where the taxpayer is aware that a specialist is assigned and has access to that individual.

The second issue I want to address is third-party contacts. The IRS often reaches out to third parties that are not under audit, but who may have needed information on the audited taxpayer. Such contacts are permitted in certain circumstances, but the IRS must give the taxpayer reasonable notice.

We are seeing increased use of questionable third-party contacts. In our experience, it appears the IRS is increasingly using these contacts when they already have the information, and other times when they have not, as required, first requested the information from the taxpayer. The IRS seems reckless in its third-party contacts, disregarding the adverse impact on the business of the taxpayer as the IRS tells customers, vendors, former employees, and others that it is examining the taxpayer.

This trend has been noticed by others doing IRS oversight. The National Taxpayer Advocate, in its 2015 annual report to Congress, raises a number of points, including that the IRS is not always effective in providing notice to taxpayers, oftentimes only providing them Publication 1, Your Rights as a Taxpayer, at the beginning of the exam and not at or anywhere near the date of a third-party contact. The practice of issuing third-party contacts should be modified to ensure notice and an opportunity to respond prior to the time a third-party contact is to actually be initiated.

In closing, I commend the Committee for its work on oversight and ensuring that small businesses receive fair treatment and good service from the IRS, and alliantgroup looks forward to working with the Committee to further improve tax administration.

Chairman CHABOT. Thank you very much.

Mr. Hudak, you are recognized for 5 minutes.

STATEMENT OF WARREN HUDAK

Mr. HUDAK. Chairman Chabot, Ranking Member Adams, members of the House Small Business Committee.

Chairman CHABOT. You might want to pull that mic down just a little bit. There you go. Thanks.

Mr. HUDAK. I was thanking everyone for the invitation today.

Chairman CHABOT. Sure.

Mr. HUDAK. My firm provides comprehensive tax services, including tax preparation, planning, and representation before the IRS. We work with all categories of small business: sole proprietors, partnerships, and S-corporations. Our representation services include audits, negotiating installment agreements, offers-in-compromise, collection due process hearings, appeals, and penalty abatements.

Today, I share with you my perspectives, and I participate here on behalf of the National Association of Enrolled Agents.

Over the last 5 years, we have witnessed a significant shift in the number and quality of IRS audits. This shift has coincided with a dramatic decrease in funding. We, too, have seen the quality of audits go down with the funding.
In short, the agency is struggling to rely more on automated and faceless decisions based less on field audits and many on just scrubbing of third-party information.

Importantly, IRS examinations range from simple issuance of an IRS notice asking for clarification of a single item, but oftentimes that leads to unintended consequences, the runaway audit that was mentioned earlier. As resources dwindled, we have seen that increase in techniques. For instance, 1099Ks. We recently had a client who triggered an audit because their revenue that they reported did not coincide with the 1099K. They had an entity change during the course of the year, had two entities and properly reported all income on both entities. Once that was presented to the auditor inside a very short period of time, in 5 minutes, the auditor was satisfied that all of the income was reported within IRS tolerances. But that did not stop. It turned into a 6-month audit with requests from third parties and infringement on the interests of the client for their ability to have privacy.

There seems to be more and more of a win-win culture for the IRS. It is not to get at the actual correct tax, but the maximum tax. In a recent call with the IRS, we had presented a Rev. Proc. to them to abate a penalty. Before I could even get the words “Rev. Proc.” out, they said, “we have it”, and they accomplished the task. When asked why do you not offer this to other taxpayers when they call in, they said, we do not want to lead the customer. And that was a problem. Why is the IRS in these terms not being more helpful? Why are they not making them aware of the provisions of the code to allow them to comply with the law in the best interest of the taxpayer? Why would it be always the best interest of the government maximizing revenue?

Training does make a difference. Increasingly, we are finding requests for things outside the scope of the audit, and we have forced audits into appeals to allow us the latitude of a fresh, independent look. Many of our clients come to us after there is a controversy, and what we find is at that point in time they are under the misguided impression that the IRS is there to assist them and represent them.

And that leads me to really my closing. The Taxpayer Bill of Rights is an awesome, awesome law. It would clear up a lot of the problems we have in the audit. Along with the Pledge of Allegiance, the ITS agents when they get up in the morning should recite the Taxpayer Bill of Rights. Nina Olson in the Taxpayers Office did an awesome job in advocating for that. She deserves all the credit in the world for accomplishing that. For small businesses in audits and compliance, we really should have more safe harbors, like the home office deduction. That was incredible. It simplified the record-keeping and, quite frankly, you are probably collecting close to the right amount of revenue.

Training in the IRS’ future state we are so excited about, but we want to be cautious. To my earlier comment, with the IRS’s future state, during that taxpayer interaction online, at some point during that interaction we have to be careful to be clear that the IRS is not their representative. Thank you.

Chairman CHABOT. Thank you very much.

Mr. Williamson, you are recognized for 5 minutes.
STATEMENT OF DON WILLIAMSON

Mr. WILLIAMSON, Chairman Chabot, Ranking Member Adams, and members of the Committee, thank you for the opportunity to testify on the issues small businesses confront when they are audited by the Internal Revenue Services.

My name is Don Williamson, and I am a professor of taxation at American University's Kogod School of Business, where for the past 32 years I have been the director of the school's Masters in Taxation program, and for the past 27 years have had my own tax preparation and tax planning practice, LaMonaca and Williamson, CPAs, in Falls Church, Virginia, which specializes in representing small businesses and their individual owners before the Internal Revenue Service.

Mr. Chairman, the majority of small business audits are conducted by correspondence. While this approach may work when the taxpayer has failed to report income reported to the Internal Revenue Service by third parties on Form 1099s, problems arise when the IRS is seeking verification of or more detail about the information on the return itself. In these cases, taxpayers' written responses to notices often sit at the IRS processing centers for months until assigned to an auditor. The auditor will often find the taxpayer's response to be insufficient, setting off a new round of correspondence, consuming yet several more months.

Furthermore, because small business owners usually rely upon enrolled agents, CPAs, or attorneys when they are contacted by the IRS, significant costs arise for even insignificant inquiries, such that many business owners simply concede to a proposed adjustment and opt to pay the extra tax.

These problems were most recently illustrated in my own practice where a client living in Texas was contacted by the IRS Philadelphia Service Center regarding the income and expenses claimed on his Schedule C. The letter did not provide the name of any person at the IRS to contact and simply requested copies of all the taxpayer's books and records. The taxpayer, at considerable cost of time and professional fees, assembled the requested information in large boxes which were mailed to the address requested. After 4 months, the client received a one-page letter with the attached page statement declaring the taxpayer's business was a hobby, resulting in a substantial proposed assessment of tax, interest, and penalties. At that point, my client had already incurred substantial fees in responding to the initial request for information, and I frankly advised him that taking the matter to the appeals division would cost even more. Nevertheless, my client insisted that I file a protest showing that his business was not a hobby. After several more months and several letters, while I was able to transfer the case from Philadelphia to the Appeals Office in Texas where the taxpayer resides, we received yet another letter asking again for a complete record of all the taxpayer's travel and entertainment expenses with schedules reconciling the individual expenses to the totals on the return, documentation which we had already provided. Nevertheless, we again began to prepare new schedules, cross-referencing each receipt to the totals on the return. However, before we could complete the work, the client received a one-paragraph letter dropping the case. As a result of this exercise that lasted for
almost a year, the client incurred professional fees that exceeded the initial adjustment in tax proposed by the IRS having not contested the matter.

The substantial cost of this case not only to the taxpayer but indeed to the IRS itself illustrates the limits of correspondence audits. Because most correspondence audits initially have one point of contact at the IRS to discuss the matter, taxpayers and their representatives simply hope they are providing the correct information. At the very least, the IRS must better facilitate the internal tracking of correspondence audits and end the process of courtesy disconnects when a taxpayer is on hold for more than 45 minutes when calling the IRS. In addition, the IRS should consider assigning a case to an arbiter if the taxpayer requests such an assignment at the time of first contact.

Finally, if the IRS can significantly improve its online capabilities, and more importantly its security over its online functions, taxpayers could respond to email communications with specific IRS personnel.

Thank you for the opportunity to testify today, and I look forward to working with the Committee on this critical problem of tax administration.

Chairman CHABOT. Thank you very much.

Ms. Breen, you are recognized for 5 minutes.

STATEMENT OF JENNIFER E. BREEN

Ms. BREEN. Thank you. Thank you for the invitation today to discuss the IRS's approach to the audits of small business taxpayers.

My name is Jennifer Breen, and I am the vice chair of the Administrative Practice Committee of the American Bar Association Section on Taxation. I am also a partner with the law firm of Morgan, Lewis and Bockius, where I represent taxpayers before the Internal Revenue Service in audits and appeals.

I am here today on behalf of the ABA Tax Section, so my testimony today should not be construed as representing the policies of the larger association.

In the IRS' 2015 fiscal year, it closed approximately 1.3 million examinations, of which over 300,000 were examinations of small business returns. The audits of these small businesses were conducted by the IRS' SBSE, or Small Business/Self-Employed Division.

When SBSE determines that a return warrants an audit, it is sorted for one of two possible types of audit: a correspondence audit or a field audit. Of the examinations completed in 2015 for small businesses, over half were correspondence audits. A correspondence audit is one that is conducted exclusively by mail. The service center or campus will first mail a standard boilerplate letter to the taxpayer to notify them that they have been selected for examination and to provide them with a list of documents that they will need to provide to be verified. Now, these notices are computer-generated. There is virtually no customization with respect to the taxpayer, the taxpayer's business, or the issues that may have been the reason that it was selected for examination in the first place. This initial generic request will require the taxpayer to provide a
variety of records to the IRS, such as the work papers that were used to prepare the return, the taxpayer's general ledger, bank statements, canceled checks, and deposit slips. A taxpayer must respond within 30 days. They must mail the requested documentation to a general address that is listed on the notice, and should the taxpayer have any questions regarding the initial letter, they are directed to call a general number or write to a general address. Once a taxpayer responds, the correspondence is then placed in a queue and then will be assigned to a campus examiner. This process can take months, and sometimes taxpayers are forced to resend the correspondence that they originally sent as the information that was mailed cannot be located by the IRS.

