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HOW TAX COMPLIANCE OBLIGATIONS HINDER SMALL BUSINESS GROWTH

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

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HOW TAX COMPLIANCE OBLIGATIONS HINDER SMALL BUSINESS GROWTH

WEDNESDAY, JULY 22, 2015

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

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

Present: Representatives Chabot, Luetkemeyer, Hanna, Rice, Brat, Radewagen, Knight, Hardy, Velázquez, Payne, Meng, Lawrence, Adams, and Moulton.

Chairman CHABOT. Good morning. Thank you all for being here. Special thanks to our witnesses who have taken the time away from their undoubtedly busy schedules to be with us here this morning. We really do appreciate that.

Earlier this year, our Committee heard from a gentleman named Scott, who owns a small mattress factory in Franklin, Ohio. Scott wants to pay his taxes. He probably wishes he could pay less but more than anything he wishes the process could be simpler. He wants a flatter and fairer code that is more predictable.

Scott is emblematic, I think, of many small businesses all across this country. There are millions of Americans out there just like Scott who feel the weight of the tax code every day. I speak to them every time I am back in my area, back in Ohio, and I hear the same concerns again and again. More Americans are frustrated with the process of paying their taxes, more so than even actually writing the check to the government. I am sure there are exceptions, but it is far too complicated. It is unacceptable and we must do better.

Making the tax code simpler is particularly important for America's small business owners, as they are disproportionately affected by the tax code's complexity. This is a finding that unfortunately has not changed with time. Studies conducted for the Office of Advocacy at the SBA over the past 10 years found that small firms pay 67 percent more to comply with the tax code than large firms do. A recent update to those advocacy studies found that firms with less than 50 employees pay on average over $1,500 per employee in tax compliance costs, whereas, firms with more than 100 pay $647.

It is because of statistics like that in 2013 this Committee asked the Government Accountability Office to examine the dynamics of small firms and their tax compliance burden. The GAO will be testifying today to outline their findings, and I would like to point out

that right at the end of the report, the GAO outlines 25 separate recommendations that they have made to the IRS over the past few years that could, and probably would in my estimation, help reduce tax payer compliance burdens. The IRS has implemented none of them, and that is a problem.

To be fair, I am not only blaming the IRS for this problem. Congress has been guilty as well. The tax code has grown to nearly 74,000 pages. The IRS did not do that; Congress did. This Committee is and will continue listening to the American people and urging Washington to make the tax code simpler and less stressful.

As I stated earlier, we have the GAO here today to discuss their illuminating report in greater detail, and we will also hear from tax experts who will suggest ways to reduce the strain on small firms through comprehensive tax reform that reduces the complexity faced by small business.

I am looking forward to the testimony of everyone here today, and I again want to thank each one of you. And I would also mention, originally there may have been a case where we were going to have two panels, but I have found over the years when we do that, oftentimes members have a certain amount of time that they can be here and they have other Committees and obligations and will listen to one panel and then not the other, and this is really a much better way to hear from all of you. And so that is why we changed that around, so if it was any inconvenience to anybody, we apologize.

And I would now like to yield to the ranking member, Ms. Velázquez, for her opening statement.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

The success of the American economy relies heavily on its vibrant small business community. Small businesses employ 50 percent of our workforce and generate nearly $6 trillion in revenue. When talking with small business owners, we often hear that an intense focus on the bottom line is necessary to succeed. They know every dollar counts and devote significant resources to work that goal.

One area every small business owner must focus on is complying with our tax laws. The tax compliance burden on small businesses takes many forms. Most notably is the complexity of the code itself. With so much paperwork to fill out every year, the majority of firms report spending more than 40 hours preparing their tax returns.

To better understand the costs of the burden and what the IRS is doing to reduce it, this committee requested the GAO report at the center of today's hearing. That report reinforced much of the anecdotal evidence we have heard on previous occasions. The complexity of the tax code creates a number of fixed cost items that do not scale with the size of the company. As a result, smaller businesses are disproportionately impacted compared to their larger counterparts.

One way to address this problem is by simplifying the tax code. By reducing its complexity, small businesses will see decreases in these fixed costs as the need for expert preparation and the time commitment will both be reduced. The complexity of the tax code cuts both ways. Taxpayers' noncompliance costs the IRS nearly

$350 billion every year prompting numerous initiatives to close the gap. One of them is the use of Form 1099-K to track electronic payments. By collecting data directly from payment processors, like Visa and PayPal, the IRS intends to cut down on underreporting and spur more businesses to voluntarily comply.

Unfortunately, if the information does not match up or errors are made, it could trigger costly and time-consuming audits for law-abiding firms. In response, the IRS began the Payment Mixed Comparison Tool (PMCT) pilot to reduce the burden which GAO was also asked to look at. While they found IRS's payment card matching program has the potential to reduce noncompliance, it was unclear whether it would reduce taxpayers burden.

GAO also found that the majority of small businesses use pass-through entities, like partnerships and S corporations, which prevent them from receiving a number of business friendly tax incentives. The average corporate tax rate is just 12.6 percent compared to 31.6 percent and 29.4 percent that S corporations and partnerships pay.

Comprehensive tax reform, not only corporate, is necessary to spur additional economic growth in our small business sector. In other words, small entities are not looking for special treatment, just equal treatment with their larger counterparts.

One of the principal tenets of tax policy is that we strive for simplicity and some semblance of certainty. The tax rules should specify when the tax is to be paid, how it is to be paid, and the amount to be paid. Through comprehensive tax reform, Congress can provide small firms with both, by limiting yearly policy changes which will help them more easily plan their business investments, operations, and estate planning based on those known laws.

I look forward to hearing from today's witnesses on the findings and recommendations contained in GAO's report. And I thank you for being here today.

Mr. Chairman, I yield back.

Chairman CHABOT. Thank you very much.

And if Committee members have opening statements prepared, we would ask that they submit them for the record.

And I will take just a moment to—before I introduce the panel, to kind of explain our rules. You get five minutes to testify. There is a lighting system. A green light will be on for four minutes. The yellow light will let you know you have got a minute to wrap up, and then the red light will come on and we ask you to stay within that as much as possible, and impose those same rules on ourselves, so we get five minutes to ask questions.

And I will now introduce our panel. We will begin with our first witness, Chris Mihm, the managing director for Strategic Issues at the United States Government Accountability Office. He leads GAO's work on government oversight and transformation issues such as performance management and collaboration, federal budgeting, regulatory policy, and federal tax policy and administration. He is a fellow and former board chair of the National Academy of Public Administration and an adjunct lecturer in Public Administration at the University of Maryland Graduate School of Policy, and we welcome you here this morning.

Our next witness will be Don Williamson, professor in the Department of Accounting and Taxation at American University. He also serves as the executive director of the University's Kogod Tax Center, a research institute focusing on the interests of small business. He has also served as an adjunct professor at American University's Washington College of Law. Professor Washington published over 50 articles in professional and academic journals and was recognized as the Bureau of National Affairs' Outstanding Author for 2007. Welcome this morning.

Our next witness will be Troy Lewis, who is vice president and chief enterprise risk management officer at Heritage Bank in St. George, Utah. He is also the manager of Lewis and Associates, a small accounting firm in Draper, Utah. Additionally, he serves as adjunct faculty in the taxation department at Brigham Young University. He is also chair of the Tax Committee at the American Institute of Certified Public Accountants, whom he is testifying on behalf of today. We welcome you as well.

Our next witness will be Les Vitale, managing director and partner at McGladrey and Pullen in Boston, Massachusetts. Mr. Vitale brings over 30 years of professional experience to his clients and his broad base of knowledge includes specialties in the traditional accounting, auditing, tax, and assurance services. He has authored technical articles and developed policy and procedural manuals for the firm in the areas of quality control, staff training and evaluation, recruiting, and technology.

We thank you all for being here, and I would now like to yield to Ms. Velázquez to introduce our final witness.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Stephen Mankowski is the vice president and national tax chair of the National Conference of CPA Practitioners, the nation's second largest CPA organization. His firm has been advising small firms on accounting and taxation for over 30 years, helping 2,000 clients annually. As an expert in the field, Mr. Mankowski has participated on IRS panels regarding compliance burden for small businesses and as a member of the NCCPAP, partook in the electronic payment pilot program that was examined by today's GAO report. Mr. Mankowski graduated from LaSalle University.

Welcome to the committee. Thank you.

Chairman CHABOT. Thank you very much.

We will begin with Mr. Mihm. You are recognized for five minutes.

STATEMENT OF J. CHRISTOPHER MIHM, MANAGING DIRECTOR, STRATEGIC ISSUES, UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE

Mr. MIHM. Well, thank you, Mr. Chairman, and Ms. Velázquez, and members of the Committee. It is an enormous pleasure and honor to be able to be with you here today to discuss our report on Tax Compliance Burden and Small Businesses. That report is being released today and it is available, of course, on the GAO website at gao.gov.

As this Committee is well aware, given the important role that small business plays in the U.S. economy, reducing the cost of compliance with the tax code frees up additional resources to expand,

hire new employees, and further contributes to economic growth. At the same time, small business tax issues are a significant contributor to the annual tax gap which is the difference between taxes owed and taxes paid on time. And as both the chairman and Ms. Velázquez mentioned in their opening statements, and IRS takes as a given as well, the overwhelming majority of taxpayers want to pay their taxes in full and timely manner. It is just that we need to make sure that we create the environment and give them the tools that enable them to do that, including reforms to the tax code as you pointed out. Thus, the key challenge for IRS is that they must minimize taxpayer burden while encouraging, and as the chairman pointed out with his reference to his constituent Scott, making possible voluntary compliance with the tax code.

My remarks today highlight the key findings of our report. I know you have seen it, so in the interest of brevity I will just hit four very key points on that.

First, most small businesses are individuals, but most small business income is generated by partnerships and corporations. According to Treasury analysis, small businesses make up about 99 percent of businesses in the United States. Treasury defines a small business for this purpose as individuals or entities with business activity that is less than $10 million in total income and deductions. Approximately 69 percent of small businesses, or about 1–6 million, are individual taxpayers who report business income. The remaining 31 percent, or roughly 7.3 million, are partnerships or corporations.

On the other hand, in 2010, individuals generated 23 percent of total income of all small businesses. This equates to about $1.4 trillion into the economy. Small business partnerships, S corps, and C corporations accounted for the remaining 77 percent of small business income, and that represented $4.5 trillion in income.

My second point. Tax compliance burdens vary across small businesses. The variance is driven by factors such as business asset size, by type—for example, is it a sole proprietor or a C corporation—number of employees and industry type. Our report details how certain tax compliance-related activities create burden. The report groups these into general categories, such as income tax activities, employee-related tax activities, and third-party information reporting.

As the chairman mentioned, SBA and IRS data has shown that there are very real costs both in terms of time and money with small businesses in order to be able to comply with the various requirements.

My third point this morning is that IRS does consider small business compliance burden in its decision making, but improvements are clearly needed. We interviewed small business representatives, including those from the AICPA, who said that IRS's outreach efforts have been effective in identifying opportunity to reduce compliance burden. As one example, IRS worked with stakeholders to develop a simplified method for small businesses to calculate the home office deduction. That change was introduced in January 2013. Previously, businesses had to complete a complex property depreciation calculation. As I am sure you have heard from your

constituents over many years, that had been a very real pain point for small businesses.

Nevertheless, and despite that real and important progress, stakeholders also pointed to a number of areas where IRS burden could be further reduced. These are areas of IRS customer service. Among others, those open recommendations that the chairman mentioned. We have recommendations in these areas that we believe need aggressive action from IRS and, that if effectively implemented, could improve service and help reduce the tax gap.

Fourth and finally, IRS's evaluation of its payment card pilot has strengths but needs to be more fully developed. This is obviously a point that Ms. Velázquez was making in her statement. IRS began this pilot program in 2012, and what it does is it compares payment data from payment settlement entities, such as credit card companies, with income reported by small businesses. The evaluation plan that IRS has for the pilot has many elements of a well-designed evaluation, which is a bit of an anomaly for IRS. They typically do not do that good of a job with their evaluations. I mean that as a positive statement I should say.

As a result, IRS has been able to make rapid and ongoing assessments of pilot activities and to make changes based on lessons learned. However, the overall evaluation lacks key performance measures for the pilot's goals—so we do not know whether or not it should be implemented more broadly, clear evaluation criteria, and other elements.

With that, let me end at that point and obviously take any questions that the Committee may have.

Thank you, Mr. Chairman.

Chairman CHABOT. Thank you very much. We appreciate that.

Mr. Williamson, you are recognized for five minutes.

STATEMENTS OF DONALD WILLIAMSON, PROFESSOR, AMERICAN UNIVERSITY, EXECUTIVE DIRECTOR, KOGOD TAX CENTER; TROY LEWIS, VICE PRESIDENT, HERITAGE BANK; LES VITALE, PARTNER, LOCAL MARKETS GROUP MCGLADREY, LLP; STEPHEN F. MANKOWSKI, PARTNER, EP CAINE & ASSOCIATES, LLC

STATEMENT OF DONALD WILLIAMSON

Mr. WILLIAMSON. Chairman Chabot, Ranking Member Velázquez, and members of the Committee, thank you for the opportunity to offer my suggestions for reducing the tax compliance burden on small businesses when preparing their tax returns.

My name is Don Williamson, and I am a professor of Taxation at American University's Kogod School of Business, where for the past 30 years I have directed the school's Master's in Taxation degree program. The MST program at American offers graduate courses in federal taxation to CPAs, experienced accountants, attorneys, and others who wish to expand their knowledge of our nation's tax law. As part of my responsibilities at American, I am also the executive director at the Kogod Tax Policy Center, which conducts nonpartisan research on tax issues affecting small businesses and emerging entrepreneurs that will enhance compliance while reducing compliance costs. And, for the past 25 years, I have had my

own tax preparation and tax planning practice for small businesses in Falls Church, Virginia.

My written testimony describes some of the tax compliance burdens imposed on small businesses that consume time and resources that cannot be employed in their businesses to create more jobs. Specifically, today, in my testimony, I want to recommend to the Committee that our tax code be amended to permit more small businesses to adopt the cash method of accounting on their tax returns. Generally, a taxpayer using the cash method of accounting recognizes income or deductions when cash is received or paid. An accrual basis taxpayer, on the other hand, must recognize income or expenses when all events fixing the right or obligation have occurred, regardless of when cash is paid or received.