Unfortunately, in many examinations, the quality of a taxpayer's response to the requests that are made by the IRS, as well as the agent's understanding of the position that has been taken by the taxpayer, is impacted by the fact that all the discussions between the two parties are held exclusively through correspondence.

Now, field audits, on the other hand, are generally conducted through direct contact with the taxpayer through a combination of face-to-face meetings, telephone calls, and written correspondence. Now, at the outset of one of these audits, the taxpayer will be provided with a request for documents that the agent has identified for review. Now, while these requests are often customized, they also contain boilerplate items that agents are required to seek regardless of the issues that the agent has identified and regardless of the type of business that the taxpayer is operating.

Regardless of the type of the examination that a small business taxpayer receives, establishing good accounting and recordkeeping will help a taxpayer prepare for an examination should one arise. Now, if one does, it is important to thoroughly and timely review all notices and requests for information that you receive from the service. While the IRS outlines the examination process on its website and in the various publications, for taxpayers, this process can be confusing. Taxpayers are often unsure about what to expect and how to proceed.

Unlike the large business and international, the LB&I Division, SB/SE does not have a public examination process policy statement whereby the division provides an organizational approach for examinations from first contact through the final stages of an issue resolution, nor does it have directives requiring discussions with taxpayers around certain examination procedures, such as the issuance of requests for information or documents.

Now, last year, the IRS, including the SB/SE, announced its Future State Initiative. Through this initiative, SB/SE has indicated that it is looking for ways to find better and more efficient manners of doing business. It has identified possible changes to include the use of digital notifications, possibly examination at earlier stages shortly after returns are filed, the use of limited issue examinations based upon specific aspects of a taxpayer’s return, and the ability for taxpayers and their representatives to exchange information electronically with an agent during the examination process.

Now, examinations do provide the IRS with an important tool to identify noncompliance. Efforts such as these that have been iden-
tified should lead to improvements in the process and help the IRS examine taxpayers more effectively and efficiently.

Thank you for the opportunity to be here today and to provide the Committee with this information.

Chairman CHABOT. Thank you very much. We appreciate the testimony of all the members of the panel here. And I recognize myself for 5 minutes to begin the questioning.

I will start with you, Ms. Petronchak, if I can.

You mentioned that one of your clients did not even know that a specialist was advising on the audit until a FOIA request was made. How and why would a taxpayer ever need to file a FOIA request to receive information related to their own audit? That sounds pretty outrageous to me.

Ms. PETRONCHAK. That is a good question. Let me try to be brief in answering it.

Chairman CHABOT. Take as much time as you need.

Ms. PETRONCHAK. A strategy used by some controversy professionals would be to file a FOIA request to ensure that they have all the information from a case file, particularly, you know, if they want to ensure they are adequately representing their client in an appeal. So that may be a large issue. Or SB/SE's work papers are not quite as thorough as those used by the large business division, so they have a lot of lead sheets. So trying to get all the information and understanding from a file, exactly who they were talking to and how they came to conclusions would be very important. And they would not get the file unless they asked for it.

Chairman CHABOT. Okay. All right. Thank you very much.

Mr. Hudak, I will turn to you at this point. What would you identify as the single biggest problem with the IRS exam program as it relates to small businesses, and how would you address it? If there are two, which one? You can take two if you like.

Mr. HUDAK. Well, that is a good question. I think third-party contact is a big ideal. Increasingly, we are seeing blanket requests to banks, blanket requests to third-parties. We are also seeing an increased number of improper contact with taxpayers. When a properly executed power of attorney is stopping by to drop off something, the taxpayer says, well, you should give that to my representative. He said, no, that is okay. You can have it. And the question is what was discussed? That is a big problem.

But increasingly, the IRS will be using this future state concept where you get a notice, the taxpayer is encouraged to create an online account, and they chat or banter back and forth with the IRS. And if you look at the taxpayer advocates' foldouts on that process and what it looks like, one comes to the realization at some point during that, the taxpayer gets the feeling they are being represented by the IRS and that is simply not the case. And there is some concern with the IRS's future state as it pertains to representation.

I think it can be satisfied in a number of ways. I know NAEA, National Association of Enrolled Agents, has asked to bring back the ability to execute powers of attorney online. We did that before. I think the Office of Chief Counsel seems to think there is a way to do that safely and with confidence.

Chairman CHABOT. Thank you very much.
I guess similar to that, if I could go back into my earlier career of practicing law, I used to handle all kinds of stuff, but one thing was in the domestic relations area. In Ohio, we have divorces and dissolutions. And a dissolution is basically the parties coming in, they usually come in together, but you cannot represent as an attorney both parties. You have to be clear. They have to sign saying, you know, I know he represents this person and not this person. You have the right to get another attorney. So I could see it is very significant for folks to know that the IRS is not necessarily your friend, maybe you instinctively know that when you are born as an American, but certainly, when you are dealing with them, you want to make sure you realize they are not representing you.

Mr. Williamson, I will turn to you at this point. What are some of the most persistent concerns you have encountered in your representation of small businesses in the conduct of the exam process? And I know you already dealt with some of them in your statement and if you want to expand upon those.

Mr. WILLIAMSON. Thank you. It is basically time. This is what really frustrates my clients. In the testimony I gave to you, we were looking at a very simple exchange of information. Had I been able to speak with someone, even on the telephone, I am sure I could have settled this scenario I just described to you in minutes; instead, it took a year. And so that is what really frustrates clients is time.

Also, in small business audits, the agent will show up, begin the audit, walk away and you do not see them for 6 months. And then suddenly you have presented to you an extension of a statute of limitations.

So my clients want to do business and they want to do it efficiently and as quickly as possible, and they do not need an IRS audit hanging over their heads for 18 months to 2 years when something could be settled very quickly.

Chairman CHABOT. My time has almost run out here, but you mentioned before about the person who was being audited and contested it and by the time they got to the end of it, all the expenses they had far exceeded the amount that the IRS said that they owed, which was wrong. But so you are in a situation where even when you win, you lose.

Mr. WILLIAMSON. You are absolutely right. I cannot tell you how often a client will receive a notice for a few hundred dollars and he contacted me to get a power of attorney to exchange information. He will pay it.

Chairman CHABOT. Yeah. It should not be like that. It absolutely should not. And thank you for shedding some light on that. My time has expired. The ranking member is recognized for 5 minutes.

Ms. ADAMS. Thank you, Mr. Chair.

Small businesses are the backbone of America. They are the entrepreneurs and the job creators that are necessary to stimulate our economy. We know that tax compliance is burdensome, both from a financial and administrative perspective. So in order to be adequately prepared in case of an audit, what is the best practice for a small business when it comes to tax records? Ms. Breen?
Ms. BREEN. Yes. So as I mentioned a moment ago, I think one of the keys is good accounting and recordkeeping. But I think that it is also important to maintain those records in real time. Tax returns are prepared after the close of the year, and oftentimes, many months after the close of the taxable year. And so it is important that as expenses and items of income are accounted for or recorded, the documentation to support that is kept in real time. When an audit occurs, it often can occur up to 2 to 3 years after the expenditure or the item of income was received. And so, therefore, it becomes even harder for a taxpayer to pull together those records. So it is important that those records are maintained in real time and in a way that a taxpayer can access them quickly should an audit occur.

Ms. ADAMS. Thank you.

Ms. Breen, audits are the primary collection tool for the IRS in their effort to close the tax gap. So what makes this the most attractive tool for the IRS, and how successful is it at recovering unpaid taxes?

Ms. BREEN. Well, I think that it is the most successful tool because it does bring success. And if we look at the statistics that the IRS releases each year about the filing season, last year the IRS reported that in 2015, over 25 billion in total recommended taxes were determined pursuant to that audit cycle, and of that 25 billion, approximately 4 billion was associated with small businesses.

As part of the IRS LB&I and SBSE future state, the other operating divisions are announcing other types of treatment streams, so ways that they could identify noncompliance or seek to enforce compliance in other ways outside of the traditional audit. If those are successful, we may see those expand into the SBSE Small Business Division as well.

Ms. ADAMS. Thank you.

The idea of individualized taxpayer accounts seems to be a popular notion. How could prioritizing accounts of enrolled agents, CPAs, and tax attorneys be helpful to small business clients as it pertains to tax filing and auditing?

Ms. BREEN. Well, the IRS has identified the need to expand its use of technology as a way to enhance the use in examinations and the way that it interacts with the taxpayer. And one of those ways would be to allow taxpayers and their representatives to exchange information electronically with the IRS. Now, these types of abilities could improve the communication between the two parties, and it could help to minimize some of the delays or missing documentation that sometimes occurs when you are communicating with the IRS and something I think that when any of us are communicating with the IRS we want to try to avoid.

Ms. ADAMS. Okay. Because data security is extremely important, considering the hack of IRS accounts, can you address how we can keep these accounts safe, particularly when these professionals are responsible for assisting small business clients?

Ms. BREEN. Absolutely. I think that it is indisputable that cybersecurity and fraud detection are integral to the IRS’s mission of enforcement and service to American taxpayers. The ABA tax section has consistently supported adequate funding of the IRS. We believe that improvements are needed that require substantial in-
vestment, and we encourage Congress to provide that sufficient funding so that the service can implement those very important initiatives in the use of technology to better service taxpayers.

Ms. ADAMS. All right. I am going to yield back my time, Mr. Chair. Thank you.

Chairman CHABOT. Mr. Gibson?

Mr. GIBSON. Thanks, Mr. Chairman. I appreciate the panelists.

I must say I am somewhat concerned by some of the testimony to date so I want to follow up, particularly with regard to due process. It was mentioned in one example we had a case where a specialist provided insight. The IRS said, well, this is the determination and there is really nothing that I can do about it. My question explicitly is where are we now in terms of current law on due process? And what recommendations would you have? So to put a finer point on the question, can the individual, can the small business, for example, call for a face-to-face meeting with all the parties where they can sit down with records and actually sort through? Is that within the Bill of Rights? I mean, is that within the current state of play that a small business owner can call for such a meeting?

Mr. WILLIAMSON. No. Basically, in my case that I recited to you, there was no right for me to sit down with someone from the Internal Revenue Service and go through these documents until I got to the Appeals Division, and then they did assign an appeals officer. Until then, in these correspondence audits it is pretty much back and forth. Now, indeed, after a while in a correspondence audit there will be someone assigned to the case at the service center, but good luck trying to reach them.

Ms. PETRONCHAK. Congressman, I would say that in the Taxpayer Bill of Rights, it talks about the right to be informed. So maybe it does not go far enough in the Bill of Rights for the situation I described in my testimony. And I used “specialist” generically. It could be a counsel employee who is advising the agent. It could be a subject matter expert in LB&I from an issue practice group. It could be an engineer or it could be a technical specialist within SBSE. Whoever that is that is working on the case, it should be more transparent to the taxpayer and they should be at those face-to-face meetings.

Recently, I was at a client site. We were having a meeting, and the SBSE agents were doing great jobs interviewing the taxpayer about issues, but there was a specialist that had been involved in the examination, and my understanding is that the specialist, he could not come to the interview. Now, I think it would have been helpful for that specialist to be at the interview to follow up and ask the pertinent questions in making a final decision on that case.

Mr. GIBSON. So to understand, there is not clarity at this point as to what the legal definition of “informed” means. That is what I am hearing from the panel at this point.

Ms. PETRONCHAK. I would agree with that. I am not aware of it.

Mr. HUDAK. I would agree with that. Very much so. I do believe that the Taxpayer Bill of Rights, though, is a document that has to be asserted. And if the representative is not involved and the practitioner is not involved, oftentimes the Taxpayer Bill of Rights
are not being asserted. The IRS is not offering this. It has to be asserted from the taxpayer or the representative.

Mr. GIBSON. Thank you. And to follow up on your original testimony, which I heard very loud and clear, so if you have a small business owner, they are working really hard hours, they are just trying to survive and flourish, and they get this notification of audit, is it clear when they receive that that they have the right to counsel? In other words, the IRS is not their advocate in this, is that clear?

Mr. HUDAK. There is an insert. To the extent they understand the notice in the first place, yes, they are notified. But they are scared. Their records are usually a mess because they are behind a grill 12 hours and at the end of the day they have got to reconcile their tips in their credit card machine. Oftentimes it just does not happen. It is not that they do not care. It has nothing to do with that. It has everything to do with this unique nature of a small business.

And I alluded to the safe harbor with the home office deduction. We need to do more things like that to relieve these burdens off of small businesses.

Mr. GIBSON. I had one other question, too. It was concerning to me with regard to the notification of third parties. It can be intimidating. It can be friends and colleagues. Is there some kind of provision now for notification at the end of this that there has been a closed case and there have been no discrepancies found?

Ms. PETRONCHAK. Congressman, I would say at the end of a case, yes. I think Jennifer addressed in her testimony there are reports at the end. But with regards to the——

Mr. GIBSON. But third parties though were notified?

Ms. PETRONCHAK. The third party does not get that. It only goes to the taxpayer.

Mr. GIBSON. So the onus is really on the taxpayer to say, look, I know you got contacted, but I was cleared. You know, there were no issues. Does the taxpayer get a full listing of all the third-parties that were contacted?

Ms. PETRONCHAK. They can request a list. I think in the Taxpayers Advocate’s Report she addresses the notification process and the requirements in the law that periodically a list should be provided. The IRS has chosen not to provide that periodic list. So unless a taxpayer requests a list, they do not get one.

Mr. GIBSON. And I see my time has expired. Thank you, Mr. Chair.

Chairman CHABOT. Mr. Davidson?

Mr. DAVIDSON. Thank you, Mr. Chairman. Thank you for the witnesses who could be here today. It is just an honor to talk with you about concerns small businesses have in interacting with the IRS.

I spent a lot of time as a small business owner myself, and would like to continue our track record of not being audited by the IRS, as I think all small business owners would like to do.

When that does happen, you have all addressed some concerns about how that process is for the small business owner. And I am curious if you have been able to discern how the IRS is measuring
the auditors? What are the metrics? Does anyone have that answer?

Ms. PETRONCHAK. Congressman, it has been a while since I looked at it, but I think in their performance elements they are measured on their taxpayer relations, their technical knowledge of a case, and how they conduct the audit. So it would be subjective things that a manager reviews and how they are evaluated.

Mr. WILLIAMSON. Technically, since the 1990s and some of the scenarios that arose in the 1990s, they made a big deal out of it is not a race to how much revenue each agent can collect versus the other agents. It is how quickly you can settle your cases and how efficient you are, and not how much revenue you have gained. It is my understanding. I have not been on the other side of the table myself to know these things.

Ms. BREEN. Historically, there were also metrics about case closures. So agents were evaluated on the number of cases they could get closed, and currency was something that was very important. The IRS with its future state has announced perhaps it is stepping away from closure as a metric and looking more to cases that have been opened.

Mr. DAVIDSON. Okay. Thanks for that.

Can anyone answer what the average cost in terms of dollars, hours, and duration an audit is for a small business?

Mr. WILLIAMSON. Congressman, as I said in my testimony, I cannot specifically say so many dollars. I will simply say it is excessive. If we can communicate with the Internal Revenue Service and show them in my cases here are the books, here are the records, what questions do you have, let us settle them today, I do not have to have a case on my desk for a year. Nine out of 10 of my cases is simply documentation, and I can show the IRS the documentation if I can have the meeting or have the telephone call and we can look at things together.

Mr. DAVIDSON. Okay. And now, there are increasingly other factors linked besides just tax compliance for small businesses, and of particular note is Obamacare. And in Congress' appropriations to the IRS, we historically have not funded the IRS specifically to enforce Obamacare audits, but the IRS has diverted a significant amount of money to do that. How has that impacted the audit process for small businesses? And how does that relate to the IRS' explanations for their ability to turn these things around in a timely manner?

Mr. WILLIAMSON. Obamacare and the returns that are required with it in the 8000 series have only been around for a couple of years, so I do not think you have an audit history where you can determine how much time is being spent and how the returns are being selected based upon the forms that the taxpayer is filing with respect to their payments of medical care insurance. So we are just not there yet to get a handle on how onerous the audits will be of issues dealing with Obamacare.

Mr. DAVIDSON. In fiscal year 2015, the IRS spent $462 million of its budget on Obamacare enforcement, so somebody must be getting enforced.

Mr. WILLIAMSON. Somebody is.
Ms. PETRONCHAK. Congressman, the only thing I can say is when the laws are passed, usually I found that it was a couple of years before you started seeing revenue agents addressing specific issues when the laws were passed; however, there is a lot of work up front with computer systems or counsel and guidance that go into it, so I can only guess that maybe that is where the money went.

But to Mr. Williamson’s point, it usually is a few years before you actually start seeing examination activity related to that.

Mr. DAVIDSON. Just one last question.

I thought it was interesting to say, hey, you actually have to go through the process and note a request, you know, a copy of other parties that have been notified. From the small business perspective, are there any other things that we might say, hey, this just ought to be standard practice that you would advise?

Ms. PETRONCHAK. I will start. Obviously, the third-party contact process needs to be looked at closely, and I think Ms. Olson's views on those speak well to that. I do not know if the Committee can look at it.

The other thing, I would not want to lose fact—on the fact-finding part. I mean, we have talked about we send in documents or correspondence; they get lost. But the interactions and the fact-finding, I think the IRS in looking at their future state needs to make sure they stay focused on face-to-face interactions with the taxpayer and does not move to too much online interaction and expect that to take care of everything.

Mr. DAVIDSON. Thank you. My time has expired.

Chairman CHABOT. Ms. Petronchak, you mentioned in your testimony that the IRS is understaffed, underfunded. There is a theme here, because the common complaint is not directed at their behavior, necessarily, although there is that. What it sounds like is they have moved to make their systems accommodate themselves in a way that reflects their ability to respond. By that I mean I am listening to this and I am thinking that they barely can keep up. I mean, if I was them trying to defend them here I would say give us what we need to do this and we can make sure that the special people are there and we can answer our phone in less than 45 minutes you said, Mr. Williamson, and that we did not get computer-generated things or letters in the mail that were essentially a list of everything, send us everything you have and maybe we will get back to you.

So I would like, just to be fair in this because we do not have anybody from the IRS here, I would like to ask what you think about that conjecture, if it is wrong, and do you think that—how much of this do you think is driven by resources as opposed to other things that we have talked about?

Mr. WILLIAMSON. Let me just chime in. I want to emphasize, and I think most of the panelists will agree with me on this, the professionalism of the individual agents we do business with is very high and I commend them for that. I think what they have tried to do is in trying to be more efficient, they become less efficient. And my case was an example of that. Had we just had some communication one-on-one, I think we could have settled my case really in minutes rather than a year.
Chairman CHABOT. What would they say about that, though?
Mr. WILLIAMSON. I do not know what they would say about it.
Chairman CHABOT. It has got to be aggravating for them to get a box of paper in the mail and have to read it all.
Mr. WILLIAMSON. You will have to ask them. I agree whole-heartedly, sir. No question about it. The hours it took us to put this together to me would be much easier for us just to sit down with somebody.
Ms. BREEN. I think the IRS has made statements over and over again that it has a commitment to looking for ways to handle audits more efficiently and effectively. And at the same time, the IRS has been publicly stating that it is doing less with less. That is why the ABA tax section does support adequate funding.
On the other hand, you have got small businesses who are also trying to do more with less in many instances. With the IRS’s new future state, I think as a practitioner, I would hope that the initiatives that they are coming up with and putting together would create an opportunity for clearer and more effective communication between taxpayers and the IRS and more focused and efficient audits. I think in that way, both America’s small businesses and the IRS can go do the jobs that they want to go do.
Chairman CHABOT. It sounds like they are building walls, though, as well. Responding to somebody, writing to someone in a paragraph and asking for essentially maybe hundreds or thousands of pages, it is easy to do on one end, but it is impossible to respond to on the other.
Ms. BREEN. Absolutely. And many instances where the letters that are sent to taxpayers that contain that perhaps brief or cryptic information or request is computer-generated. So no human being is actually looking at that letter or looking at that return once it is first selected and saying, hey, let us look at X, Y, and Z, and let us ask these very specific questions to the taxpayer.
Chairman CHABOT. So you think it has been dumbed down to the point where it is easier to ask a big question that requires a lot of work than ask a simple question that requires homework?
Ms. BREEN. I think because the computer is issuing these letters in the beginning, it is giving you a boilerplate list. Taxpayers have no idea what it is they are supposed to give. They do the best they can. They send it in and hope that someone looks at it.
Chairman CHABOT. What do you think? You were there 29, 28 years?
Ms. PETRONCHAK. Yeah, I was.
Chairman CHABOT. You must have made a lot of enemies in that time.
Ms. PETRONCHAK. Yeah, I am sure. You know, most people like revenue agents. I think they said most of them are professional.
You know, there are cultural problems at the IRS. It is not all funding. Yes, funding would help. They could do things, maybe they need training. Third-party contacts is a cultural issue. They could do something with training, revising their procedures for that to fix it.
I talked about the use of specialists. Yes, more specialists would help them if they really want to have a specialist on a case devote
their resources, but maybe they work fewer cases if they do not have a specialist and it requires that type of resource, instead of opening it up and not being fair to taxpayers during that exam.