As detailed in my written testimony, I believe that more small businesses should be allowed to adopt the cash method of accounting, rather than the current law requirement imposing the accrual method that is uniformly considered more complex and offers few advantages to small businesses whose chief concern with regard to their financial condition is their cash flow. It is important to note that the method of accounting adopted by a business, whether the cash method or the accrual method only affects the timing of when a business reports income or deductions on its tax return. The accounting method a business uses does not determine whether an item of income is taxable or expense is deductible, and does not affect the total income and deductions a business will recognize over its lifetime.

However, despite the greater simplicity and better fit of the cash method for small businesses, the entire revenue code continues to deny the cash methods to corporations with average gross receipts exceeding $5 million. As discussed in the Senate's Bipartisan Tax Working Group Report on business income tax issued this month, I urge Congress to increase the current threshold for use of the cash method to $10 million. Raising the threshold to $10 million will mean that 99 percent of all businesses in the United States could adopt the cash method.

But even when the cash method is available to a small business, certain judicial doctrines, such as constructive receipt for the recognition of income, impose unnecessary complication on a small business simply to accelerate the reporting of income by, in most cases, a few months before actual cash is received. Also, the requirement that a cash method small business may not deduct its cash outlay to purchase or produce inventory until that product is sold may satisfy accounting theorists but offers no immediate tax benefit to small businesses that expend considerable sums creating jobs.

To further reduce the compliance burden on small business therefore, I urge Congress to go beyond the proposals discussed in the Senate's Bipartisan Tax Working Group Report, and enact a simplified cash method of accounting described in detail in my written testimony. Under this method of accounting, a small business would simply look to its checkbook to determine its taxable income. It sounds simple and it is. Permitting small businesses to elect a simplified cash method of accounting will reduce tax compli-

ance costs, ease the burden of tax administration, and clarify the measurement of taxable income.

Thank you again for the opportunity to testify, and I would welcome any questions from the Committee.

Chairman CHABOT. Thank you very much.

Mr. Lewis, you are recognized for five minutes.

STATEMENT OF TROY LEWIS

Mr. LEWIS. Chairman Chabot, Ranking Member Velázquez, and members of the Committee, thank you for the opportunity to testify today.

My name is Troy Lewis. I am the vice president and chief enterprise management risk management officer at Heritage Bank in St. George, Utah. I am also a tax practitioner, adjunct faculty member at BYU, and chair of the Tax Executive Committee of the American Institute of CPAs. I am pleased to testify today on behalf of the AICPA.

We applaud the leadership taken by the Committee to consider ways to reduce the complexity faced by small businesses when preparing their taxes. Small businesses are the foundation of the U.S. economy, employing over half of the private sector workforce and creating nearly two-thirds of this nation's new jobs.

Unfortunately, compliance with federal tax laws can act as a roadblock. Unlike large corporations, time spent by small businesses in complying with tax laws is much more costly because they do not have the luxury of a large customer base with which to spread those costs.

We need to keep in mind that time devoted to tax law compliance has an impact on business creation, job growth, and economic prosperity. First, it is imperative that small businesses and their tax return preparers have the ability to communicate with the IRS when preparing their taxes and addressing compliance issues. However, there has been increasingly limited access to the agency. Through an informal survey we conducted earlier this year, we learned that over half of our members were either somewhat dissatisfied or very dissatisfied with the services they received from the IRS. This is no surprise considering that only 17 percent of our members said that the agency answered their telephone calls within a half hour. Most of our members were on hold for extended periods of time or did not have the time to wait that long.

Let me share with you one member's experience. "I was on hold for over an hour and a half. When the IRS agent finally picked up the call, they needed to transfer to another agent. I had to wait on hold for another hour. Finally, I received a recorded message that the office was now closed and I needed to call again the following day."

Unfortunately, this is not a unique experience. Many taxpayers also experience the IRS's so-called courtesy disconnects where the IRS disconnects a call without taking a message if the caller has been on hold for two hours. Nothing is more discouraging, frustrating, or inefficient for a caller than being hung up on after waiting for nearly two hours.

We understand the IRS has new initiatives and obligations, but taxpayer services must remain a high priority in order for small businesses to receive the assistance they so desperately need.

Another challenging tax compliance obligation that small businesses recently dealt with was the tangible property regulations. These rules, which address how businesses should report the purchase and improving a property are almost 500 pages of technical guidance and procedures. Now, to be fair, the regulations clarify some rules. However, they were still significantly burdensome for small businesses. The AICPA pushed hard for relief and stressed that time was of the essence. The IRS finally issued partial relief on February 13th, well into the filing season. Unfortunately, some small businesses and their tax practitioners had already spent time and resources attempting to comply with the regulations. If the IRS had acted sooner, small businesses could have been spared some administrative burden.

There are other issues that remain open in regards to the repair regulations. Currently deducted amounts in excess of the Safe Harbor threshold, taxpayers must prove that expensing such amounts in the current year clearly reflects income.

However, the clear reflection of income test can be challenging for any taxpayer, but especially for small businesses. These rules force taxpayers to depreciate the cost of items, such as a computer or a printer, over a number of years. To provide meaningful relief, Congress should increase the $500 Safe Harbor threshold to $2,500 and index the amount annually for inflation. To further reduce burden, we also suggest that you allow taxpayers with reviewed financial statements to use the higher $5,000 threshold.

Finally, we encourage you to examine all aspects of the code to reduce the complexity faced by small businesses when preparing their taxes. For example, penalty provisions need to consider their effect on voluntary compliance, and employers operating across state lines need a uniform, national standard for nonresident income tax withholding rules. The income tax deadline should also promote an efficient flow of taxpayer information to provide small businesses sufficient time to file accurate returns.

In summary, small businesses and tax practitioners are interested in, and so desperately need, tax reform to reduce the burden that hinders growth.

Again, with that, Mr. Chairman, thank you for the opportunity to testify, and I would be happy to answer any questions.

Chairman CHABOT. Thank you very much.

Mr. Vitale, you are recognized for five minutes.

STATEMENT OF LES VITALE

Mr. VITALE. Thank you. Thank you, Mr. Chairman, Ranking Member Ms. Velázquez, and members of the Committee.

My name is Les Vitale. I am a partner at McGladrey, a national firm. I work out of the Boston office, which is comprised of about 650 professionals. McGladrey is a firm that has 8,000 professionals that practice in 80 cities across the country. In addition to that, the group I practice in specifically is a small practice group called the Local Market Group. The Local Market Group is made up of about 50 professionals, including five partners. My client base in par-

ticular represents about 40 small businesses with sales ranging from under five million to up to 100 million in revenue with employees from 10 to just about 200. All of my clients are privately owned and many are family owned. The majority of my client companies are S corporations.

In preparation for today's testimony, I determined that it was best that I poll the practice group so that it was representational of the members of my firm. In trying to come up with some common themes, we did so, and we came up with three challenges that I would like to present to the Committee today. And those subjects include the TARS legislation relative to depreciation, privacy and security, and also S corporation basis.

So the rules with regards to TARS legislation in a word are onerous. The depreciation rules were originally set out to spread the timing of a deduction so there really is no question about the fact that something is deductible. So it is a question of not if, but when. So one of the items that was pointed out by my colleague, Mr. Lewis, was that there are differences between small and large companies and what they are allowed to do under these regulations, which has created a burden for the small client. Many of my companies do not have what is referred to as an applicable financial statement. Large companies, in particular large public companies, so very large companies that have audits due, the rules therefore are different. They are allowed larger thresholds up to $5,000. The small clients in our practice unit, the small S corporations, the family-owned businesses, have a $500 de minimis exception amount only if they elect it.

When polled, the members of my practice unit said that one of the things they have spent the most time on this year is the administrative and compliance requirements related to the TARS legislation. That legislation and those rules required and are requiring the filing of a Form 3115. 3115 could take on average from 10 to 15 hours of time. Larger corporations, even longer.

One of the suggestions and one of the recommendations that we would make in our firm, and we have talked about this internally, is the simplification of the election requirements in electing safe harbor for the de minimis rules. One method would be to simply modify the current Form 4562, which is the current depreciation form. It could simply be redesigned to include the questions that are asked of the 3115, and really reduce down the time requirements to prepare that form.

We would also suggest that the safe harbor amounts be revisited and consider raising those levels to $5,000. One of the things that the laws do not take into account is the degree of differences between companies. Service companies versus innovation companies are very different. Their needs and their investment in capital and there is really nothing in the code and the current constitution of the forms that allows for that flexibility.

In addition to that I wanted to cover briefly the privacy issues. In our firm, we have had over 20 breaches in the last four or five months. I have two going on right now. Those have required a significant amount of time, and I know I am not here to suggest that I have the answers to security and privacy breach, but the time that is spent on the phone, as also pointed out by my colleague, has

been significant, and I personally have spent probably 15 to 20 hours trying to resolve two cases.

The last item that I wanted to cover was S corporation basis. I have a client case right now that is under audit. The client has closed the business. They have been in business for about five years. They lost money each year, and the auditor has spent three days on the audit right now at great expense to the client, and it is all about the amount of basis that the client had. The basis rules and my dialogue are contained in my testimony feeder review.

Thank you very much for your time to present these.

Chairman CHABOT. Thank you very much.

Mr. Mankowski, you are recognized for five minutes.

STATEMENT OF STEPHEN F. MANKOWSKI

Mr. MANKOWSKI. Chairman Chabot, Ranking Member Velázquez, and members of the Committee, thank you for inviting me to testify today.

My name is Stephen Mankowski, and I am a CPA. I am the executive vice president and tax policy chair of the National Conference of CPA Practitioners.

Tax compliance burden has been defined in the GAO Report on Small Businesses as the time and money spent by the taxpayer to meet tax obligations, not the associated liabilities. An objective of the administration and the IRS has been to minimize taxpayer burdens and eliminate unnecessary ones.

There has been a decided change in how business is transacted. Credit cards have become the norm. Business owners have had to accept the payment processing, compliance, and equipment rental costs as cost of doing business. Online sales have caused the IRS to question the voluntary compliance of reporting all revenue.

As a result of a 2008 law, payment card processors had to begin reporting credit card receipts of the IRS and the merchant in 2011 and added the number of monthly transactions for 2012. Once a merchant annually has 200 transactions and sales of at least $20,000, they will receive Form 1099-K, Merchant Card and Third Party Network Payments. Initially, 1099-K results were to be placed directly on the specific lines on tax returns. This changed as many issues arose. Specifically, there was confusion on how sales tax gratuities and merchandise returns were handled on 1099-K. Those same concerns still exist and are just some of the reasons that the IRS has not taken a stronger stance on the use of the information on these forms.

Business owners track revenue by specific categories, such as sales, consulting, or rental income. They do not track revenue based on how they are paid. Trying to accurately track revenue to match the 1099-K would actually result in an accounting nightmare. To further complicate the recordkeeping, businesses receive a 1099-K for each specific payment processor—one for MasterCard/Visa, one for American Express, one for PayPal, and another for Discover. And even a second round if they change processing firms during the year.

From the IRS viewpoint, this form has helped increase voluntary compliance among small businesses. Many virtual businesses that had previously flown under the radar are now filing income tax re-

turns and paying taxes. In addition, the 1099-K has allowed the IRS to establish a database whereby they can obtain a better understanding of the revenue sources within particular industries.

The IRS instituted a pilot program for the 2015 filing season called the Payment Mixed Comparison tool that utilizes database. NCCPAP was invited to participate in this program, which allows our members to enter selected data from the client's 1099-K. The tool accesses the IRS database by a specific merchant category code (MCC) and compares various ratios for a business. The result tells the CPA if the results are within the specifications of the database. A common flaw with the 1099-K is that if the payment processor enters an incorrect MCC code for a business, the results could be beyond the standard deviation, which may result in an IRS notice. The results from the tool have been strictly for the benefit of the taxpayer and for informational purposes only.

Currently, the IRS is not capturing data from this tool. The database will continue to improve as the volume of 1099-K data is input into the tool. Unfortunately, the tool did not get the expected usage due to practitioner concerns. Specifically, many practitioners did not believe that the IRS was not tracking results, the name of the tool was not the best, and the tool did not go live until February 2015, after most CPAs had already completed their training and had begun preparing tax returns. In addition, many felt there should be a better results besides typical or unusual. Hopefully, this program will continue and improve next year and we will see more uses by tax professionals. If used properly, this tool could actually reduce taxpayer burden by addressing issues of credit card revenue while the data is still fresh in the business owner's mind.

The form 1099-K program also has the potential to be a disaster. This is a repeat of warnings from NCCPAP and others in the practitioner community when the form 1099-K matching program was first proposed. The IRS should use all tools possible to ensure tax compliance and close the tax gap. However, as the GAO has correctly indicated, this is a flawed system with no reliability of matching gross income with the 1099-K reports.

I would like to thank Chairman Chabot, Ranking Member Velázquez, and all members of the Committee for the opportunity to present this testimony today. I will be happy to answer any questions. Thank you.

Chairman CHABOT. Thank you very much. I think it was excellent testimony by all the witnesses here this morning, so we thank you for that. And we will go ahead and open up the questions, and I will yield myself five minutes to begin.

I will start with you, Mr. Mihm, if I can. In your report, you identified around 25 past GAO recommendations that if implemented could help reduce compliance burden on small businesses. How seriously do you feel that the IRS has taken the GAO's recommendations thus far?

Mr. MIHM. I think on the whole, Mr. Chairman, the IRS does take our recommendations seriously. I mean, they have wide ranging and very difficult responsibilities. We are always making recommendations.

Chairman CHABOT. Have they implemented any of them?

Mr. MIHM. They implement quite a few. The ones that we are talking about today are ones that we believe they have not yet implemented, and there are still plenty of opportunities on that.

Just as an example, the telephone answering over the last year. 2014, if you called 67 percent of the time you could get through. 2015, you were getting through 59 percent of the time. I am sorry, 39 percent of the time. These are the courtesy disconnects. What an Orwellian term that Mr. Lewis has mentioned. The wait times——

Chairman CHABOT. The courtesy disconnect as it was referred to, if you have been waiting on there for two hours, their courtesy is to basically hang up on you?