Mr. HUDAK. We have heard a lot of comments from NAEA's members about disappearing auditors going away on detail, going away on training, disappearing for 6 months. Increasingly, they are working from home, telecommuting. The question is, with the security, I understand they are doing to keep costs down, but at the end of the day, you know, they are carrying taxpayer information home with them and there is a concern there. But I think it is all being driven by the same budget issue that we have been discussing today.

Chairman CHABOT. Well, thank you for that. I appreciate it.

I want to thank everybody for being here today. We have heard a number of problems. Some might describe it as an epidemic to small business; the exam process that is. These issues need to be addressed, and I hope that today's hearing is a good first step in our ensuring that that happens.

I want to thank you all again for being here. I appreciate the effort of our distinguished panel in bringing these issues to light. Sunshine is essential for change. All too frequently, taxpayers are hesitant to take the IRS to task publicly for fear their situation may actually get worse. I cannot blame them for that. So these problems persist. Creating an environment where we can identify, discuss, and take these issues head-on is a key goal of this Committee. And I especially want to thank our witnesses again for working to achieve that goal.

If there are no comments, ma'am, would you like to have a closing statement?

Ms. ADAMS. Just to thank you all very much. It has been very insightful. And I would appreciate the opportunity to hear from you.

Chairman CHABOT. Thank you. This Committee hearing is adjourned.

[Whereupon, at 12:04 p.m., the Committee was adjourned.]
APPENDIX

Statement of Kathy Petronchak
Director – IRS Practice and Procedure
alliantgroup, LP

Before the United States House of Representatives Committee on Small Business
Regarding the Committee’s Hearing on
“IRS Puts Small Businesses through Audit Wringer”
Submitted September 14, 2016

Chairman Chabot and Ranking Member Velázquez:

Thank you for inviting me to testify before the House Committee on Small Business. It is an honor to provide comments today for your hearing “IRS Puts Small Businesses through Audit Wringer”.

I am Kathy Petronchak, Director of IRS Practice and Procedure at alliantgroup, LP. I have been with the firm for almost three years and prior to this, I worked in a big 4 accounting firm for five years in the tax controversy area dealing mostly with medium and large businesses. Prior to coming to the private sector, I worked at the IRS for almost 29 years. My last position with the IRS was that of Commissioner, Small Business/Self Employed Division but during my executive career I also served in the Large & Mid-Size Business Division. I believe this experience gives me a unique perspective into how the examination process is currently being conducted for both small and mid-size businesses.

As background, the firm of which I am a part, alliantgroup, is a leading tax service consultant for small and medium businesses across the country. alliantgroup has approximately 650 professionals located nationwide, focused on assisting small and medium sized businesses to avail themselves of proper and available tax incentives, including tax credits, designed to create U.S. jobs, promote research and investment, and otherwise help the United States remain the leader in the global economy. We also assist these businesses in tax planning, and we represent them before the IRS and state tax regulators. In providing these services, we partner with the CPA firms of these businesses. We work with over three thousand CPA firms and tens of thousands of businesses from all over the country in a remarkably diverse set of industries. Our work and daily interactions reveal that our CPA partners and clients share a common experience relating to their dealings with the IRS. Thus, we are uniquely positioned to speak to the issues you wish to discuss today.

Mr. Chairman, if there is one takeaway from my message today, it is that IRS practices and procedures during the examination of small businesses need to improve, and perhaps improve dramatically. However, I truly view this as an opportunity that can benefit both taxpayers and the IRS.
There are a number of steps the IRS can take that will improve their work and also make life easier for taxpayers, especially those with limited resources.

My testimony today focuses on challenges that small businesses face when dealing with the IRS, and more specifically, what the IRS can do to make the examination process more fair, efficient and transparent. A number of issues that I will discuss today are exacerbated by the funding problem that has plagued the IRS for a number of years now. I urge you to support adequate funding for the IRS so that it can upgrade its systems, hire new enforcement staff, train its employees to ensure competence in handling tax issues, provide timely guidance to taxpayers and ensure better service for American taxpayers as well as a fair administration of the tax code. And I want to make sure it is understood that while I believe that the IRS can improve its procedures in the handling of small business examinations, IRS employees generally try to do the right thing.

We believe there is some inconsistent treatment of small versus large businesses by the IRS, as well as differing procedures being used in audits of these businesses. It is vitally important to remember that America’s small businesses do indeed have needs, interests and resources that may differ significantly from those of larger businesses. However, as I will discuss below, some of the procedures utilized in large business audits provide added transparency that would bring greater fairness to the small business examination. If these procedures were adopted for all taxpayers, the IRS can improve transparency in its examination of small businesses and better ensure they are treated fairly.

Today I would like to focus on five issues that taxpayers face when dealing with the IRS: 1) IRS fact finding and the information document request process, 2) alternative dispute resolution, 3) expert assistance, 4) the Appeals process, and 5) third party contacts.

1. IRS Fact Finding and the Information Document Request Process is Not Uniform

An important aspect of an IRS examination is the information document request process. The IRS issues to taxpayers information document requests, or “IDRs,” requesting books and records and email communications, as well as requesting supporting documentation and explanations of various items on their tax returns. The documents taxpayers provide in response to the IDRs give the revenue agent the information needed to determine whether a taxpayer has taken a correct or reasonable position on its tax return. The process is often lengthy and can take a taxpayer hours upon hours to gather, organize, and explain documents. And while it is important for the IRS to conduct fact finding in an examination, it is also vital for the IRS to understand that a small business does not have the resources that the Fortune 1000 have to deal with voluminous document requests. Additionally, the taxpayer can find an audit by the IRS intimidating since they do not have frequent interactions with the IRS. Often times, a taxpayer will have to hire an outside representative, such as a CPA or attorney, to help them deal with the audit and respond to the IDRs in an orderly and timely fashion.

The IRS’ Large Business & International Division (LB&I) has refined the examination process with a goal to make it more transparent and efficient – worthy goals for any examination of a taxpayer, whether large or small, from the perspective of both the IRS and the taxpayer. LB&I agents are now required to ensure that IDRs are issue focused, have been discussed with the taxpayer before being issued in final
form, and contain a response date that has been discussed with the taxpayer.\textsuperscript{1} Publication 5125, issued in February 2016, has required agents examining the tax returns of large and mid-size companies to open up communications with companies and to work closely with them. While neither perfect in design nor implementation, this process is intended to lead to increased transparency in the examination process with issues being clearly identified by the IRS and taxpayers receiving timely feedback on the responses that have been provided. We believe the IDR process in LB&I has improved as a result of this focus.

Small business examinations do not have similar procedures in place. Rather, there are only loose guidelines on issuing IDRs. The Internal Revenue Manual provides guidance on the use of “lead sheets” and work paper organization but provides little focus on how to work transparently and collaboratively, where possible, with taxpayers. It is our experience that these procedures can lead to IDRs that cover a number of issues within one request and with what seems short response times for a voluminous amount of documents.

The two processes described here have created a difference in treatment of large and small business in IRS examinations. While LB&I appears to be pushing for clarity and efficiency during the audit process, small businesses are generally left to the decisions of the individual revenue agents, many of whom mean well. However, there are no real procedures in place in SB/SE to encourage more discussion concerning the course of an examination and, in fact, the press to close cases as quickly as possible acts to discourage transparency. This has only worsened as budgets have declined. I also would mention that one of the byproducts of this issue that we are experiencing is that in some examinations, the first clear indication of the primary issue of an examination is when a 30 day letter is received by the taxpayer. At this point the taxpayer needs to agree with the IRS or decide to file a protest with Appeals to have an impartial hearing on the issue. This is remarkably too late in the process.

To be clear, having a straightforward upfront meeting between the taxpayer and the IRS that lays out what the issues are, what the roadmap is going forward for documents and interviews, as well as expected timelines is to everyone’s benefit. The taxpayer understands the concerns of the IRS and can be better responsive to IRS questions and requests for documents. Thus, we believe that the Small Business/Self Employed Division (SB/SE) should adopt many of the LB&I transparency measures.

2. The IRS is Decreasing its Use of Alternative Dispute Resolution

The IRS Fast Track Settlement (FTS) program was officially established in 2003.\textsuperscript{2} It was created as an expedited dispute resolution option that is available for taxpayers who want to mediate their disputes with an Appeals Official acting as a neutral party. The purpose is to bring the revenue agent together with the taxpayer, so the two parties could discuss their positions and come to an agreement to settle an issue or the entire case, without having to go through the formal administrative Appeals process or to court. Although the original adoption of the program in 2003 covered only large and mid-size businesses, it was expanded in 2013 to enable all small businesses under examination to more quickly settle their differences


with the IRS. For years FTS has been accepted as a powerful tool for taxpayers, allowing them to iron out their differences with the exam team on one or more contentious issues and reach a mutual agreement to close the case, allowing both parties to move on with their lives.

However, in recent years, our experience has been that small businesses are less likely to be accepted into the FTS process. FTS must be agreed to by both the taxpayer and the revenue agent and in recent experience, revenue agents and managers seem more reluctant to utilize this dispute resolution tool. This statement is based on statistics that were shared by IRS Appeals in a March 2016 presentation at a Tax Law Conference where the number of fast track settlement cases for small businesses decreased from 230 in fiscal year 2014 to 177 in fiscal year 2015. A cause for this could be the decreased budget for the IRS. Revenue agents are spread thin, handling many cases at a time and as indicated earlier, may not be discussing issues with taxpayers early enough in an examination to facilitate the use of FTS.