Mr. MIHM. They hang up on you. Yeah.

Now, very often though you beat them to the punch because the hang-up rate in 2014, the individual saying I cannot take this anymore was 29 percent of the calls. It was 57 percent this year. And that is also explained by the wait time. The wait time in 2014 was about 17 minutes and about 28 minutes this time. And these are averages.

What we have urged IRS to do is a couple of things. One is that they need to benchmark their telephone assistance service. They are not the only organization in the United States that has a call center, and so there are plenty of other places that they can benchmark against.

Second is that they need to then also be thinking of an integrated strategy that considers how they can provide service and information to taxpayers using both the phone and then also using and augmenting the IRS website and having more of an Internet-based strategy for getting information out there.

And then finally, they need to engage the Congress. As their resources have been going down in recent years, they need to make sure that they take a strategic approach, sit down with the Congress and say these are the tradeoffs that are being made. If there are different tradeoffs that we should be making, please give us guidance on that. But those are all open recommendations.

Chairman CHABOT. Thank you very much.

Mr. MIHM. Yes, sir.

Chairman CHABOT. Mr. Williamson, I will turn to you next.

Now, you are a professor and you also have a tax preparation service yourself. What is the biggest one or two complaints that you hear from the small businesses that you do their taxes for?

Mr. WILLIAMSON. Well, they do not understand the law. And when taxpayers do not understand the law, they come to disrespect the law. And we all know what happens next, and that is fraud, that is cheating. So what we need is simpler rules that I, as a tax return preparer, can explain to my clients and they can accept me to prepare the return and pay their fee to pay their tax. I think all of us here today have said taxpayers want to pay their tax. I hail from Utica, New York. I know the people in Utica, New York, want to pay their tax. But the problem is they do not understand the law.

Chairman CHABOT. And you indicated that you feel strongly that going to a simplified cash method of accounting——

Mr. WILLIAMSON. Absolutely, sir.

Chairman CHABOT.—would be one of those critical things we could do to make it more understandable?

Mr. WILLIAMSON. The clients I represent, and I represent the smallest of the small probably at this table, where $300,000 or $400,000 a year of sales on a Schedule C is a living for your family. Those folks do not need to do depreciation schedules and be on the accrual method and do cost of goods sold. They know what they need. They need cash in the bank, and they are willing to take some of that cash and pay their tax with it.

Chairman CHABOT. Thank you.

Mr. Lewis, you said something which I agree with very much, and if you want to expand upon it briefly, you said that the time spent by your average small business person in compliance with the tax code is time that they are not spending on what their basic business is and having a successful business so they can perhaps expand and create more jobs for more people. Is that accurate, and did you want to comment on that?

Mr. LEWIS. Yes, it is accurate. And I think one thing to keep in mind is any one particular provision when it starts out has a reason. These tax code laws that we are talking about, at one point there was either a motivation or something. But when added upon the ones from last year and adding upon the ones from last year and the last year and the last year, you find that you have got these layers. And what we have done is we are not taking everything away. So every single year you find yourself getting more and more. So even if you say this particular provision is not that burdensome, you have to take it in context of what about the last 20 years and all of that added together. It is simple. They have so much time in a day. If you are taking their time by making them comply with regulations, you are taking time away from what they do.

Chairman CHABOT. Thank you.

I will be real brief in my last question, Mr. Vitale.

Do you think it has reached the point where it is almost impossible for a small company nowadays to do their own taxes?

Mr. VITALE. Yes. We have some very small clients similar to the professor, and even the smallest of small clients, they have access to TurboTax and a lot of tax programs that supposedly could make their life easier, but we get calls all the time from small, small companies that still need help with that.

Chairman CHABOT. Thank you.

Mr. Mankowski, I apologize. I ran out of time, but I am sure you will get more questions.

So I now yield to the ranking member for questions.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Mihm, the payment card pilot essentially compares 1099 forms from payment processors with tax returns to identify underreporting and inconsistencies. If the information on the forms does not match, the IRS sends out notices. What is the benefit of a notice if it leads honest companies to have to put in additional work to reconcile forms that may be mismatched for unrelated reasons such as self-tax, tips, so forth?

Mr. MIHM. Yes, ma'am. There are actually two benefits. One is before the notice goes out, you would hope that the knowledge that

IRS is receiving this payment card information and that this matching is taking place will be an incentive to get them to do that. IRS has seen some very early data that they believe is showing that that is the case. Again, this is a minority of taxpayers we are talking about.

For the other taxpayers, it is, as clearly you are implying in the question, it is not much of an advantage for them if they have to, in a sense, go back and correct an IRS record on this. This gets to why we think it is so important for IRS to have a good evaluation strategy. The potential for this pilot, like a lot of third-party information reporting, is that it can really reduce burden, can help improve compliance, so it could be a big deal. And I realize that all three of those were conditionals that I used—could, could, could. But they have to make sure that they implement it the right way. They have to make sure that they reach out to the stakeholders and engage them in the design of the program, and they need to make sure that they are actually measuring the performance so that they know if they are actually getting more benefit for this program or are we sending out bogus notices to people that is actually causing more headaches for honest taxpayers.

Ms. VELÁZQUEZ. An important element, of course, is the type of outreach that the IRS will do.

Mr. MIHM. Absolutely, ma'am.

Ms. VELÁZQUEZ. So when you look at tax compliance and the effect it could have on small businesses, did you also look at the fact that since 2010, the IRS lost 18 percent of its budget? Does that have anything to do——

Mr. MIHM. Yes, ma'am. And that was the reference I was making to the question of the chairman, is that the IRS needs to engage with the Congress, given how much their budget has gone down. Now, this has all been with added responsibilities. You know, both in the growth of the number of taxpayers, Affordable Care Act implementation responsibilities, other changes to the tax laws. They are in a very difficult position as an agency, and I realize there is not a lot of appetite to be looking to plus up the IRS budget.

Ms. VELÁZQUEZ. Right.

Mr. MIHM. Which means why do we have to engage in that?

Ms. VELÁZQUEZ. But we need to understand that by cutting the budget so that it punishes the agency, in reality, it punishes small businesses because they will not get the type of services needed, such as when you place a call and expect for someone to be able to answer that call.

Mr. Mankowski, you describe how accepting credit cards and their related fees is becoming the norm and just another cost of doing business. However, as you stated, the complexity of accepting different cards with different rules about deposits and deductions adds to taxpayers' burden, how does the rising popularity of electronic payments impact your firm's typical small business client?

Mr. MANKOWSKI. Thank you. It has been a major impact on the clients. They are finding that in the past where they have just been able to just accept cash and checks, that more and more of the population, for whatever reason, has an aversion to carrying cash, and they are paying with credit cards even if it is for a two

dollar soda at the convenience store or wherever else they are transacting business. So it is something that they have really been having to assume the burden of. And with that, they have added fees, not just with the processing fees that are going to vary based on the type of credit card that is being used, whether it is a points card or so forth that tend to have higher rates, in addition to the different rates that MasterCard/Visa, versus American Express or Discover. But now they are also finding that in addition, because of credit card fraud that has also been going on, that now they also have added compliance burdens that they are required to go through, whether it is some sort of training and annual webinars or seminars that they need to undergo to be aware of compliance and whether there are different rates and different services that they are required to do if the card is present or if the card is not present, to make sure that they are not participating in the fraud that they are trying to prevent.

Chairman CHABOT. Thank you.

The gentlelady's time has expired.

The gentleman from Missouri, Mr. Luetkemeyer, who is Vice Chairman of this Committee, is recognized for five minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. I am way over here on the corner.

Mr. Williamson, you mentioned in your testimony cash accounting, accrual accounting. You do business with a lot of small businesses, and there is a thought process of lowering the amount where you have to start going to accrual accounting. What would that do to a lot of the small businesses you deal with?

Mr. WILLIAMSON. It would make it a lot easier for them to file their tax returns.

Mr. LUETKEMEYER. If you lower it to——

Mr. WILLIAMSON. Lower it? No, we are advocating raising the threshold that would permit you to drop the cash method to $10 million. To lower that, I think you would have serious compliance problems.

It alludes to the point I was making a moment ago about disrespect for the system. And if people do not feel that filing their tax return adds any value other than having their money confiscated by the federal government, I do not know if you would get very many correct tax returns as a result.

Mr. LUETKEMEYER. You were talking about noncompliance. I was reading the problem with Greece this past month or so here that they have 95 percent noncompliance with regards to paying——

Mr. WILLIAMSON. Well, I sincerely hope we never——

Mr. LUETKEMEYER. I do not know how in the world their economy can exist if they have got 95 percent noncompliance.

Mr. WILLIAMSON. I think we see it is not.

Mr. LUETKEMEYER. They have got a one percent problem, do they not?

Mr. WILLIAMSON. Yes, sir.

Mr. LUETKEMEYER. You also made a comment, and I want to follow up on this which is quite interesting, that your clients do not understand the law.

Mr. WILLIAMSON. Yes, sir.

Mr. LUETKEMEYER. If you have small business people who do not understand tax law, how can they make good plans? How can they make good business decisions? How can they make good judgments on how they want to run their business? Are you advising them on this? Are you taking an advisory role? Or are they just out there like a ship without a rudder? Because if you do not understand the tax implications of the business decisions you make, you can really mess up your business pretty quickly.

Mr. WILLIAMSON. Precisely, Congressman. And too often that is the case. People make business decisions without understanding the tax consequences of them. And I like my clients to always know they can call me and ask a question and will not necessarily get a bill off the top, not like the lawyers. But I would hope that they would call me. But the problem is the law is so complex.

Chairman CHABOT. The chair will strike that last remark from the record. Just kidding.

Mr. WILLIAMSON. But you are absolutely right, Congressman. Businesses do not understand tax law, and too often make the wrong decision.

Mr. LUETKEMEYER. And the complexity of it just adds to the problem.

Mr. WILLIAMSON. Yes, sir.

Mr. LUETKEMEYER. So we are adding to that problem every year as we go about our business here.

Mr. Lewis, you are in the banking business. I have got a quick question for you here. We have created fewer businesses in the last six years than we have lost, so we have actually gone backwards. And of course, when you are talking about creating businesses, it is small businesses that we are talking about creating. And so have you seen in your business world, that the tax code and the complexity of it and the cost of compliance, all of this is a factor that has caused fewer businesses to actually be created?

Mr. LEWIS. Yes, and that is a great question. I think the answer in short is yes. Again, it goes back to simple algebra. At some level there is only so many hours——

Mr. LUETKEMEYER. You better make simple algebra very simple for me.

Mr. LEWIS. There are only so many hours in a day, and there is only so much time and there is only so much revenue coming in. And again, look at the banking, look at the financial services, for instance. The last decade there has been all this bank regulation that has come upon us. Just look at the bank itself. What you find is you find all this additional level of compliance that is required, and any one particular provision makes sense. There is a reason for it. But taken as a whole, it becomes problematic because in the end, really, as was mentioned here, a small business owner, what really matters to them is what they can put in their pocket at the end of the day. It is the cash in their pocket. It is what they can do. It is what they can consume. It is to take that money and pay for tuition for their child. It is to take a vacation. It is to pay a mortgage. That is what really matters. And all the rest of this that we are discussing is getting to that bottom line.

So you asked the question, what kind of an impact does it have? First of all, I cannot advise a client right now on the tax law for

the current year because we have the extenders that are still out there. How can I go to somebody and tell them what is going to happen with bonus depreciation? Or 179? They are going out to make a decision right now. They want to make a decision but instead they are paralyzed because they do not know. Tell me what the law is they will say, and then I will know how to react. You can help me, because after that it is an Excel spreadsheet. You can run it. But before then, without certainty, without permanency, you run into this problematic situation where, yeah, it does impact those businesses.

Mr. LUETKEMEYER. That is interesting. You talk about 179 depreciation. Last year we did the extender I think two weeks before the end of the year, and I have got a good friend of mine who runs a business that he sells a lot of rock crushers and drills and things like that for quarries. And he, over the course of the year, sold 11 different drills. Sold 11. But he sold six of them in the last two weeks of the year. Now, these things cost between $100,000 and $125,000. And I can tell you the same story with regards to farmers buying tractors and farm equipment. They waited until the last two weeks of the year in order to make that decision because they were looking for this opportunity.

Mr. LEWIS. It certainly was not because of Christmas; no.

Chairman CHABOT. The gentleman's time is expired, but if you wanted to comment.

Mr. LEWIS. I was going to say and the reality is the commentary would be if the tax law has a shorter shelf life than say a carton of milk, it is probably something we ought to look at. That is going to impact them.

Chairman CHABOT. The gentleman's time is expired.

The gentlelady from North Carolina, Ms. Adams, who is the ranking member in the Investigations, Oversight, and Regulations Subcommittee, is recognized for five minutes.

Ms. ADAMS. Thank you, Mr. Chairman, Ranking Member Velázquez, for hosting this hearing.

Tax burden on small businesses buried in the complexities of the tax system is something that we must tackle head on. The state of North Carolina is home to more than 800,000 small businesses, which means that there are more than 800,000 small firms in my home state that potentially have tax compliance issues, including cost burdens associated with tax compliance.

Mr. Williamson, how should the current tax code be altered to reduce that cost burden for small businesses?

Mr. WILLIAMSON. Well, in terms of the tax return itself, we could make that a lot simpler. All of us have advocated here with respect to advancing more cash method of accounting so you do not have the need to compute your inventory, cost of goods sold, the depreciation schedules you have to keep. Basically, treat everything as 179 as was alluded to earlier, or as bonus depreciation, 100 percent depreciation. And so it is simply to prepare your tax return based upon your checkbook and the cash that comes in, the cash that goes out, and we net the two and that is your taxable income. That makes a very simple tax return.

Ms. ADAMS. Okay.

Estimates by Internal Revenue Service of the size and the composition of the federal tax gap indicate that small businesses organized as a pass-through entity account for a substantial share of that gap. Their contributions are thought to be the result of honest mistakes born of the complexity of the code and tax evasion tied to cash payments for goods and services. How should the federal tax code be reformed to reduce noncompliance by small businesses?

Mr. Williamson?

Mr. WILLIAMSON. Well, as far as the pass-through entities go, and as was already pointed out here in the testimony, most revenue for small businesses is coming through pass-through entities. We can, again, through the cash method of accounting, easily determine what the net profit is of the business and allocate it to your partners or to your S company shareholders on the K1s. The complication that arises is they need to separately account for all the items on a partnership return or S company return because they might impact an individual partner or individual S company shareholder differently. That is a problem in terms of the pass-through entities.

I would offer, and again, I think a proposal has been made, for earlier filing of pass-through entity returns so that the information forms through the individual partners or shareholders would be in their hands a lot sooner, and that way they would have more time to prepare their tax returns and that would increase compliance.

Ms. ADAMS. Okay. I have one final question.

Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending.

For Mr. Williamson and Mr. Mihm, have you studied the impact that tax compliance has on minority-owned firms, and if so, what is the rate of minority-owned firms closing their businesses as a result of the difficulty in the tax compliance compared to white-owned firms?

Mr. WILLIAMSON. Congressman Adams, I do not have those statistics in front of me. I can be happy to do my best to try to find some of that information for you but I have no information on the relative closures of minority firms versus nonminority firms at my fingertips. I am sorry.

Ms. ADAMS. Would either of the other gentlemen like to respond?

Mr. MANKOWSKI. Ma'am, we do not have that information either, but we would be happy to work with Mr. Williamson and others to make sure we answer your needs on that.

Ms. ADAMS. Okay.

One challenge to tax compliance for small businesses may be that the tax code has no uniform definition of a small business, so how should small businesses be defined for tax purposes?

Mr. WILLIAMSON. What we have done in the Tax Policy Center is to define them as $10 million of gross receipts. If you look at provisions of the Internal Revenue Code, Uniform Capitalization Rules, some of the other provisions regarding, $10 million seems to be a generally accepted threshold. And I think that is what the GAO study used as well.

Ms. ADAMS. Would either of the other gentlemen like to respond?

Mr. MANKOWSKI. Yes, ma'am. We have used, taking Treasury's lead, we use $10 million, although as you point out, there are a variety of different ways that you can do it. Number of employees. But we use the $10 million. I should also point out that the way IRS is organized implicitly assumes that the $10 million, their small business unit has a $10 million threshold to the organizations or entities that it looks at.

Ms. ADAMS. Thank you.

Mr. Chair, I yield back.

Chairman CHABOT. Thank you. The gentlelady yields back.

The gentleman from New York, Mr. Hanna, who is chair of the Subcommittee on Contracting and Workforce is recognized for five minutes.

Mr. HANNA. Thank you, Chairman.

The tax cap that you spoke of, Mr. Mihm, and everybody alluded to in one way or another, I would like to talk to you about the underground economy and the propensity for it to grow over time through difficulty in the tax code and what you see on the ground. It is a concern to a lot of people. I mean, there are all kinds of incentives not to pay your taxes. One of them is other people are not. In the aggregate nature of the 1099s and collecting credit cards, that is pretty subjective. It certainly can be. I am curious how it is fair.

And Mr. Williamson, one of the problems with going from five to 10 on a cash basis, and what the IRS does now is if you buy inventory on a cash basis, then basically, you are mixing your accrual system with your cash system.

So Mr. Mihm, if you could address my question about the underground economy and its growth. If you are prepared to do that a little bit, or anybody who would like to.

Mr. MIHM. Yes, sir. The tax gap as you are mentioning is enormous. I mean, IRS estimates—this is based on 2006 data—but it is about $450 billion a year. And this is the difference between legally owed and actually paid in a timely manner. Some of that is clearly the underground economy, meaning that it is nonfilers. In the technical term, this is people that ought to be filing that just are not.

Mr. HANNA. Do you have any idea? How could anyone have an idea what that is? But do you have one?

Mr. MIHM. Well, they have a national research program so it is an enormously complex estimation that they do. The size of the underground economy is probably the weakest aspect of that estimate. A lot of that, also the tax gap source is underreporting of people who do actually report but do not report the full amount.

Mr. HANNA. But so much happens with compliance on the margin.

Mr. MIHM. Yes, sir.

Mr. HANNA. Virtually everything, right?

Mr. MIHM. Right.

Mr. HANNA. So marginally, difficulty with filing, as Mr. Williamson talked about, the cash basis, which is certainly easier, what do you think that looks like today?

Mr. MIHM. Well, your point, sir, about it being marginal is exactly right, and it gets to what one of the key strategies needs to be, which is assuming that most people do want to pay their taxes—now, we are not talking about the underground economy in this case, but assuming that most people do want to pay their taxes, and then making it easier for them to do so, because in many cases where there is underreporting, the amount of underreporting makes it hard to justify going after any one individual. I mean, you have to in some senses to get a deterrent effect to make sure that people always know that they have to, but you do not want to spend a million dollars going after $5,000. You cannot do that in all cases.

Mr. HANNA. But is that not part of the problem?

Mr. MIHM. Yes, sir.

Mr. HANNA. I mean, because what you are really doing is you are sending a message that you are incentivizing smaller taxpayers' amounts of money because you are only after those people where the money is. Right? Willie Sutton.

Mr. MIHM. Yes, sir.

Mr. HANNA. But when you look at the aggregate number, you mentioned $450 billion, that would draw you towards an opposite conclusion. It might.

Mr. MIHM. Well, that is why good customer service is so important. That is why third party reporting that makes compliance relatively easy for people is so important. Because obviously, you are making exactly the right point here. Trying to chase the money after the fact is ultimately not going to be very good. It is not going to be good for the businesses because of the mistakes that could be made as the ranking member mentioned. It is not going to be good for the IRS because of the cost benefit of that. We need to make sure that we have in place the right independent third party reporting. We make sure we have the customer service.

Mr. HANNA. So even though the money is not there, the value of going after those people who fall completely under the radar, not paying at all, the underground economy, there is value in that?

Mr. MIHM. Yes, sir. You cannot do that in all cases but we need to do enough of it so that as the vice chair was mentioning in his questions, is that we do not get basically a sucker tax system where the people who are paying their taxes are the criminals.

Mr. HANNA. Mr. Williamson, how do you reconcile, if you got to 5 to 10 on a cash basis and get rid of accrual for everybody under that, how do you reconcile—and I have got about 38 seconds—the inventory?

Mr. WILLIAMSON. That is the point. That was the point in my written testimony, Congressman. We would eliminate cost of goods sold and that the purchases or construction of inventory would be deducted as those costs are incurred regardless of when the product is actually sold.

Mr. HANNA. But are you not giving bonus depreciation to everything that used to be called inventory?

Mr. WILLIAMSON. That is what we were saying. In a world that we would be advocating, bonus depreciation would be extended to inventory.

Mr. HANNA. Thank you. My time is expired.

Chairman CHABOT. Okay. Thank you very much. The gentleman yields back.

The gentlelady from American Samoa, Ms. Radewagen, who is the Subcommittee chairman on Health and Technology is recognized for five minutes.

Ms. RADEWAGEN. Thank you, Mr. Chairman.

My question is for Mr. Vitale. Is it safe to say that the higher cost associated with the tax compliance obligations that tax professionals endure push small business owners to waste their time preparing their own complicated taxes instead of growing their business?

Mr. VITALE. Great question. There is probably an element of truth to that. The fundamental problem is going to remain until the code is simplified and clarified. The person who has invested in their business and has a lot at stake is, more often than not, going to eventually reach out to the professional to try to get the right answer and the best answer possible. And that is an expensive proposition. But the cost of them not doing that and going the other way at the end of the day could probably be much more costly by their failure to comply.

Ms. RADEWAGEN. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman CHABOT. The gentlelady yields back.

I now recognize the gentleman from South Carolina, Mr. Rice, who is chairman of the Subcommittee on Economic Growth, Tax, and Capital Access for five minutes.

Mr. RICE. Gentlemen, thank you so much for being here today. I heard directed stated or allusions to the fact in all of your testimony that small businesses are the backbone of the economy and the backbone of job creation in this country; right? Pretty much everybody agrees with that.

Beginning in 2009, for the first time since it has been recorded, more American businesses are closing than are opening. Do you think this outdated and burdensome tax code has anything to do with that, Mr. Mihm?

Mr. MIHM. That is something, sir, that we really have not looked at directly, so I will have to defer to my colleagues on the panel if I may.

Mr. RICE. Okay. Well, do you think overburdening government regulation, do you think that has anything to do with it?

Mr. MIHM. Well, there are certainly, as we pointed out in this testimony, other findings looking at regulations in general. There are costs associated with the implementation of regulations. There are costs to small businesses. And we have a table that shows that for corporations, if you have less than five employees, it can be between, you know, around $4,500 per employee in order to comply. That is a substantive cost that is imposed.

Mr. RICE. Do you think the complexity of our tax code creates a barrier to formation of small business?

Mr. MIHM. Certainly, the complexity of the tax code creates a barrier to any economic activity. It creates a barrier to compliance. It creates a barrier to economic growth.

Mr. RICE. Mr. Williamson, for the first time, beginning in 2009 and continuing through today for the first time more American

businesses are closing than forming. Do you think our complicated tax code has anything to do with that?

Mr. WILLIAMSON. In my personal experience, what it is usually about is "I better get out of business because I cannot pay my payroll taxes for my employees."

Mr. RICE. Mr. Lewis, do you think—same question to you. Do you agree our tax code is a burden to formation of small business and to continuing small business?

Mr. LEWIS. I think the tax code is certainly a contributor. One of the things that I think is missing in most of our regulation, which is in essence what tax law is, is we failed to adequately address the cost benefit. I know I hear it. I see it. People talk about it. But are we really looking at cost benefit from the small business lens? That is the question. Right? I mean, you will hear people, they will espouse from the floor this is a good thing and it weighs, outweighs, but I think the real issue is from a small business lens. One of the things we have is a fundamental——

Mr. RICE. Mr. Lewis, it is not that I do not want to hear; I do want to hear, but I only have five minutes left to keep going.

Mr. LEWIS. All right.

Mr. RICE. Mr. Vitale, I am going to shift questions on you.

Since 2010, notably the date that Dodd-Frank was enacted, bank formations have slipped from an average of 100 per year to three per year. Do you think that will have any effect on small business given that new banks are typically small banks and they are typically the ones who lend to small business?

Mr. VITALE. I believe the answer is yes based upon—I will affirm in our client base, we are a $1.6 billion revenue firm. Sixty, 70 percent of our business is labeled as small to midmarket, and with the reduction in the number of banks that we have seen—community banks, local banks, we have seen many of our clients go to alternative markets for their financing. That financing is often much more expensive.

Mr. RICE. But the really small businesses, those alternative markets are not really available to them, are they?

Mr. VITALE. The alternative market is usually an angel investor or private investor, and that money is even more expensive.

Mr. RICE. Mr. Mankowski, do you think that the slippage of an average of 100 bank formations to three, which these new banks are typically the lenders to new banks, do you think that will have an effect—to small businesses, excuse me—do you think that will have an effect on business formation?

Mr. MANKOWSKI. I think as far as business formation, not necessarily, because a lot of the businesses, recently they have been the byproduct of the overall economy where they have been downsized out of their current opportunities, and now they have exhausted their unemployment benefits and they have kind of been forced into their own businesses. So the bank formation, not so much of causing people to not form their businesses, but I think it hurts them if they are looking for additional revenue because I do agree that the smaller banks and the community banks seem to be the ones that really are more in tune to lending to the small businesses.

Chairman CHABOT. The gentleman's time has expired.

The gentleman from Nevada, Mr. Hardy, who is chair of the Subcommittee on Investigations, Oversight, and Regulations, is recognized for five minutes.

Mr. HARDY. Thank you, Mr. Chairman.

I just happen to be a small business owner myself, or at least I used to be. And Mr. Williamson made the statement, Mr. Lewis, just a few minutes ago, the fact that people, businesses want to pay their taxes. And I agree. As a small business person, I want to pay my taxes. Would you agree the reason we want to pay our taxes is because we have to have a good, sound foundation to make sure we are profitable in paying taxes in order to receive revenue from banks?

Mr. LEWIS. Yeah. I mean, one way to look at it is that small business owner is in a partnership with the federal government. There are a lot of services, a lot of economic ability to make money. And so there is this agreement. And the tax code is sort of like the partnership agreement. It defines how we are each going to behave with each other, and I think the majority of Americans that own these small businesses are hard-working, they are entrepreneurial, and they want to do what is right. It is when you start adding in complexity, the lack of certainty, the perception of inequality, I think that is where you start getting the fringes where people start to take a step back and either through overt or covert actions maybe are a little less complaint. But I think the majority want to comply.

Mr. HARDY. I believe there are a number of things that are causing small businesses to fail, but in 2012, 64 percent of all employees working were working for small businesses. Today, we have the lowest number of small businesses in the last three decades or further. Is it because of our tax regulations? Do you think it is a combination of a number of things? Anybody care to address that?

Mr. WILLIAMSON. Well, I will just say that it is very difficult for my clients when they decide whether they are going to take the next step and hire someone. As we have seen here today, it is very expensive. Just the tax compliance costs are very expensive. The 941s, the W-2s, the payments every two weeks or a month. That is very intimidating for a small businessman to take on that first, second, or third employee, and then to have the cash flow, of course, to be able to pay them their wage.

So regarding small businesses, that, in my practice, holds them back as to whether they are going to hire those first two or three people. That is a big, big deal with them, and the tax rules impede that.

Mr. HARDY. Some months ago we had a hearing here and they discussed other tax causes to small businesses, and once you grow just even your business a little bit, the average, I think it was, about $1.2 to $1.5 million per year for people to get their taxes done once they reach a certain threshold. Have you seen that, Mr. Williamson, on your avenues? That is just to prepare it to get it to you folks.

Mr. WILLIAMSON. That is true. To assemble the books and records to put them on my desk so I can do the return is quite a procedure for them. And to ask me, or anyone at this table to do that kind of work can be very, very expensive, and it is very hard

to find people that have the skills to assemble that financial information for them in order to have me even begin the tax return. No question about that.

Mr. HARDY. The 1099 form, Mr. Mankowski, why does the 1099 requires so much for small businesses, is such a burden? Can you go into a little deeper process of what your discussion was there?

Mr. MANKOWSKI. Yes, there are two aspects. First is that there is common belief that there are items that to go onto the credit card receipts that are not revenue to the business owner, such as sales tax, gratuities, and even if someone has a return of merchandise that they purchased.