Finally with respect to the alternative dispute resolution process, I must note that taxpayers and their representatives welcome the opportunity to resolve as many issues as possible at the lowest possible level. The tax community supports FTS. Although a mutual agreement may not always be reached, the use of fast track settlement and other alternative dispute resolution processes benefit both the IRS and taxpayers. Small businesses need to focus on their business at hand and having a disagreement with the tax authorities hanging over their head for a long period of time distracts from their business needs. The fast track settlement process is authorized for all taxpayers and I strongly encourage its increased use by the Service. Resource levels in examination and appeals may be driving reluctance to use the process but it can be a great benefit for all parties.

3. Assistance and Decision Making by Unseen Third Parties Eliminates Transparency and Rights of Small Business Taxpayers to be Heard

In an IRS audit, the revenue agent has traditionally been the point of contact for the taxpayer and is supposed to be the individual that manages the audit and makes the ultimate determination. There are instances when specialists are needed for an examination and the IRS has a formal process for agents to request assistance from specialists such as engineers, appraisers, and computer audit specialists. However, we have experienced instances where some SR/SE agents hand cases off to specialists when valuation or highly technical issues are being addressed. While this assistance is necessary, the process is often mysterious and the taxpayer is left in the dark regarding who is conducting and deciding their examination. There are times the agent does not notify the taxpayer that he/she has turned the case over to a specialist or that he/she is consulting with a specialist or subject matter expert.

This practice of an unknown specialist/expert making the decision on a taxpayer’s case prevents small businesses (and in this instance, some large businesses) from knowing and understanding what is actually going on in their audit. They are left uncomfortable about what information is actually being shared and what is the basis for the IRS determination. In other situations, revenue agents have told our taxpayers that a specialist/expert is advising on their audit, but will not allow the taxpayer access to the

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3 Federal Bar Association Tax Law Conference, Practice and Procedure Symposium, Recent Developments at Appeals Panel (March 4, 2016).
expert. We are even told by agents that they may agree with our position but have no authority over their own examination. The perfect situation is where the taxpayer is aware that an expert/specialist is assigned to the examination and they have access to that individual to discuss the facts and law involved in the issues being addressed.

My firm has advised a number of small businesses where this happened to them. For example, a revenue agent who lacks expertise or experience may simply hand the case over to an IRS engineer or technical expert and have them make the ultimate decision that is written up in an examination file. In the best case scenario the specialist/expert is involved in the case and openly advising on document requests and participating in discussions with the taxpayer. However, there is another area in which budget cuts have had a pernicious impact on the process. The specialists may not have adequate time to do a quality job. For example, in some of our cases revenue agents have only “consultations” with specialists/experts on a case rather than a real referral. Having only hours and not weeks to work an issue related to a specific taxpayer may not lend itself to a specialist being fully informed of the facts in a particular case. Moreover, in some of these cases, the taxpayer is not aware that this has occurred or has not had an opportunity to discuss technical conclusions that have been made. My firm has encountered situations in which the taxpayer did not know this happened, until a FOIA request was made for documents from the revenue agent’s administrative file in preparation for Appeal.

There is another recent experience with SB/SE agents that creates a greater concern in the exam process for small businesses and whether they are being treated fairly. Recently we have been advised informally by revenue agents that there is a new approval process for their final reports by a “technical specialist.” Agents have not specified who is reviewing their lead sheets and workpapers prior to discussion and issuance to the taxpayer of a report. They have indicated that the specialists are looking at these and that their hands are tied in determining the proposed adjustment for those taxpayers. This is particularly troublesome if the specialist is making the ultimate decision when they are not intimately familiar with the facts of the taxpayer. To the extent this is happening, it is the antithesis of the transparency that should occur in an examination.

As an example, my firm recently encountered a case in which the revenue agent told my client, a small business owner, that he was going to sustain a majority of the business’ tax credit at issue. However, the agent then told our client that he had to have a specialist review his final report. Several weeks later, the agent told us that the specialist had directed him to close the case, sustaining very little of the tax credit. The agent’s manager informed us that he did not have the authority to reverse the specialist’s decision or to offer fast track settlement as an alternative dispute resolution. Sadly, situations like this lead to perceptions that the IRS is not treating taxpayer’s fairly although I would note that the agent actually doing the examination was apologetic about the practice.

Taxpayers understand the role of IRS is to enforce the tax law. However, when they perceive that they are being unfairly treated anger at the IRS will increase and voluntary compliance will ultimately suffer. Part of being treated fairly is knowing who is working or advising on a particular taxpayer’s examination and how the outcome of that examination may be impacted by them. A clear communication of all those working on a case and providing technical direction is not a big ask by a taxpayer. It may also
be a budget issue, but ensuring that agents are properly trained for the issues they are being asked to examine benefits the IRS and taxpayers alike when they can be discussed and resolved in a more efficient manner.

4. The Appeals Process and Clouds on the Horizon

Before heading to court, the final administrative step a taxpayer can take to contest an adverse determination by IRS Appeals is through IRS Office of Appeals. The IRS Office of Appeals is “an independent organization within the IRS whose mission is to help taxpayers and the Government resolve tax disagreements.”\(^4\) Taxpayers can present their arguments and negotiate a settlement with an IRS Appeals Officer. I appreciate the vital and important work of Appeals and want to state how important IRS Appeals is for so many small businesses seeking a fair review of their tax issues without having to go to court.

While the role of IRS Appeals is greatly appreciated by those seeking resolution there are improvements that taxpayers would like to see. While I addressed alternative dispute resolution earlier I did not note that one of the benefits is the speed of decisions that can be reached. The goal for small business is to make a decision within 60 days of an application being accepted. While there is not always agreement in FTS there is always the option to pursue a regular appeal on the case.

Compared to FTS timelines, a hurdle for small businesses with IRS Appeals, is the length of time it takes to render a decision. Again, due to budget cuts, Appeals Officers have incredibly large caseloads, and may be unable to hear cases for months. This means that the taxpayer’s tax returns and status with the IRS is in a sort of purgatory, as it has to wait on the Appeals Officer to hear its case. While our small business owners are most appreciative of the opportunity to attend the conference and have a frank discussion with Appeals they are not as thrilled about the time it takes to hear a final decision.

Due to the positive experience with Appeals in the past I am concerned with some changes to the Internal Revenue Manual regarding future conference practices. It has been noted that face-to-face conferences will continue with the consent of Appeals but taxpayers will be offered telephone and virtual conferences as first options. If small business owners are not given an opportunity to have a face-to-face meeting it would be a major setback for them.

Further, there is a perceived lack of uniformity in the decisions reached by Appeals. As with SB/SE, there are no objective standards that Appeals must use to analyze a case. In fact the Internal Revenue Manual states there is “no substitute for preparation, judgment, and common sense”\(^5\) to conduct a conference. Appeals employees must analyze the merits of a case based on the hazards of litigation – i.e. the risk that a court would find an issue favorable for the taxpayer. Congress should ensure that Appeals weighs the hazards of litigation uniformly-small businesses with limited resources should not be at a disadvantage from large businesses that have law firms on speed dial. Some have the perception that small businesses may be at a disadvantage in Appeals discussions because all are aware that a small

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\(^5\) IRM 8.6.1.4 (Oct. 01, 2016)
business does not have the resources to go to court. A lack of resources is not a litigation hazard. Appeals needs to recognize this perception exists and take what actions it can to counter it.

5. Third Party Contact Procedures Need to be Reformed

The IRS often reaches out to third parties that are not under audit, but will have information and documents on the taxpayer that is under audit. Such contacts are not impermissible in certain circumstances, but the IRS must give the Taxpayer under audit “reasonable notice” of such a contact. While these contacts are often times justified as necessary to corroborate a taxpayer’s records/testimony or to obtain otherwise unavailable data, we are seeing increasing use of the contacts that warrant concern.

I would like to echo the findings made by Nina Olson, the National Taxpayer Advocate in her 2015 Annual Report to Congress. Ms. Olson raises a number of interesting points. First, the IRS is not always effective in providing notice to taxpayers, often times only providing them Publication 1, Your Rights as a Taxpayer or some similar general notice at the beginning of the exam and not at or anywhere near the date of a third party contact. Such notice is useless and does not effectively apprise taxpayers that such contact will be made, to whom it will be made, or that the taxpayer can request a third party contact report from the IRS. Second, the Taxpayer Advocate Service found that the IRS did not first ask taxpayers for the information requested from third parties in 22.8 percent of examination cases. This is unacceptable given the extraordinarily important taxpayer privacy protections that go out the window with third party contacts.

Ms. Olson also discussed other valid concerns: the disclosure of confidential taxpayer information protected under IRC § 6103; that taxpayers are often not given the prior opportunity to volunteer information on their own; that third party contact requests can be vague; and that the IRS does not automatically provide periodic third party contact reports.

In our experience, it appears the IRS has seemingly been using these contacts on an increasing basis in general examinations where we represent the taxpayer, often times when the IRS already has the information they request from third parties, and other times when they haven’t even requested the information in the first place. Requesting the information from third parties in these situations is intrusive, burdensome and needless. It creates an unnecessary burden for small businesses, and the practice of issuing third party contacts should be modified to ensure notice and an opportunity to respond prior to the time a third party contact is to actually be initiated. I would encourage the Committee to review closely Ms. Olson’s concerns and to ask for her views on what steps should be taken to ensure taxpayer’s rights are being protected.

Conclusion

Thank you Chairman Chabot and Ranking Member Velázquez for allowing me to testify today on this important topic of the IRS and small businesses. Small businesses are vital to jobs and growth of our

6 26 USC § 7602(c).
economy. I commend the Committee for its work and oversight in ensuring that small businesses receive fair treatment and good service from the IRS - a goal that I believe is widely shared at the IRS. Ensuring that small businesses are on at least an equal footing with large companies in front of the IRS is a good start. I hope today I was able to highlight major issues small business owners are facing when dealing with the IRS.
Statement of Warren Hudak, EA, CPA
Before the U.S. House of Representatives
Committee on Small Business,
September 14, 2016

Chairman Chabot, Ranking Member Velazquez and members of the House Committee on Small Business, thank you for the invitation to participate in today’s hearing reviewing the state of audits at the Internal Revenue Service.

My name is Warren Hudak, President of Hudak & Company, which is located in Lemoyne, Pennsylvania. I am an enrolled agent, certified public accountant, and small business owner. I testify today as a member of the National Association of Enrolled Agents. The opinions I express in this testimony are mine alone.