Take a restaurant as an example. If you put your gratuity onto your credit card, that will show up on the 1099-K, but that is not revenue to the business owner. Another concern from a 1099-K perspective is if you have one of your vendors that pays you with a credit card, where normally they would issue you a 1099-MISC depending on the type of service, if you pay with a credit card, you no longer have that responsibility to issue that person the 1099-MISC if their only payments were credit cards in excess of $600 total for the year. If you now have payments under the $600 that were totaled under with cash or checks, you are relying on the credit card processor to issue the 1099-MISC. In essence, it falls on the 1099-K, not through the 1099-MISC, a form that the government is not really using for full verification of the income for the business owner.

Mr. HARDY. Okay. Let me ask one last question.

Mr. Vitale, as far as the IRS, can you elaborate how they can and should be providing us better security for small businesses and all businesses in their businesses to make sure we are protecting that security of those tax returns?

Mr. VITALE. Sure. One of the things that I highlighted in my written testimony was the use of PINs. We have some experts in the office that specialize in security, cybersecurity, and I believe the way the world is going towards a PIN-based system, the current Social Security Number is very vulnerable, very easy to get at. It is very easy to hack, and that is the gateway to a lot of theft. And I believe the transition has to happen sooner rather than later.

Chairman CHABOT. The gentleman's time has expired.

We are going to move into a second round, and we are going to start off with Ranking Member, Ms. Velázquez, for five minutes.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Mr. Williamson, we know that there has been a movement away from businesses organizing as C corporations in favor of pass-through entities. Today, corporate tax revenue makes up less than 10 percent of our federal revenue. What is it about pass-through entities that make them such an attractive business structure, and what is the effect on small firms when our tax policy hinders their use?

Mr. WILLIAMSON. Well, that is an excellent question, and obviously, the answer is, of course, C corporations are subject to two levels of tax, once at the C corporation and then a second tax when any sums are distributed to the shareholders. That is why you have a continuing decline in C corporations, particularly when you

have S corporations available that are corporations for all purposes other than the IRS revenue code. And also, now you have the LLC, the limited liability company, that provides the same limitation on personal liability of the owners of the business. So that is why you see C corporation numbers go down and pass through numbers go up.

Ms. VELÁZQUEZ. Thank you.

Can you elaborate on whether individual tax rates influence business decisions?

Mr. WILLIAMSON. Well, that goes in, again, and my written testimony referred to that, is that if we are going to reduce the corporate tax rate in this country, some consideration must be given to small businesses; that the LLC, the S corporation, indeed the sole proprietor, will be paying effectively higher rates than C corporations. And C corporations do not have to pay dividends. And the owner of a C corporation can sell the stock rather than take distributions. So some consideration must be given to the sole proprietorship and partnership and LLC industry.

Ms. VELÁZQUEZ. Thank you.

Mr. Mankowski, you mentioned the PMCT pilot program had some drawbacks, including an overly simplistic, typical, or initial response when comparing a client's data to the database. What recommended changes would you make to better implement the program this coming tax season?

Mr. MANKOWSKI. Thank you. As far as the implementation, if the IRS really wants to maintain the anonymity for the users, they really can have some of the specific results that many of us practitioners would be looking for to know where their ranking is inside of the usual or the unusual. So it is almost a catch-22. How much information do you really want to get to see where you are at in the specific categories? I think having the ability to have it rolled out earlier this year as year two to the practitioner community, at least for those who have been in the pilot program already, will just add on to the number of users that are going to be familiar with the tool that now when they are doing their preseason training, it will be more at the forefront that this tool exists, even to the extent to go back and look at the 2014 tax data and see where the results came in, meet with their business owners and say, "Here is where some of the results were coming out." Use it as a preseason tool and potentially have the ability to advise our clients and work with them so that they can avoid that love letter from the IRS that they get usually about a year, year and a half after the fact, that at least if it is addressed and have some general information and answers when they get a letter from the IRS if their results were out of spec, you can pull the results out of your file and say, "Mr. Business Owner, remember we talked about this last year? Here is some of the information. We have done the leg work." And then they are better able to answer the notices at that point.

Ms. VELÁZQUEZ. Thank you.

Thank you, Mr. Chairman. I yield.

Chairman CHABOT. Thank you. The gentlelady yields back.

In my five minutes, I would like to do something a little bit different. We have had some great answers to some, I think, very good questions as well. But rather than ask specific questions, I

would just like to, you know, we are making a record here. If there is just one point that you would like to leave with the Committee, something you would like us to implement, or act upon, or consider, you know, I would be happy to hear. And since I did not get to you, Mr. Mankowski, maybe I will begin with you and we will just go down the line. But you have got about a minute each. You do not have to take it all up but I would ask you not to probably go any further than that.

You are recognized.

Mr. MANKOWSKI. Thank you.

As far as one parting comment, I think that the IRS has almost been in a catch-22 recently. They have been asked to do more and more between implement the Affordable Care Act last year along with repair regulations, and for the current year, also implement the Employer Shared Responsibility portions. They are doing this with, I believe, one of the congressmen had mentioned that their budget has been down 17 or 18 percent over the last few years, and that is an annual decrease that they have been getting. So they have been getting—having to do more and more with less resources. And even now they are looking at saying, "Well, how come you have not done more with the 1099-K." You reach a point where they are in a hiring freeze, they cannot bring on staff, and as not bringing on staff, they are also having the attrition from the higher level people. The people who are not coming on now are the ones that may be a little bit more tech savvy that can really take the service to the next level to make it a better service for all the practitioner and taxpayer community.

Chairman CHABOT. Thank you.

And maybe I will just—one quick thing in response. If perhaps they should not use at least some of the resources for targeting groups who have a certain political persuasion and wasting resources on that, and then having to have their people come and testify and defend themselves and records are lost and all the rest, too. But I hear what you are saying and tend to agree with it.

Mr. Vitale?

Mr. VITALE. Sure. I think to that point, the one observation I have and the recommendation would be to have the service reevaluate how it deploys its resources, where it spends its time. With my clients with businesses, those that are very successful have good strategic plans. They have a plan. They invest the right time and money into the areas that yield the best benefit.

As a case in point, in my written testimony I spoke at the end of a client that I have under audit. The client has lost money, restaurant business, five years, very difficult, two partners put all their own money in, lost it, borrowed money, paying that off, lost it. And the auditor has spent three days auditing a company where even if she makes a change, it is not going to make a difference. So I think those three days, 24 business hours, could be spent by people at the service doing better things than that.

Chairman CHABOT. Thank you.

I have only got two minutes left. Mr. Lewis?

Mr. LEWIS. I will be quick.

Chairman CHABOT. You have got 45 seconds.

Mr. LEWIS. Two things. Number one, what can Congress do? Congress can support small businesses by reforming the tax code. It needs to be simple, it needs to be fair, and it needs to be equitable. You give that to small business owners and they will respond. They want it, they need it, you can give that to them. That would be wonderful.

Second thing, IRS services. There is no substitute, there is no additional reference point or no additional source that we can go to to serve those clients and to serve those taxpayers.

Chairman CHABOT. And the third one real quickly?

Mr. LEWIS. That is the second one. That is the two. Just IRS services, focus on those.

Chairman CHABOT. Very good. Thank you.

Mr. Williamson?

Mr. WILLIAMSON. Yes. Strategically, you can have carve outs for small businesses. You are considering international tax reform as we speak. You can have carve outs for small businesses of under $10 million so they do not have the same level of compliance. They will not go overseas. Take a look at the forms. Take a look at the requirements. Tactically, and I think it has been mentioned here, the $2,500 increase to the allowance to simply deduct anything and not have to depreciate it.

Chairman CHABOT. Thank you very much.

And you have got my last 50 seconds.

Mr. MIHM. I will do my best not to take the full 50, Mr. Chairman.

I think you have got excellent ideas, so I will not repeat them, but just align myself with those and go off on a bit of a different direction, and that is on the identity theft at IRS. It costs them about $5.8 billion in 2013, IRS estimates, in which they pay to identity thieves. Now, they stopped or recovered, they estimate, about $24 billion before it goes out. That is a real target of opportunity for them to be more strategic in going after—and it is a priority area for them to reduce the amount of identity theft as it affects IRS.

Chairman CHABOT. Thank you. My time is expired.

The gentleman from New York, Mr. Hanna is recognized.

Mr. HANNA. Mr. Williamson, I will get back to your cash basis.

How do you manage? I mean, we know even if you are on accrual now, you are on accrual. It does not matter the size necessarily. I mean, the $5 million point for cash. But how can you—how do you avoid cheating on your—by essentially buying inventory, growing your business, or maybe that is what you want to happen. How do you——

Mr. WILLIAMSON. I agree, Congressman. That is not cheating; that is growing.

Mr. HANNA. Right. Right. But I mean does it not become manipulative if you are essentially, with 179, you are saying go out and buy a piece of equipment, which may or may not be good. You have to hope the owner does that smartly. On the other hand, you could conjecture that the same thing would happen with inventory simply to avoid paying taxes. But I guess that is part of your point, is it not?

Mr. WILLIAMSON. Frankly, I cannot think of anything less manipulative than a totally cash basis of accounting, and simply use the checkbook as we are advising.

Now, clearly, it may not be as financially accurate, and I am not here to say that if you are filing SEC reports you need to be on the cash basis. Certainly not.

Mr. HANNA. What you are suggesting though is ultimately it works itself out.

Mr. WILLIAMSON. Oh, yes.

Mr. HANNA. Over time, whether you do something more one year or not as much the next year, over a period of time——

Mr. WILLIAMSON. Over the life of the business you recognize the same amount of income and have the same amount of expenses.

Mr. HANNA. I understand.

Mr. WILLIAMSON. It is all timing.

Mr. HANNA. Mr. Mihm, do you want to speak to that at all?

Mr. MIHM. No, sir. That is not an issue that we looked at in any detail.

Mr. HANNA. So with the IRS cutting back on their budget, I mean, it really is kind of, you know, everyone here has complaints with the IRS for one reason or another. But back to the 1099-K, I am guessing, Mr. Mankowski, that you do not like it that much. You do not like aggregating, turning a lot of it into guesswork, comparing businesses on the aggregate, and then coming up with conclusions that this person or that person, company or not, has complied or not?

Mr. MANKOWSKI. I do not believe, I mean, the form itself, at least in my estimation, was kind of created to get a lot of your people who have been conducting business on the Internet. Your eBay sellers. And from that perspective, I think the form has been very successful. There are clients that have come in that have no idea that they had a million dollars worth of business that they had done on eBay. So it does not mean they made a million dollars, they just sold goods to that level.

So from that perspective, it has been accurate. Unfortunately, the majority of businesses are not conducting their business on the Internet, and it has really been—they are collateral damage because they are out there reporting their revenue as it is, and they have been doing that all along, but they are the ones that are getting the notices.

Mr. HANNA. The ones being like Dragnet. You throw this giant net in the water and some people deserve to be caught, others do not.

Mr. MANKOWSKI. Right.

Mr. HANNA. But everybody may be inconvenienced based on some subjective notion that the IRS has about the general idea of what that business ought to be paying or this business.

Mr. MANKOWSKI. Right. Unfortunately, a lot of those businesses that are getting the large credit card sales through their online businesses—I will take someone, a client who is on eBay. By the time they have their listing fees, their shipping fees, their PayPal fees, and then their cost for the product, they do not make a lot of money.

Mr. HANNA. I am going to take a rare moment to defend the IRS. If you were them and your budget was going down every year, this would be exactly what you would want to try to do, to aggregate businesses based on numbers from 1099s, come up with broad conclusions about who is good and who is bad.

Mr. MANKOWSKI. From that perspective, yes. I think time will hash out what needs to be adjusted out of this form, specifically the restaurant owner with gratuities, sales tax, and how that is going to be affected and how they are looking, because the IRS is sending out soft notices that as long as the taxpayer responds, here is my brief reconciliation, here is my gratuities, and this is my number I reported, they are fine with that. It is just a lot of extra work on the business owner to really go back and try to figure out whether it is right or wrong because they do not track their revenue based upon whether it is credit card, cash, or checks.

Mr. HANNA. Right. And if the IRS published those numbers I suppose it would be another problem, what they are looking for, what they are not looking for.

My time is expired. Thank you, Chairman.

Chairman CHABOT. Thank you. The gentleman yields back.

The gentleman from South Carolina, Mr. Rice, is recognized for five minutes.

Mr. RICE. Mr. Mankowski, you were talking a minute ago, just when I was speaking in my first five minutes, I was talking about maybe some of the reasons why for the first time in American history we are seeing business dissolutions outpace business formation. And you said earlier that the IRS has had to implement Obamacare in the last two years and we did not give them any more resources to do that. Has not small business had to implement Obamacare in the last two years, too?

Mr. MANKOWSKI. If you look under the IRS description of small business being the $10 million and less, they have been because they are the business——

Mr. RICE. Okay, they did have to implement, too.

Mr. MANKOWSKI. Yes.

Mr. RICE. Did we give them any additional resources to do that with?

Mr. MANKOWSKI. I do not know the answer to that, sir.

Mr. RICE. Could that have something to do with the slowdown in formation of small businesses?

Mr. MANKOWSKI. Yes.

Mr. RICE. Okay. The tax code, I was a tax lawyer and a CPA for 25 years. This stuff is fun to me. The tax code was designed 50–60 years ago and it was competitive at the time. Does anybody up there believe that our tax code remains competitive in the world?

Mr. MANKOWSKI. I will use an example that a friend of mine recently had a baby and she was saying, "Oh, well, over in France, as an example, they get paid so many months of childcare or maternity leave." And a quick search said, "Well, that is great, but based on your income level, you would be paying 40-plus percent in annual tax just to the government compared to what you are paying now." So, yeah, you may get an extra two months or so of

paid maternity leave, but every year you would be paying in 10 to 15 to 20 percent more in tax.

Mr. RICE. Okay. I have got to keep going.

Do you think our tax code is competitive for American—does our tax code make American business more or less competitive? More or less?

Mr. MANKOWSKI. I would say less just from a compliance perspective.

Mr. RICE. Do you agree with that across the board?

Mr. MANKOWSKI. Yes.

Mr. RICE. Thank you.

Do you think that that has something to do with the decline in business formation in America? Mr. Mankowski? And I have to ask an answer quick.

Mr. MANKOWSKI. Yes, I do.

Mr. RICE. Okay.

Next question. Did each of you have the chance—I assume all of you had the chance to review Dave Camp's tax reform proposal last year. I want to know just a one-word answer from you all, would that make the United States Tax Code more or less competitive in the world.

Mr. Mihm?

Mr. MIHM. I cannot give you a bottom line on that. We did review it. I mean, we worked with the Committee and they used a lot of our work as they were putting it together, but we did not come to a bottom line decision.

Mr. RICE. You do not think it would be preferable to what we have now?

Mr. MIHM. I really cannot speak to that, sir.

Mr. RICE. Mr. Williamson?

Mr. WILLIAMSON. I have not looked at it in quite a while but I would say it would make American more competitive.

Mr. RICE. Mr. Lewis?

Mr. LEWIS. Representative, Dave Camp should be commended for what he did. It showed us what real reform would look like, and that effort itself, I know we will have issues with any particular provision, but that overall effort, that is exactly what we are talking about.

Mr. RICE. Mr. Vitale?

Mr. VITALE. I believe that is a better start.

Mr. RICE. And Mr. Mankowski?

Mr. MANKOWSKI. I believe it is a good start but it would also complicate things a lot as well.

Mr. RICE. Okay. And that came out of the House Ways and Means Committee.

Mr. Mihm, have you had a chance to review the president's tax reform proposal?

Mr. MIHM. No, sir, we have not.

Mr. RICE. Have you seen it, Mr. Williamson? Have you gone through it?

Mr. WILLIAMSON. I have not gone through it. I have seen portions of it. Most notably, regarding the cash method of accounting rules, that he will take the $25 million with some carve outs for some qualified personal service corporations, I think.

Mr. RICE. Mr. Lewis?

Mr. LEWIS. Yeah. The same thing as Mr. Williamson. I have just seen particular provisions, and some of those were not necessarily small business favorable.

Mr. RICE. Have you seen the whole package put together?

Mr. LEWIS. No, I would not say the whole package. No.

Mr. RICE. I have not either. I do not think there is one.

Mr. LEWIS. I have seen parts of it.

Mr. RICE. My point in this is I do not think the president has made a specific proposal. I think Dave Kamp and the House Ways and Means Committee made one. I do not think the president has put one forward. And if we are going to get tax reform done, we have got to have leadership. And when you look at these things that I have been talking about, between the imposition of Obamacare, between Dodd-Frank, ancient tax code, you can understand, if you look at the statistics on the decline in formation of small businesses, you can understand why this is happening, just to put a perspective on it.

Thank you very much.

Chairman CHABOT. The gentleman yields back.

And we want to thank our distinguished panel for being here this morning and now this afternoon. We appreciate it. I think the GAO report has certainly confirmed that small firms are having a tough time dealing with the tax code and we need to simplify it and reform it. I would like to say we are close to that. However, I like to be truthful, and I do not think we are close to that, although we are working on it. But you all have given us, I think, some very good ideas. And particularly as it would affect small business folks, so thank you for that.

And I would ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record. And if there is no further business to come before the Committee, we are adjourned. Thank you.

[Whereupon, at 12:37 p.m., the Committee was adjourned.]

APPENDIX

United States Government Accountability Office

Testimony
Before the Committee on Small Business, House of Representatives

For Release on Delivery
Expected at 11:00 a.m., ET
Wednesday July 22, 2015

SMALL BUSINESSES

IRS Considers Compliance Burden in Tax Administration, but Needs a Plan to Evaluate Its Payment Card Information Pilot

Statement of J. Christopher Mihm, Managing Director, Strategic Issues

GAO-15-754T

Chairman Chabot, Ranking Member Velázquez, and Members of the Committee:

I am pleased to be here to discuss our report on small business tax compliance burden, which is being released today.[1] Given the important role small businesses play in the U.S. economy, reducing the cost of compliance with the tax code may free up resources to expand, hire new employees, and further contribute to economic growth. At the same time, we have previously reported that small businesses are a significant contributor to the annual tax gap—the difference between taxes owed and taxes paid on time. Therefore, a key challenge the Internal Revenue Service (IRS) faces is balancing efforts to minimize taxpayer burden with efforts to encourage voluntary compliance with the tax code.

One way IRS is seeking to achieve this balance is by piloting a payment card matching program. Under a 2008 law, payment settlement entities—such as credit card companies and third-party network payers like PayPal—began reporting to IRS the gross payments they process for each participating merchant on IRS Form 1099-K, *Merchant Card and Third Party Network Payments*.[2] In 2012, IRS began the payment card pilot to research and test ways to use Form 1099-K data to most effectively and efficiently improve voluntary compliance, detect noncompliance, and minimize burden on small business taxpayers.

My remarks today highlight the key findings of our report on small business tax compliance burden and IRS's payment card pilot.

To conduct this work, we analyzed Treasury and IRS data, research, and other documentation and interviewed agency officials. We used our guidance on program design evaluation to assess IRS's payment card pilot evaluation plan. More detailed information on our objectives, scope, and methodology can be found in our report. We conducted the work on

[1]GAO, *Small Businesses: IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts*, GAO-15-513 (Washington, D.C.: June 30, 2015)

[2]26 U.S.C. § 6050W; 26 C.F.R. §§ 1.6050W-1, 1.6050W-2.

All of a merchant's payment card transactions are reportable on Form 1099-K. However, third-party network transactions are only reportable if a merchant's aggregate amount of such payments for the year exceeds $20,000 and if the aggregate number of transactions exceeds 200.

which this statement is based in accordance with generally accepted government auditing standards.

Most Small Businesses Are Individuals, but Most Small Business Income Is Generated by Partnerships and Corporations

Small businesses make up 99 percent of all businesses, according to estimates produced by Treasury's Office of Tax Analysis using 2010 taxpayer data.[5] For these estimates, small businesses are defined as individuals or entities with substantive business activity but with less than $10 million in total income and deductions. Approximately 69 percent of small businesses (about 16 million) are individuals who report business income and the remaining 31 percent (or roughly 7.3 million) are partnerships or corporations. Individuals generated only 23 percent (or $1.4 trillion) of the total income of all small businesses, whereas small business partnerships, S corporations, and C corporations accounted for the majority—77 percent (or about $4.5 trillion)—of total small business income. Overall, small businesses with at least one employee (not including owners)—a group that only makes up about 20 percent of the small business population—produce about 71 percent of total small business income.

Tax Compliance Burdens Vary Depending on a Small Business's Size, Number of Employees, Entity Type, Industry, and Other Characteristics

Small businesses are required to undertake a number of tax compliance-related activities that create burden. The tax compliance burden associated with these activities varies by characteristics of the small business. Some of these characteristics include the business's size as measured by its assets, entity type, number of employees, and industry. These activities can be grouped into general categories:

- **Income tax activities.** Every year, small businesses need to maintain tax-related records and file income tax returns. Some small businesses are required to pay estimated income taxes quarterly. The type of small business dictates the income tax returns and related schedules that need to be filed. Some of the returns include a set of schedules embedded in the form—found within the income tax return—while some small businesses and individuals with business income must attach a mandatory schedule to their return.

[5]See GAO-15-513, appendix II, for detailed information on the scope, methodology, and research analyzed for these estimates.

- **Employer-related tax activities.** Small businesses with employees are responsible for reporting, withholding, and depositing employment and unemployment taxes. The number of employment tax reports and deposits required depends on the number of employees and the resulting employment tax liability owed at a particular time. Small businesses also report health care and retirement information. The information reported for these areas depends on a business's number of employees.

- **Third-party information reporting and industry-specific tax activities.** Small businesses are required to report on certain transactions they enter into with other entities. For example, using Form 1099-MISC, small businesses report items such as rent payments and payments to nonemployees. IRS uses this information to verify compliance by comparing the income or expenses reported by third parties to the income or expenses reported by small businesses on tax returns. Some small businesses may have industry-specific requirements to pay excise taxes, including environmental, communications, and fuel taxes.

IRS has developed several models to provide information for assessing the impact of the tax code and IRS programs on taxpayers. Estimates produced by these models indicate that burden increases with the size of businesses, whether measured in terms of assets, receipts, or employment; however, burden per dollar of assets or receipts or per employee declines with size because of economies of scale. For example, according to IRS, corporations and partnerships with 1 to 5 employees have an estimated tax compliance burden of $4,308 to $4,736 per employee, but corporations and partnerships with more than 50 employees have a much lower estimated per employee burden—$182 to $191.

IRS's Decision-Making Framework Includes Consideration of Small Business Compliance Burden

IRS's strategic plan identifies reducing taxpayer burden as a strategic goal. Additionally, the *Internal Revenue Manual* lists guiding principles to help employees consider how a policy could affect compliance burden. For example, under the guiding principle "leverage existing data," the manual directs employees to consider if there are opportunities to leverage data that is already collected by IRS or by accessible third parties.

IRS provided examples of how it works with internal and external stakeholders to reduce taxpayer burden on small businesses. For example, IRS collaborated with Treasury and external stakeholders to

develop a simplified method for some small businesses to calculate a home office deduction, which was introduced in January 2013. Previously, businesses had to complete a complex property depreciation calculation.

We interviewed small business representatives who acknowledged IRS's external stakeholder outreach efforts and how they have been effective in identifying opportunities to reduce compliance burden. However, they also described a number of areas where small business compliance burden could be further reduced. These areas include issues related to IRS customer service, filing requirements, lack of or delayed official guidance, and compliance contacts. While IRS is aware of many of these concerns and, through various initiatives, has made efforts to address these issues, continued attention to these areas will be key to effectively reducing compliance burden. In many cases we have made recommendations that, if implemented, could help to reduce these burdens.[4]

IRS's Overall Evaluation of Its Payment Card Pilot Has Several Strengths, but Does Not Fully Address All Elements Necessary to Effectively Assess Results

In an effort to improve tax compliance among small businesses while minimizing the burden on compliant taxpayers, IRS began piloting a program in 2012 that compares payment data from payment settlement entities (such as credit card companies) with income reported by small businesses. IRS is testing ways to use the payment data to detect underreporting of taxable income while minimizing small business taxpayer burden. IRS's evaluation plan for pilot activities integrated many characteristics of a well-designed evaluation. As a result, IRS has been able to make rapid, ongoing assessments of pilot activities and continually incorporate changes based on what has been learned. This approach has allowed IRS to test many hypotheses simultaneously while limiting the number of small business taxpayers affected by the pilot.

However, the overall evaluation plan for the pilot lacks characteristics of each element that are necessary to ensure a quality evaluation. For example, IRS has not clearly defined the stages of the pilot or measurable goals that it can use to determine when the pilot has moved from one stage to the next, or if it should move. Without defining the stages and establishing related metrics, IRS will not be able to articulate

[4]See GAO-15-513, appendix IV, for a list of selected open recommendations

the pilot's status at critical points in time. Further, it will not be able to justify the investment of additional resources if it cannot demonstrate progress toward those goals. In addition, IRS has not developed a full evaluation plan for the pilot. Among other missing elements of a quality evaluation, IRS has not developed evaluation questions, identified evidence-based evaluative criteria, or documented limitations. We recommended that IRS clearly define the stages of the payment card pilot and establish measurable goals for determining when the pilot advances from one stage to the next. We also recommended that IRS develop an evaluation plan that addresses the missing elements. IRS agreed to incorporate an evidence-based assessment of the payment card pilot that includes identifying clearly defined pilot stages and implementing an evaluation plan with measurable goals. IRS stated it will provide a more detailed response to our recommendations after our report is released.

In conclusion, the tax compliance burden faced by small businesses can vary considerably depending upon a number of factors. Through its research and outreach activities, IRS is cognizant of the compliance cost to taxpayers and explicitly considers this burden in administering the tax code. IRS's new payment card matching program has the potential to enhance the agency's ability to identify noncompliant small business taxpayers while minimizing taxpayer burden. However, IRS has a long road ahead in determining whether, and how, the payment card pilot program and its many activities can be fully implemented.

Chairman Chabot, Ranking Member Velázquez, and Members of the Committee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

GAO Contact and Staff Acknowledgments

If you or your staff have any questions about this testimony, please contact James McTigue, Jr., Director, Strategic Issues at (202) 512-9110 or [illegible]. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony are Brian James, Assistant Director; Sonya Phillips, Analyst-in-Charge; Courtney Liesener, Robert MacKay, James R. White, Nell Williams, Robert Gebhart, Kirsten Lauber, Donna Miller, Edward Nannenhorn, Karen O Conor, Andrew Stephens, and James Wozny.

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2. Are you testifying on behalf of an entity other than a Government entity?	**YES** X	**NO**
3. Other than yourself, please list what entity or entities you are representing: American Institute of Certified Public Accountants		
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Signature: Troy K Lewis **Date:** July 17, 2015

United States Government Accountability Office

Report to Congressional Requesters

June 2015

SMALL BUSINESSES

IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts

This Report Is Temporarily Restricted Pending Official Public Release.

GAO-15-513

June 2015

GAO Highlights

Highlights of GAO-15-513, a report to congressional requesters

SMALL BUSINESSES

IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts

Why GAO Did This Study

A challenge IRS faces is balancing efforts to minimize taxpayer burden with efforts to ensure compliance with the tax code. Small businesses are a vital source of economic growth in the United States. Reducing their costs for complying with the tax code may free up resources to expand, hire new employees, and contribute to the growth of the U.S. economy. GAO was asked to examine small business tax compliance burden and IRS's payment card pilot that addresses taxpayer non-compliance. This report: (1) describes characteristics of the small business population (2) describes how characteristics of a small business affect compliance burden; (3) describes how IRS integrates small business compliance burden considerations in decision-making; and (4) assesses IRS's plan for evaluating its payment card pilot. To answer these objectives, GAO analyzed Treasury and IRS data, research, and other documentation and interviewed agency officials. GAO used its guidance on program design evaluation to assess IRS's payment card pilot evaluation plan.