My firm provides comprehensive tax services including return preparation, planning and representation before the IRS. We work with all categories of small businesses (sole proprietorships, partnerships and S-corporations), nonprofit organizations, and individuals. Our representation services include audits, negotiating installment agreements, offers-in-compromise, collection due process hearings, appeals, and penalty abatements.

Today I share with you my perspectives as both a tax practitioner and a small business owner. While I participate under the auspices of NAEA, the opinions I express in this statement are mine alone.

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Over the last five years, we have witnessed a significant shift in the number and quality of IRS audits. This shift, of course, has coincided with a dramatic decrease in funding levels at the agency. We’ve seen a 24 percent decrease from 2010 to 2014 in the number of staff performing audits. Enrolled agents, as the taxpayer’s representative, have had a front row seat to the effect of this funding on enforcement actions by the IRS.

In short, the agency relies more heavily on automation and faceless decisions and less on auditors in the field. Many new auditors are not properly trained and have only a cursory knowledge of the Internal Revenue Manual, which is the foundational document guiding all the actions IRS takes during the course of an audit.

Importantly, IRS examinations may range from the simple issuance of an IRS notice asking for clarification of a single tax return item that appears to be incorrect (correspondence examination) to a face-to-face interview and review of the taxpayer’s records. While there are significant problems associated correspondence audits, I will focus my testimony today on field audits.

Because of the decline in resources we have seen two rough trends with audits: greater pressure to make each audit a success for the government and poorly trained and prepared auditors.

**Pressure for a Win**

As resources have dwindled, we have witnessed an increase in techniques we believe are intended to bring in more revenue not necessarily the correct amount of taxes. Many of these techniques are intimidating and all too familiarly carry a presumption of guilt. For instance, recently I represented a taxpayer that received an audit notice. At the audit, it was clear that a Form 1099 from a credit or debit card payment entity had triggered the audit. We immediately explained that the income reported by the credit card company had been split between two businesses tax returns and consequently had been properly reported and taxes paid. The original purpose of the audit having been explained, the auditor then clearly did not want to “waste” a scheduled afternoon audit proceeded to spend the rest of the afternoon randomly fishing around in the taxpayer’s records. In the end, our client suffered no changes in tax liability but owed a substantial amount of practitioner fees.
While practitioner representation fees can be expensive, not have representation can be even worse. Increasingly, we find auditors that are bypassing taxpayer representatives who hold properly executed powers of attorney. Most taxpayers want to cooperate, so when the auditor shows up at their place of business they go out of their way to answer questions and attempt to explain business practices. One of my favorites:

Auditor: “How often do you make cash deposits?”
Taxpayer: “As needed.”
Auditor: “Is that once a day, once a week, once a month?”
Taxpayer: “Maybe once a week”
The Auditor later expands the audit because he sees instance when a deposit was not make every week.

Taxpayers rarely understand the agency’s purpose for the audit. It is to collect information to substantiate the tax return in whole or in part. Taxpayers usually provide rambling explanations that either provide reasons to expand the audit or lead the auditor to inaccurate conclusions. Often the direct contact becomes a way to maximize tax, as the IRS expands the audit scope.

Another problem area is what I refer to as the “friendly-stop-by.” The auditor just happens to be in the area and drops off a summons. Or, the auditor presents the audit report directly to the taxpayer with the signature lines tabbed and suggests the taxpayer sign accepting the report without consultation of the appointed representative. Unfortunately, in both these instances these innocent actions significantly prejudice the client’s right to challenge the IRS’s position.

Another technique used to maximize pressure on the taxpayer is the use of third party contacts. We see the IRS send third party summons to venders, financial institutions, clients, and even neighbors. This behavior is seen as a way of pressuring the taxpayer to agree to proposed return adjustments. One can only imagine how much pressure it puts on the taxpayer when the IRS auditor calls clients, venders and neighbors and says “I am from the IRS. I’m wondering what you can tell me about Joe Taxpayer.” Taxpayers feel intimidated and often completely capitulate in order to preserve their business reputations.
As intimidating as many of these techniques are, we find that lack of training also harms taxpayers in audits. New auditors are not well-versed with the Internal Revenue Manual. Many enrolled agents find themselves in situations where they are literally providing auditors with highlighted copies of pertinent sections of the IRM. For instance, we recently had an auditor ask for 10 years of records, even though the statute of limitations allowed him only three years.

We have found ourselves with auditors working remotely from their homes. We had to tell them we will not provide them with sensitive financial information until they are able to substantiate the records will be kept in accordance with IRS procedures.

One of my enrolled agent colleagues told me she has had a number of instances when she has forced an audit into appeals because it is clear that the subject matter of the audit is beyond the knowledge of the auditor. Other auditors are often over their heads with case load and subject matter as demonstrated by simple audits going on for months.

These may seem like trivial matters but as they say "time is money" and endless audits or uninformed auditors cost small businesses money and loss of focus on their core business.

Closing

Taxpayers have rights, including the right to challenge IRS' position, and the right to pay no more than the correct amount of tax. While we as a nation have a noble tradition of pro se representation, that path is fraught with peril, especially for the small businessman or woman. Small business owners do not have the expertise to go toe-to-toe with IRS, even in the best of times, when IRS staff is fully trained, carries a reasonable workload, and is provided with the proper tools. Just as important, small business owners don't have the time to go toe-to-toe with IRS.
Fortunately, taxpayers also have the right to retain representation. Even with this solution in place, we need to be sure IRS is not making end runs around representatives, and we need to be sure IRS is making focused, reasonable queries of small business owners, and of all taxpayers for that matter. 

Thank You So Much,
Warren S Hudak
President

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Testimony of
Donald T. Williamson
Kogod Eminent Professor of Taxation
Howard S. Dvorkin Faculty Fellow
Executive Director, Kogod Tax Policy Center
Kogod School of Business
American University
Washington, D.C.

Committee on Small Business
United States House of Representatives

Hearing on
“IRS Puts Small Businesses Through Audit Wringer”

September 14, 2016
Chairman Chabot, Ranking Member Velazquez and Members of the Committee, thank you for the opportunity to testify on the issues small businesses confront when they are audited by the Internal Revenue Service.

My name is Don Williamson and I am a professor of taxation at American University’s Kogod School of Business where for the past thirty-two years I have been the Director of the School’s Masters in Taxation degree program. The MST program at American University offers graduate courses in federal taxation to accountants and small business owners who wish to expand their knowledge of our nation’s tax laws. Our course offerings include not only traditional classes in subject areas such as the taxation of corporations and partnerships, international taxation and tax policy but also more specialized areas of the tax law such as IRS practice and procedure that address the issues of this hearing regarding the IRS examination of small business tax returns.

In addition to my academic work, for the past 27 years I have had my own tax preparation and tax planning practice, LaMonaca & Williamson, CPAs, in Falls Church, Virginia which specializes in the tax issues facing small businesses and their individual owners. LaMonaca & Williamson prepares hundreds of tax returns of small businesses as well as representing such taxpayers daily before the IRS examination, appeals and collection divisions, thereby making me uniquely qualified to speak with you today.

I. Complexity of the Law Contributes to Time Consuming, Unproductive Return Examination

Over the course of my tenure as an academic and tax practitioner I have seen with dismay the Internal Revenue Code grow in complexity, becoming intrusive and pervasive in its reach and incomprehensible to all but those who devote their careers to its study.

This complexity arises, in part, from the now annual amendments to the Internal Revenue Code that have a profound, even paralyzing, effect on small businesses that impedes their efficient operation and obstructs their ability to grow and create jobs. In fact, since 2001, there have been approximately 5,000 amendments to various sections of the Internal Revenue Code—about one per day on average. Consequently, not only small business persons, but even their tax advisers are overwhelmed by the complexity resulting in steady increases in fees advisers charge to their small business clients.

The National Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours preparing tax returns or otherwise responding to IRS inquiries about the preparation of their returns, the equivalent of 1.25 million full-time jobs. In meeting these requirements 70% of small businesses employ tax professionals to prepare their returns and represent their interests before the IRS at a cost of more than $16 billion for the services of attorneys, accountants and other professionals.
In addition to waste time and resources, there is the practical reality that it is impossible today to be knowledgeable in the entirety of our tax law. Professionals must specialize in areas (e.g., corporations, partnership, employee benefits, etc.). As a result, small businesses find that they must employ a team of tax advisers to prepare their returns and ultimately represent their interests if the returns are audited. Our own Kogod study of more than 40,000 self-employed small business owners, which we conducted earlier this year together with our research on the sharing economy, found that more than 44% of our respondents paid more than $200 for assistance in preparing their annual taxes. While generating a lucrative “cottage industry” for tax professionals, small businesses—who comprise more than 99% of all businesses—suffer from burdensome tax compliance requirements that require professionals advice and divert time and resources away from activities encourages business growth and create jobs.

In fact, a survey conducted by the National Federation of Independent Business found that CPAs, attorneys, enrolled agents and other tax specialists not only prepared, at least in part, over 90% of all tax returns filed by small businesses but were also retained to represent small businesses when they were selected for IRS audit. When small business owners believe they are unable to file their own tax returns, represent their own interests before the IRS or simply contact the IRS by telephone without being subject to a “courtesy disconnect” after remaining on hold for 30 minutes, resentment towards the “system” arises, creating a cynicism and disrespect toward our tax law that will only foster non-compliance and ultimately fraud.

II. Why Target Small Businesses for IRS Examination?

As part of the tussle over tax rates and appropriate deductions that create an overly complex statute, tax collection and enforcement accomplished by IRS audits of tax returns remain a necessary and appropriate tool needed to enforce our tax laws. But in deciding what taxpayers to select for audit, the IRS needs to recognize that on an hourly basis of IRS auditor time, the agency collects far more revenue from large corporations with higher taxable incomes than from small and medium size businesses with lower incomes. But, nevertheless, the highest number of audits for 2014 of individual tax returns with business income was in the lowest range of business returns, i.e. $200,000 to $400,000, amounting to 50% of all audits of upper income individual returns. Indeed, the chances of a Schedule C being audited are almost twice as great as a small corporation being audited. This evidence seemingly indicates that small proprietorships are in the audit crosshairs.