What GAO Recommends

To improve the evaluation of the payment card pilot, GAO recommends that IRS clearly define the stages of the pilot and establish measurable goals for determining when the pilot progresses from one stage to the next and develop an evaluation plan for the overall pilot that includes evaluation questions, complete descriptions of needed data, and evaluation criteria. IRS agreed to take the recommended actions

View GAO-15-513. For more information, contact James R. McTigue, Jr. at (202) 512-9110 or McTiguej@gao.gov

What GAO Found

According to estimates produced by government tax researchers using 2010 taxpayer data, small businesses (defined in the research as individuals or entities with substantive business activity but with less than $10 million in total income and deductions) make up 99 percent of all businesses. Approximately 69 percent of small businesses (about 16 million) are individual taxpayers who report business income and the remaining 31 percent (or roughly 7.3 million) are partnerships or corporations. Small businesses with at least one employee make up about 20 percent of the small business population, but produce about 71 percent of total small business income.

Small businesses undertake a number of tax compliance-related activities that create burden. These activities can be grouped into general categories such as income tax activities, employer-related tax activities, and third-party information reporting activities. The tax compliance burden associated with these activities varies depending on the businesses' asset size, filing entity type (e.g., sole proprietor, partnership), number of employees, and industry type. According to IRS research, compliance burden increases with the size of businesses, whether measured in terms of assets, receipts, or employment. IRS also measured money and time burden as a portion of total business receipts, total assets, and burden per employee. Across all three measures, IRS results were consistent with the assumption that small businesses face significant fixed compliance costs combined with decreasing marginal costs as the business grows.

IRS's decision-making framework for administering the tax system includes consideration of small business compliance burden. For example, IRS's strategic plan identifies reducing taxpayer burden as a strategic goal. IRS provided examples of how it works with internal and external stakeholders to reduce taxpayer burden on small businesses. For example, IRS collaborated with Treasury and external stakeholders to develop a simplified method for some small businesses to calculate a home office deduction, which was introduced in January 2013. Previously, businesses had to complete a complex property depreciation calculation.

To improve tax compliance among small businesses, in 2012, IRS began piloting a program that compares payment data from payment settlement entities (such as credit card companies) with income reported by small businesses. IRS is testing ways to use payment data to detect underreporting of taxable income while minimizing small business taxpayer burden. While IRS's plans for evaluating the pilot include many key evaluation elements that GAO identified, other elements are missing. For example, IRS has defined high level pilot goals such as improving voluntary compliance and reducing the tax gap, but has not established measures for determining progress against these goals. Additionally, the plan did not adequately document evaluative questions, data collection needs, or the evaluative criteria necessary to assess whether pilot activities produced the intended results. Without these and other elements, IRS cannot ensure it is making evidence-based decisions about expanding and integrating pilot activities into broader small business compliance improvement efforts.

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Abbreviations

CEAP	Correspondence Examination Assessment Project
FICA	Federal Insurance Contributions Act
FTE	full-time equivalent
FUTA	Federal Unemployment Tax Act
IRS	Internal Revenue Service
OTA	Department of Treasury – Office of Tax Analysis
RAS	Office of Research, Analysis, and Statistics
SB/SE	Small Business and Self-Employed Division
SOI	Statistics of Income
Treasury	Department of the Treasury

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GAO U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

June 30, 2015

The Honorable Steven Chabot
Chairman
Committee on Small Business
House of Representatives

The Honorable Sam Graves
House of Representatives

Small businesses are a vital component of economic growth and job development in the United States. Although no single definition of a small business exists, one common characteristic used to identify a small business is number of employees. Businesses employing fewer than 100 people accounted for a little more than 34 percent of U.S. employment in 2012. Businesses with fewer than 500 employees accounted for more than 48 percent.[1] Like all businesses, small businesses face compliance burdens as a result of the tax code. Given the important role small businesses play in U.S. employment and overall economic progress, reducing the cost of compliance may free up resources to expand, hire new employees, and further contribute to the growth of the U.S. economy.

While limiting compliance burden is important, we have also reported that small businesses are a key contributor to the annual tax gap—the difference between taxes owed and taxes paid on time.[2] The Internal Revenue Service (IRS) most recently estimated the U.S. tax gap to be $450 billion for 2006. Nearly 40 percent, or $179 billion, of the tax gap can be attributed to the underreporting of business income tax on individual income tax returns, and by extension the underreporting of self-employment tax, which is largely assessed on the same business income for self-employed taxpayers. An additional 4 percent of the tax gap, or $19 billion, can be attributed to small corporations, which IRS defines as having less than $10 million in assets. One challenge IRS faces is

[1]U.S. Census Bureau, Statistics of U.S. Businesses: Employment and Payroll Summary: 2012 (February 2015).

[2]GAO, Tax Gap: Sources of Noncompliance and Strategies to Reduce It, GAO-12-651T (Washington, D.C.: Apr. 19, 2012).

balancing efforts to encourage voluntary tax compliance through reducing taxpayers' costs of compliance with enforcement efforts to address noncompliance.

Beginning in 2011, IRS began receiving new information that could help improve voluntary compliance. Under a 2008 law, payment settlement entities such as credit card companies and third-party network payers like PayPal began reporting to IRS the gross payments they process for each participating merchant on IRS Form 1099-K, Merchant Card and Third Party Network Payments.[3] In 2012, IRS began a payment card pilot to research and test ways to use Form 1099-K data to most effectively and efficiently improve voluntary compliance, detect noncompliance, and minimize burden on taxpayers.

You asked us to examine small business tax compliance burden and IRS's payment card pilot. This report: (1) describes the characteristics of the small business population; (2) describes how characteristics of a small business affect compliance burden; (3) describes how IRS integrates small business compliance burden considerations into decision making; and (4) assesses IRS's plan for evaluating its payment card pilot.

We used estimates from researchers at the U.S. Department of the Treasury (Treasury), Office of Tax Analysis (OTA) to describe general characteristics of the small business population, such as the number of small businesses and total income.[4] We examined IRS, academic, and other research on small business tax compliance burden to identify how small business characteristics affect compliance burden. We reviewed IRS's strategic plan and other relevant documents, and interviewed agency officials about various burden reduction decisions and initiatives. We obtained the perspectives of the small business community through literature reviews, document reviews, and interviews. We used criteria

[3]26 U.S.C. § 6050W; 26 C.F.R. §§ 1.6050W-1, 1.6050W-2.

All of a merchant's payment card transactions are reportable on Form 1099-K. However, third-party network transactions are only reportable if a merchant's aggregate amount of such payments for the year exceeds $20,000 and if the aggregate number of transactions exceeds 200.

[4]Appendixes I and II include more detailed information on the scope, methodology, and research analyzed for the first objective.

from our prior reports on program design and evaluation to assess IRS's plan for evaluating the payment card pilot.[5]

We conducted this performance audit from July 2014 to June 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Identifying the Small Business Population

A consensus does not exist on a definition of small business, including which specific attributes or thresholds distinguish small businesses from other firms. Estimates of the small business population are driven by the purpose, concepts, and data that are used to produce the estimates. As we have previously reported, various thresholds such as number of employees, gross receipts, and number of shareholders may be used when determining which provisions of the tax code apply to a small business.[6]

In this report, we rely on studies that use taxpayer data for individuals and entities that generate business income. Businesses (including small businesses) file specific tax forms based on certain attributes of the business, such as the ownership structure and how the business income is taxed. Below are different types of businesses and the required forms and schedules.

Nonfarm sole proprietorships (Form 1040, Schedule C) are unincorporated and owned by a single individual. Net business

[5]Criteria were developed from GAO, Program Evaluation: Strategies to Facilitate Agencies' Use of Evaluation in Program Management and Policy Making, GAO-13-570 (Washington, D.C.: June 26, 2013); and Designing Evaluations: 2012 Revision, GAO-12-208G (Washington, D.C.: January 2012).

[6]GAO, Tax Policy: Differences in Definitions and Rules in the Tax Code, GAO-14-652R (Washington, D.C.: July 18, 2014).

income or loss is included in the owner's individual adjusted gross income.

- Landlords (Form 1040, Schedule E-Part I) are individuals who report rental real estate activity on Part I of Schedule E.
- Farmers (Form 1040, Schedule F or Form 4835) are individuals who report farm income or landowners who report farm rental income.
- C corporations (Form 1120) are owned by shareholders. Corporate income is taxed at the corporate level on taxable income and at the shareholder level on distributed profits.
- S corporations (Form 1120-S) cannot have more than 100 shareholders, among other requirements. Gross income is distributed to shareholders and taxed at the shareholder level.
- Partnerships (Form 1065) are unincorporated businesses that have two or more owners. Profits and losses are distributed to owners who are taxed at the partner level.

IRS has separate operating divisions that focus on different types of taxpayers—individuals, small businesses and self-employed, large businesses, and tax exempt organizations. The Small Business and Self-Employed division oversees taxpayers filing tax returns as individuals with business income and as businesses with less than $10 million in total assets. However, not all of these tax returns are for business entities. This is because the principal purpose of some entities that file tax returns reporting business income may not be to generate revenue or to engage in substantive business activity. For example, some C corporations can serve as investment vehicles that engage in little or no business activity. Further, partnerships may be created to redistribute profits generated by another partnership and may not generate income themselves.[7] Filers of Form 1040, Schedule C, may be independent contractors who may more closely resemble employees rather than small businesses. Additionally, rental income for some individuals may be incidental and not represent business activities.

[7]GAO, Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance, GAO-14-453 (Washington, D.C.: May 14, 2014).

Small Business Tax Compliance Burden

We define tax compliance burden as the time and money spent by the taxpayer to meet tax obligations. This would include federal, state, and local obligations. This does not include tax liability. For the purposes of this report, we are only examining compliance burden as a result of federal tax obligations.[8] Time spent on tax activities can include working with a paid professional, tax planning, keeping records, completing forms, submitting forms, learning tax laws, and working with IRS on tax issues. Monetary burden can include expenses for hiring a paid professional to file taxes, investing in a tax software system, paying for payroll services, and legal fees. When measuring tax compliance burden, researchers may separate burden into both time and money, or they may place a value on the time spent by taxpayers and add it to monetary burden to create a single measure of tax compliance burden.[9] A key concept in tax administration is minimizing burden, including eliminating unnecessary burden.

[8]The IRS models we reviewed for this report focus only on federal tax obligations.

[9]IRS and our past reports have used the terms compliance costs and compliance burden interchangeably.

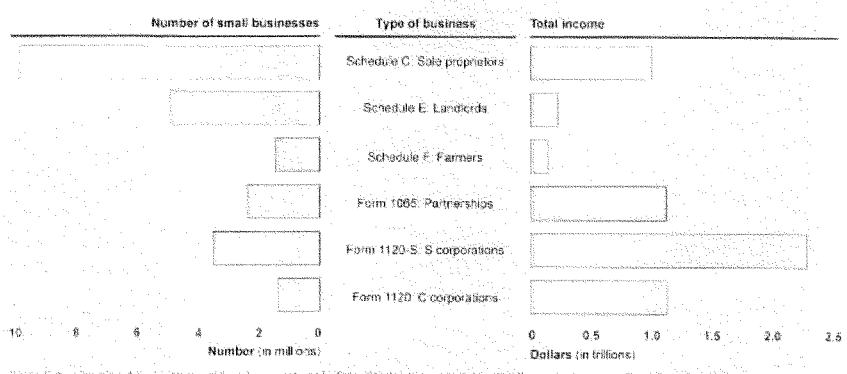
Most Small Businesses are Individuals, but Most Small Business Income is Earned by Partnerships and Corporations

As shown in figure 1, using data from researchers at Treasury's Office of Tax Analysis (OTA), most small businesses (approximately 69 percent or 16 million) are individual taxpayers who report business income on their Form 1040, using Schedule C (sole proprietor), Schedule E-Part I (landlords), or Schedule F (farmers).[10] The remaining 31 percent of small businesses (or roughly 7.3 million) are partnerships, S corporations, or C corporations. OTA researchers also provide a total income measure, generally defined as the sum of all business income reported on tax returns, including gross receipts, rents, dividends, capital gains, royalties, and interest.[11] Individual small businesses generated only 23 percent (or $1.4 trillion) of the total income of all small businesses, whereas small business partnerships, S corporations, and C corporations accounted for the majority—77 percent (or about $4.5 trillion)—of total small business income.

[10]We use estimates from OTA researchers to describe the characteristics of the small business population. We refer to the estimated number of small business filers as the number of small businesses. See Richard Prisinzano, Jason DeBacker, John Kitchen, Matthew Knittel, Susan Nelson, and James Pearce, "Identification of Small Businesses Using Tax Data: 2010 Update" (presented at the 2013 National Tax Association's Spring Symposium, May 17, 2013); Office of Tax Analysis, Department of the Treasury, Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, Methodology to Identify Small Businesses and Their Owners, Technical Paper 4 (August 2011); and appendix II for further discussion of the data.

[11]The OTA total income measure serves as a proxy for the total business activity, and is not the same as taxable income. In particular, costs of doing business are not deducted and business losses are not used to offset other types of income.

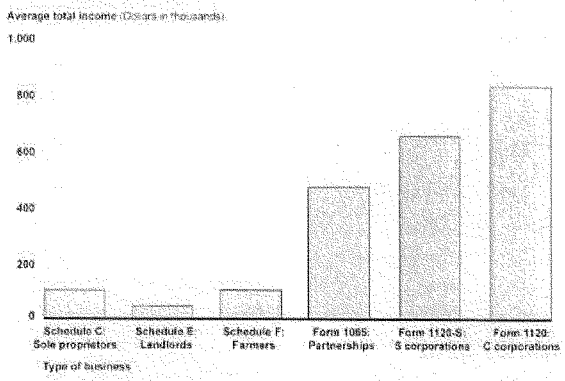
Figure 1: Estimated Number and Total Income by Type of Small Business (2010)



Note: We refer to the estimated number of small business filers as the number of small businesses. The number of individual filers with business income includes taxpayers filing multiple schedules. Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest. Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule. See appendix II for further discussion of the treatment of data used for this figure.

When looking at the average total income for small businesses (total income divided by number of filers), partnerships, S corporations, and C corporations each generated more than $450,000 on average, while sole proprietors, farmers, and landlords reported income of about $100,000 or less on average. Figure 2 shows the estimated average total income by small business type.