One reason the IRS appears to disproportionately target small business taxpayers is the view that small businesses receive most of their income in cash, which can be particularly difficult to identify and easily misreported. The IRS has done multiple studies on the tax gap, i.e., the difference in the amount of taxes imposed and the amount of taxes paid every year, and concluded that where information reporting or tax withholding is not imposed, there is a 63% net misreporting rate of income. As a result, the IRS uses au-
dits of small businesses and their owners to find unreported income. But, both the IRS and taxpayers agree such exercises are time-consuming and imperfect with the IRS collecting just $7.3 billion from audits last year—it's lowest in 13 years.

Most audits are not random, i.e. the IRS has a secret algorithm for determining how likely each taxpayer is to have unreported income. Employing this calculus, the IRS has concluded that small businesses are less likely to be paying their fair share of taxes relative to much larger enterprises, a surprising conclusion in light of frequent press reports of multi-national corporations allocating billions of dollars of profits to no or low tax jurisdictions to avoid U.S. income taxation.

In short, use of IRS resources disproportionately targeting small businesses, regardless of the degree of misreported income by a few, is both an inefficient use of IRS resources and unfair to the vast majority of small businesses that properly report all their income while generating more growth and creating more jobs than any other sector of our economy.

III. Unwinding the Wringer

The excessive time and expense of auditing small businesses is, in part, due to the difficulty the IRS has in conducting examinations of tax returns when specific personnel are not assigned to a taxpayer's case. While audits are often conducted by correspondence, they can also be performed by IRS personnel who go to the taxpayer's business or ask the taxpayer to come to the local IRS office. The majority of small business audits are conducted by correspondence. If the issue involves adjustments based on third-party income reporting documents, e.g. Form 1099s, where the taxpayer failed to report income, the matter can be promptly settled by the taxpayer paying the tax on the omitted income plus paying interest on the deficiency. Penalties are often not imposed.

However, problems begin when there is a disagreement over the proposed adjustment or the IRS is seeking verification of the information on the return. In these cases, taxpayer responses to written notices often sit at IRS processing centers for weeks or even months until assigned to an auditor. Once a taxpayer's response is actually reviewed by an IRS auditor, it is often the case that the auditor will often find the taxpayer's response to be insufficient setting off a new round of correspondence consuming several more weeks or months. Rather than this exchange of letters that inevitably must be made by certified mail to ensure receipt by the IRS, a meeting, or even simply a telephone call, with someone at the IRS assigned to the case could often settle the matter in a few minutes.

Furthermore, because small business owners rely upon enrolled agents, CPAs or attorneys when they are contacted by the IRS, significant costs arise for even insignificant inquiries. In fact, many small business owners simply conclude that the cost of their time and professional fees is not worth the effort to dispute the proposed adjustment and opt simply to pay the extra tax—rather than continue to fight.
Because most correspondence audits have no point of contact at the IRS to discuss the matter, taxpayers and their representatives simply hope they are providing the correct information. At the very least the IRS must better facilitate the tracking of correspondence audits so taxpayers may receive more prompt service. In addition, IRS should consider assigning cases to an auditor or perhaps a group of auditors if the taxpayer requests such an assignment at the time of first contact. Perhaps, if the IRS can significantly improve its online capacity, and, more importantly, its security over its online functions, taxpayers could respond to e-mail communications with specific IRS personnel.

IV. Inefficient Conduct of Audits—A Case Study

Ironically, small businesses which are more likely to be audited are less likely to have the resources to respond to inquiries and assemble evidence to support or explain their tax returns. In addition, individual taxpayers continue to have an almost illogical fear associated with being selected for an audit resulting in a strained relationship between taxpayers and an agency simply seeking to verify the information reported on a tax return. Finally, the impersonal approach by the IRS in correspondence audits, apparently due to the lack of personnel to conduct the examinations, makes for a frustrating and inefficient exercise.

These problems were illustrated most recently, in my own practice, where a small business client living in Texas was contacted by the IRS Philadelphia service center to explain the income and expenses claimed on his Schedule C. The letter did not provide the name of any person at the IRS to contract to discuss the audit and simply requested copies of all the taxpayer's books and records. With no way to understand what specific items on the return were under examination, the taxpayer, at considerably cost of time and professional fees, assembled the requested information in three large boxes which were mailed to the address requested.

After four months, the client received a one page letter with an attached one page statement of explanation declaring the taxpayer's business was a "hobby" and therefore the net operating loss claimed on the return was disallowed resulting in a substantial proposed assessment of taxes, interest and penalty. At that point, my client had already incurred fees of several thousand dollars in responding to the request for information; and I frankly advised him that taking the matter to the Appeals Division would cost even more. Nevertheless, my client insisted that I file a protest showing that his business was not a hobby.

After several more months and several letters where I was able to have the Appeals Office in Texas rather than Philadelphia hear the case, we received another letter asking again for a complete copy of all the taxpayer's travel and entertainment expenses with schedules reconciling the individual expenses incurred to the totals on the return, documentation which we had already provided. I called the Appeals Officer assigned to the case and explained that we had already supplied the examination division with this information. The Appeals Officer insisted we supply the information in
even greater detail than we had the first time. Therefore, we again began to prepare new schedules cross-referencing each receipt to the totals on the returns. However, before we could complete the work, the client received a one paragraph letter dropping the case. As a result of this exercise that lasted for almost a year, the client incurred professional fees that exceeded the initial adjustment in tax proposed by the IRS had he not contested the matter.

The substantial cost of this case, not only to the taxpayer but also the IRS itself, illustrates the limits of correspondence audits. Had an IRS employee in Philadelphia been assigned to this case, the matter would have been resolved in a few weeks rather than a year. So often audits of small businesses and individuals are resolved by simply having documentation to support the items claimed on the return. In this case the taxpayer had the documentation and I am confident the entire matter would have been closed with one face-to-face meeting.

IV. Conclusion

The burden of compliance costs, including the often unnecessary examination of small business tax returns, arises not only because of the complexity of the tax law but also because of basic inefficiencies in the selection of returns for audit and the conduct of the examinations themselves. Because of these inefficiencies, small businesses have had to turn over responsibilities for the audit of their returns to tax professionals whose fees have made it necessary for taxpayers to concede possibly incorrect IRS adjustments. By revisiting its approach to the conduct of correspondence audits, the IRS can make such examinations more efficient thereby raising additional revenue for the government and lessen the burden on the tax paying community that is the fastest growing sector of our economy.

* * *

Thank you for the opportunity to testify today and the Kogod Tax Policy Center looks forward to working with the Committee on this critical problem of tax administration.
Good morning, my name is Jennifer Breen, and I am honored to be here today. I have been a tax practitioner for over fifteen years and have spent time as an attorney for the Internal Revenue Service (the “IRS”), in-house as a member of a corporate tax department, and as an outside advisor to taxpayers. I am currently a tax partner with the law firm of Morgan, Lewis & Bockius, LLP, in Washington, D.C., where my practice includes representing taxpayers involved in examinations before the IRS.

I appear before you today in my capacity as Vice Chair for the Administrative Practice Committee of the American Bar Association Section of Taxation. This statement is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the policy of the Association.

The Section on Taxation appreciates the opportunity to appear before you today to discuss examinations of small business taxpayers by the IRS, and it is honored to serve as a resource to the Committee on this topic.

The Section of Taxation is comprised of more than 17,000 members. Our members include attorneys who work in law firms, corporations and other businesses entities, government, non-profit organizations, academia, accounting firms, and other multidisciplinary organizations.

Our members provide advice on virtually every substantive and procedural area of the tax law, and interact regularly with the IRS and other government agencies and offices responsible for administering and enforcing such laws. Many of our members, including myself, have served in positions at the IRS, the Department of the
Treasury, the Tax Division of the Department of Justice, and the Congressional tax writing committees.

Examinations of Small Business Taxpayers: A Background

The IRS’s Small Business/Self-Employed Division (“SB/SE”) is one of four IRS operating divisions. It has responsibility for approximately 57 million taxpayers, including 41 million self-employed individuals and 9 million small corporations (those having $10 million or less in assets). SB/SE’s enforcement responsibilities include examining individual and business tax returns to detect misreporting. Examinations, or “audits” as they are often called, consist of a review of a taxpayer’s books, records, and other data to ascertain the correctness of any return or to make a return where one was not made by the taxpayer. Examinations are authorized by Internal Revenue Code section 7602, which gives the Secretary of the Department of the Treasury, the IRS’s parent agency, authority to conduct such examinations.

In the IRS’s 2015 fiscal year, the IRS closed approximately 1.3 million examinations. Of those examinations, over 300,000 were examinations of small business returns, with the majority of those returns reflecting a total income of under $1,000,000, and over 200,000 of these returns reflecting income of under $200,000. These audits resulted in over $4 billion of the $25 billion in total recommended additional taxes across all IRS examinations during the 2015 fiscal year.

Examinations provide the IRS with an important tool to identify noncompliance in reporting tax obligations and help to enhance voluntary reporting compliance. In so doing, examinations help to reduce the “tax gap,” which is defined as the amount of tax liability that is not paid voluntarily and timely. Earlier this year, the IRS estimated that the gross tax gap for the 2008-2010 time period (the most current estimates available) was $458 billion and that $52 billion would eventually be collected, resulting in a net tax gap of $406 billion.

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1 The IRM states the mission of SB/SE is “to help small business and self-employed taxpayers understand and meet their tax obligations, while applying the tax law with integrity and fairness to all.” IRM 1.1.16.1.1.
2 SB/SE also has enforcement responsibility for estate, gift, fiduciary, excise and most employment tax returns.
3 The IRS operates on a fiscal year running from October 1 through September 30.
4 Statistics from the IRS 2015 fiscal year, Internal Revenue Service Data Book, 2015, Publication 55B, March 2016. For purposes of the numbers contained herein as they pertain to small business returns, the following categories of returns were included: 1) individual income tax returns reporting Schedule C business activity with positive income of $1,000,000 or less and small corporations with total assets of under $10,000,000. These numbers do not include partnership returns, as the data presented by the IRS to date does not distinguish between large and small business partnerships for the IRS’s 2015 fiscal year.
5 Id.
6 Id.
I. Selection for Examination

After a return is filed, SB/SE uses a variety of methods to identify whether a return should be identified for potential examination. These methods include the use of a computer scoring program (called the “Discriminant Index Function” or “DIF”9) and other methods, such as internal and external referrals, the use of data matching (where the information reported to the IRS from third parties is matched against the information reported by the taxpayer), and random identification. Many of the methods used by the IRS use some form of automation to determine which returns should be selected, and most, but not all, involve some form of manual review to further evaluate which returns have audit potential. These selection methods create a pool of returns that the IRS has identified for possible audit.

Revenue Agents and other IRS employees then conduct a review of the pooled returns in a procedure known as “classification.”10 During the classification procedure, an employee determines whether a return warrants an audit through a review of the information reported on the return.11 During this stage, the taxpayer is not notified of the potential for selection, and if the employee classifying the return finds no issues, the IRS will take no further action on the return at that time. The returns that are identified during this process as warranting further review then become available to assign for examination. The IRS reviews more returns than are selected for audit to ensure that it has enough returns that are available for examination when staff become available to be assigned to an examination.12 Due to limited resources, the IRS will only examine a limited number of the returns filed, making the classifier’s role critical to ensure resources are used effectively.

II. The Examination

During the classification process outlined above, returns selected for potential examination are also sorted for one of two types of possible audit, a “Correspondence Audit” or a “Field Audit,” based upon guidelines set forth by the IRS. Both of these examinations are discussed in detail below. Of the over 300,000 examinations completed for small businesses in 2015, approximately 160,000, or...
over half, were conducted as a correspondence audit and the remainder were conducted as a field audit.\footnote{Statistics from the IRS 2015 fiscal year, Internal Revenue Service Data Book, 2015, Publication 55B, March 2016.}

A. Correspondence Audits

Correspondence audits, also called “Campus Examinations,” are the most basic type of audit and are conducted exclusively by mail. These examinations are conducted through one of four “campus” locations, commonly referred to as “service centers,” that are located in Brookhaven, New York; Cincinnati, Ohio; Memphis, Tennessee; and Ogden, Utah.

Once a return has been selected for a correspondence audit, an IRS analyst will review the return to ensure it adheres to the selection rules embedded in the automated processes, and then the return is assigned to a campus through automated processes. Generally, this means there is no further review by a manager or oversight group to determine whether to assign, hold, or screen out returns.\footnote{GAO, IRS Return Selection: Certain Internal Controls for Audits in the Small Business and Self-Employed Division Should be Strengthened, GAO-16-103: Published December 16, 2015. Publically Released January 13, 2016.}

Once assigned to a campus, examinations are initiated by a standard boilerplate letter, the “initial contact letter,” which is mailed to the taxpayer to notify them that they have been selected for examination, provide them with a list of items to be verified, and with a copy of IRS’s Publication 3498-A, The Examination Process (Audits by Mail). As these notices are computer generated, there is virtually no customization with respect to the taxpayer, the taxpayer’s business activities, or the possible issues that have triggered the examination. Rather, the initial request is generic in nature and requires the taxpayer to provide a variety of records to the IRS.\footnote{Generally, the first request seeks general records including the following: chart of accounts; year-end workpapers which reconcile the taxpayer’s books to the tax return; adjusted closing trail balance; year-end adjusting journal entries and closing entries, the general ledger; bank statements, duplicate deposit slips and canceled checks for all bank accounts; and copies of financial statements.} A taxpayer must respond within 30 days by mailing copies of the requested documentation to a general address for the campus conducting the examination. Should a taxpayer have any questions regarding this initial letter, they are directed to call a general number or write to the campus’s general address, as the case not yet been assigned to a specific campus examiner at this point in the process.

Once a taxpayer responds, the correspondence is placed in a queue to be assigned to a campus examiner, who will notify the taxpayer that the response was received. This process can take months, often due to the number of cases in the queue. Sometimes, a taxpayer is forced to resend the correspondence as the original information mailed cannot be located by the IRS.

In some instances, after submitting the requested information, taxpayers will receive notification that nothing more is needed and that their examination is being closed with no changes. However, in many instances, the examiner will contact the taxpayer with fur-
This testimony focuses on the general processes utilized by the SB/SE operating division of the IRS, as it is the division responsible for conducting examination of small business taxpayers. Other operating divisions, such as LB&I, utilize different or additional processes not addressed here.

As a whole, the IRS conducted the majority of its 2015 audits, 72.6 percent, via correspondence. As noted above, with respect to small businesses, over half of these audits were done via correspondence. For some types of small business taxpayers, this percentage is even higher. For example, of the nearly 170,000 small business taxpayers reporting gross receipts of under $100,000 that underwent an audit in 2015, more than 65% underwent a correspondence audit.

B. Field Audits

Field audits are generally conducted through direct contact with the taxpayer or the taxpayer's representative through a combination of face-to-face meetings, telephone calls, and written correspondence. SB/SE conducts these types of examinations through field offices located in seven regional areas across the United States. When classifying a return to determine whether to identify it for a potential field audit, the employee considers whether the issue would likely require an on-site inspection of a taxpayer's books, records, or assets, whether extensive time is anticipated to complete an audit, and whether the issues appear complex. In such instances, IRS guidance recommends that a field audit should be considered over one conducted via correspondence.

For cases that are referred to the field for examination, the inventory provided to each office is generally reviewed by a group manager, who has the discretion to assign, hold, or screen out returns for audit based upon resource constraints or priority of the workload. The group manager then assigns each case to an agent who will conduct the examination. Once assigned, the agent will notify the taxpayer that its return has been selected for examination and will provide it with a list of documents the agent has identified for review through an Information Document Request.

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Similar to the boilerplate requests made in a correspondence audit, the first request in a field audit generally seeks general records including the following: chart of accounts; year-end workpapers which reconcile the taxpayer's books to the tax return; adjusted closing trial balance; year-end adjusting journal entries and closing entries, the general ledger; bank statements, duplicate deposit slips and canceled checks for all bank accounts; and copies of financial statements. In addition, this request also contains boilerplate items agents are required to seek regardless of the issue or issues the agent has identified for examination or the nature of the taxpayer's business. The letter will suggest a date and time for the first meeting with the taxpayer or the taxpayer's representative, at which the taxpayer is expected to produce the records requests for the agent's review.

At the outset of the examination, and generally at the first meeting with the taxpayer, the agent will also spend time asking the taxpayer a series of questions. Some of these questions will have been customized through the agent's development of the case. However, often these questions are boilerplate and are required by SB/SE guidelines for procedures and techniques that should be used in every examination, regardless of the issues or type of taxpayer involved.

After the agent has reviewed the initial information and met with the taxpayer, in some instances, taxpayers will receive notification from the examiner that nothing more is needed and that their examination is being closed with no changes. However, in many instances, the examiner will contact the taxpayer with further issues he or she has identified or for additional documents to be requested through subsequent IDRs.

C. Completion of an Audit

Both correspondence and field audits can be concluded in one of three ways: as a “No Change,” as “Agreed,” or as “Unagreed.”

A No Change resolution means that during the examination the taxpayer was able to substantiate that all of the items being reviewed on the return were correctly reported and the examination results in no changes. While the IRS did not tabulate data reflecting the total percentage of No Change examinations that occurred in 2015, it did report statistics as broken down by specific types of taxpayers. In nearly every instance of small business taxpayer examinations, No Changes occurred more frequently in cases for which a correspondence audit was conducted. Additionally, for some groups of small business taxpayers, the likelihood of completing a correspondence examination that resulted in no changes was high. For example, of the 13,684 business returns with total positive income of under $200,000 and total gross receipts of over $200,000 that were selected for examination, 2,135 were subjected...
to a correspondence audit and over half of the examinations resulted in no change.\textsuperscript{19}

An examination that has concluded as Agreed means the IRS has proposed changes and the taxpayer understands and agrees with the changes. If a taxpayer agrees with the audit findings, the taxpayer will be asked to sign the examination report or a similar form, depending on the type of audit conducted. If money is owed, the taxpayer will be required to make a payment or seek to utilize one of the payment options offered by the IRS, if one is available.\textsuperscript{20} Of the over 300,000 small business cases closed in 2015, roughly 4\% closed in agreement.

Finally, cases that are closed as Unagreed are those where the IRS has proposed changes with which the taxpayer has disagreed. If the taxpayer does not agree with the findings, a conference with a manager may be requested for further review, the taxpayer may seek review by the IRS Office of Appeals or may seek to use of the IRS’s Appeals Mediation Programs.

Conclusion

In 2015, the IRS examined a total of approximately 1.4 million tax returns, and a large part of these returns were associated with small businesses across the United States. Although the experience of an examination by the IRS can require time and attention and cause uncertainty for the taxpayer, examinations are an important tool for the IRS to identify noncompliance in reporting tax obligations, help to reduce the tax gap, and enhance voluntary reporting compliance.

The IRS outlines the examination process on its website and in Publication 556, \textit{Examination of Returns, Appeal Rights, and Claims for Refund}, for taxpayers who have never experienced an examination. The examination process nevertheless can be confusing and time consuming. Consequently, taxpayers often are unsure about what to expect and how to proceed. Unlike the Large Business and International (“LB&I”) Division, SB/SE does not have a public “Examination Process” statement whereby the Division provides an organizations approach for examinations from the first contact through the final stages of issue resolutions, nor does not have directives requiring discussions with taxpayers around certain examination procedures, such as the issuance of IDRs.

Regardless of the type of examination a small business taxpayer experiences, establishing good accounting and recordkeeping will help a taxpayer prepare for an examination, should one arise, and help to put the taxpayer in a position to effectively and efficiently respond to any issues raised by the examiner. Good record keeping is not enough, however. It is also important to be cooperative and responsive to all IRS notices and requests for information.


\textsuperscript{20} See Publication 594, \textit{The IRS Collection Process}, for more information regarding these options.
Last year, the IRS, including SB/SE, announced its “Future State Initiative.” Through this initiative, SB/SE has indicated that it is looking for ways to find better and more efficient ways of doing business, including using technology to transform the examination process. It has identified possible changes to include the use of digital notifications of possible examination at early stages shortly after filing, the use of limited-issue examinations based upon specific aspects of a taxpayer’s return, and the ability for taxpayers and their representatives to exchange necessary information electronically with an agent during an examination. Efforts such as these should lead to improvements in the examination process and help the IRS examine taxpayers more effectively and efficiently.

Thank you for affording me the opportunity to be here today to provide the Committee with this information. I look forward to your questions.