Figure 2: Estimated Average Total Income by Type of Small Business (2010)



Source: Richard Prisinzano et al., "Identification of Small Businesses Using Tax Data: 2010 Update" presented at the 2013 National Tax Association's Spring Symposium, May 17, 2013. (GAO-15-513)

Note: The average total income per small business is the ratio of total income and the number of filers for each type of business. We refer to the estimated number of small business filers as the number of small businesses. The number of individual filers with business income includes taxpayers filing multiple schedules. Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest. Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule. See appendix II for further discussion of the treatment of data used for this figure.

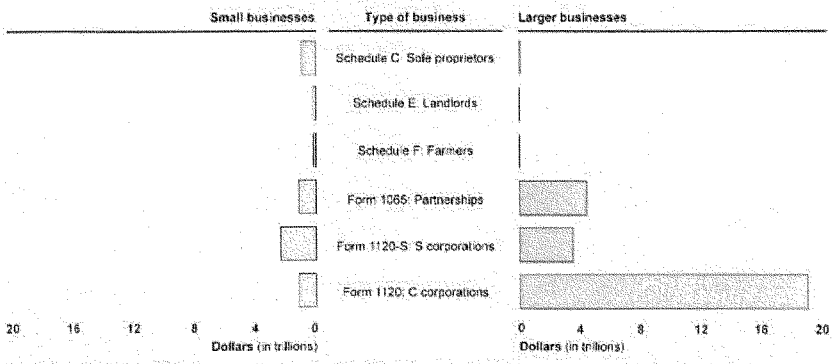
About 99 Percent of Businesses Report Total Income and Deductions of Less Than $10 Million

Small businesses (as defined as reporting total income and deductions of less than $10 million) make up 99 percent of the taxpayers identified as being engaged in substantial and substantive business activity.[12] For each type of filer, small businesses account for at least 95 percent of businesses. Among individual filers reporting business income, small businesses account for most of the reported income. However, among S

[12]Researchers at OTA define a taxpayer as engaging in substantial and substantive business activity if (1) total income or deductions exceed $10,000, or their sum exceeds $15,000; and (2) total deductions exceed $5,000. These two tests help indicate whether the entity generates non-negligible income and if the entity behaves as a business, respectively.

corporations, C corporations, and partnerships, larger businesses account for most of the reported income, even though they are far outnumbered by small businesses, as shown in figure 3. The estimated average total income across all types of small businesses is $250,000, while the average total income for larger businesses is estimated to be $121 million.

Figure 3: Estimated Total Income by Type for Small and Larger Businesses (2010)



Source: Wu and Prasad et al., "Identification of Small Businesses Using Tax Data: 2010 Update," presented at the 2013 National Tax Association's Spring Symposium, May 17, 2013. | GAO-15-513

Note: Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest. Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule. Small businesses are defined as businesses that have $10 million or less in both total income and total deductions. Larger businesses are defined as businesses with more than $10 million in total income or total deductions. See appendix II for further discussion of the treatment of data used for this figure.

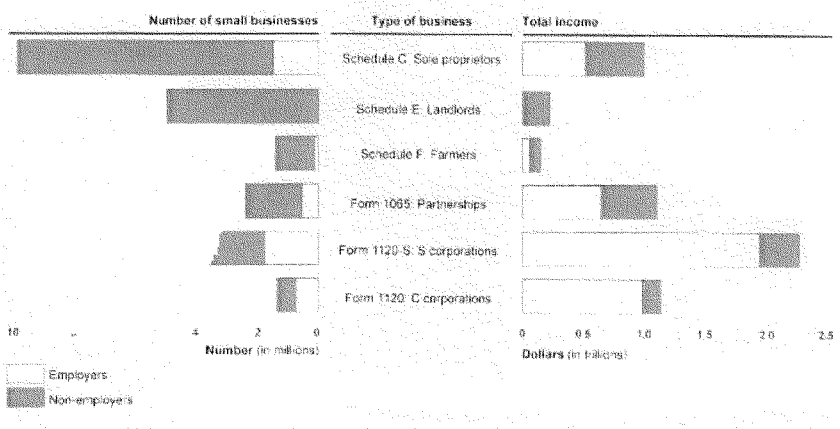
Most Small Business Income Is Generated by Employers, but Most Small Businesses Are Not Employers

Small businesses with at least one employee (which we will refer to as employers) generated most of the reported total income for small businesses (or about 71 percent).[13] Employers account for about 86 percent of total income for small business C corporations and S corporations combined and about 55 percent for small business sole proprietors, farmers, and partnerships.

Employers make up about 20 percent of all small businesses. Employers make up 16 percent of the combined group of small business Schedule C sole proprietors, Schedule F farmers, and partnerships and 51 percent of the combined group of small business C corporations and S corporations. Figure 4 shows the estimated number of small business filers and total income separated by employers and non-employers.

[13]Researchers at OTA define small businesses as employers if labor deductions are greater than $10,000. Schedule E-Part I landlords are categorized as non-employers because those returns lacked the necessary information to determine labor expenses for these businesses. While Schedule C sole proprietors report contract labor (line 11, Schedule C) and Schedule F farmers report labor hired (line 22, Schedule F), there is no equivalent information reported on Schedule E-Part I.

Figure 4: Estimated Number of Small Businesses and Total Income by Employer and Non-Employer (2010)

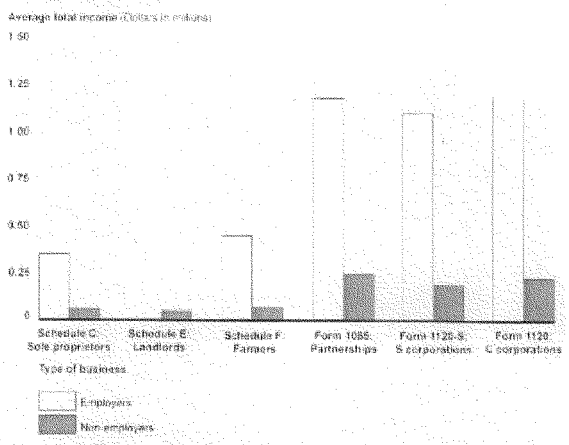


Source: Robertson, Gerald et al. "Small Business Filing for Data 2010 Update," presented at the 2013 National Tax Association Spring Symposium, May 17, 2013 (GAO 15-513).

Note: We refer to the estimated number of small business filers as the number of small businesses. The number of individual filers with business income includes taxpayers filing multiple schedules. Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest. Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule. All Schedule E filers are defined to be non-employers, therefore no bars for employers appear in the above figure for Schedule E Landlords. See appendix II for further discussion of the treatment of data used for this figure.

As shown in figure 5, employer small businesses, on average, generate more income than non-employer small businesses.

Figure 5: Estimated Average Total Income for Small Business by Employer and Non-Employer (2010)



Source: Richard Hoffman et al., "Tax Models of Small Businesses Using Tax Data," 2014 IRS Statistics of Income Research Conference, May 12, 2015. | GAO-15-513

Notes: The average total income per small business is the ratio of total income and the number of filers for each type of business. We refer to the estimated number of small business filers as the number of small businesses. The number of individual filers with business income includes taxpayers filing multiple schedules. Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest.

Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule. All Schedule E filers are defined to be non-employers, therefore no bar for employers appears in the above figure for Schedule E Landlords. See appendix II for further discussion of the treatment of data used for this figure.

Tax Compliance Burdens Vary Depending on a Small Business's Size, Number of Employees, Entity Type, Industry, and Other Characteristics

Small businesses undertake a number of tax compliance-related activities that create burden.[14] These activities can be grouped into general categories:

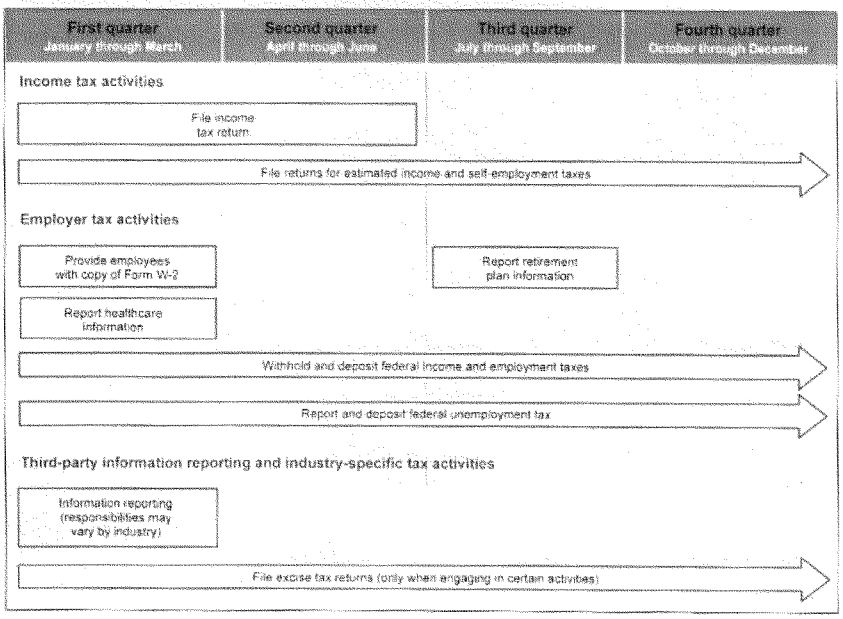
- income tax activities,
- employer-related tax activities, and
- third-party information reporting and industry-specific tax activities.

The tax compliance burden associated with these activities varies by characteristics of the small business. Some of these characteristics include the business's asset size, filing entity type, number of employees, and industry type.

Tax compliance activities are not limited to the annual filing of a tax return, but rather occur throughout the year. For example, sole proprietors are generally required to file income tax returns every April. Some small businesses need to pay estimated income taxes four times a year. Moreover, small businesses with employees are required to deposit employment taxes either monthly or semiweekly, and to report summary information of these activities on a quarterly basis. Additionally, depending on specific business operations, other tax compliance activities such as reporting excise tax, tax planning, and recordkeeping happen throughout the tax year. Figure 6 provides an overview of some of these tax compliance activities for sole proprietors and when they occur.

[14]We are not presenting a comprehensive list of all tax-related activities. Rather, we are highlighting some of the more common activities to provide a general sense of the range of activities small business taxpayers conduct to comply with tax laws.

Figure 6: Overview of Tax Compliance Activities of Small Business Sole Proprietors



Source: GAO analysis of Internal Revenue Service (IRS) documents. | GAO-15-513

Appendix III, table 8 provides a more detailed description of tax activities.

Income Tax Activities, Such as Filing Income Tax Forms and Schedules, Vary by Small Business Type

Every year, small businesses need to file income tax returns and may pay estimated income taxes quarterly. The type of small business dictates the type of income tax returns and related schedules that need to be filed. Some of the returns include a set of schedules embedded in the form—found within the income tax return—while some small businesses and individuals with business income must attach a mandatory schedule to

their return. For example, the primary corporate income tax return, Form 1120, U.S. Corporation Income Tax Return, contains eight embedded schedules, while sole proprietorships file Form 1040, U.S. Individual Income Tax Return, and attach Form Schedule C, Profit or Loss from Business.

Employer-Related Tax Activities, Such as Withholding Employment Taxes, Depend on a Business's Number of Employees

Small businesses with employees are responsible for reporting, withholding, and depositing employment and unemployment taxes. While these requirements may impose a cost on employers, withholding is widely believed to improve compliance and may reduce compliance burdens for employees. The number of employment tax reports and deposits depends on the number of employees and the resulting employment tax liability owed at a particular time (see table 1). In general, businesses with an employment tax liability greater than $50,000 need to make deposits more frequently than businesses with a lower liability. Additionally, each year, the employer must furnish a copy of Form W-2, Wage and Tax Statement, to each employee. Since the characteristics of employers vary, responsibilities for withholding, depositing, and reporting employment taxes can differ. For example, consider a small business restaurant owner who has 20 employees and has an employment tax liability of less than $50,000. She files a Form 941 quarterly which details the income tax withholdings for each of her 20 employees. Since her liability is less than $50,000, she deposits these withholdings monthly. At the end of the year, she must complete 20 Forms W-2 to report wages, tips, and other compensation paid to each employee.

Table 1: Employment Tax Requirements

Type of employment tax	Primary return	Deposit
Personal income tax withheld[a] Social Security and Medicare tax withheld (the Federal Insurance Contributions Act tax, or FICA)	Form 941, Employer's Quarterly Federal Tax Return[b]	Monthly if liability ≤ $50,000 in lookback period— (last two quarters of previous tax year and first two quarters of the current tax year). Semiweekly if liability > $50,000 in lookback period. If $100,000 or more in taxes is accumulated on any day during a monthly or semiweekly deposit period it must be deposited by the next business day.
Federal Unemployment Tax Act (FUTA) tax	Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return	If FUTA tax is $500 or less in a quarter, carry it over to the next quarter. Continue carrying tax liability over until the cumulative tax is more than $500. At that point, it must be deposited for the quarter.

Source: GAO analysis of IRS documents | GAO-15-513

Notes:

[a]For the purposes of the regulations governing deposit requirements, income tax withholding is generally considered an employment tax. 26 C.F.R. § 31.6302-1(e).

[b]Form 943, Employer's Annual Federal Tax Return for Agricultural Employee, is used by employers of agricultural workers.

Small businesses also report health care and retirement information. The information reported for these areas depends on a business's number of employees. The entity type also plays a role in the information reported about health care. Under the Patient Protection and Affordable Care Act, employers report the cost of coverage under an employer-sponsored group health plan on Form W-2. Beginning in January 2016, employers with 50 or more full-time employees will need to provide employees with a Form 1095-C, Employer-Provided Health Insurance Offer and Coverage. Some employers decide to offer pension plans and are responsible for reporting this information. While businesses must maintain records about these plans, most pension plans do not have any separate filing or reporting requirements with IRS. However, certain retirement plans offer small employers and self-employed individuals a deduction for contributions, and allows them to defer tax on income paid into the plan. To receive deductions, the small businesses must report this information to IRS using certain forms.

Third-Party Reporting Varies Depending on Business Size and Entity Type; Excise Tax Burden Is Industry Specific

Many businesses, including small businesses, are required to report on certain transactions they enter into with other entities. This is a form of third-party reporting. IRS uses this information to verify compliance by comparing the income or expenses reported by third parties to the income or expenses reported by small businesses on tax returns. Using Form 1099-MISC, small businesses report items such as rent payments and payments to nonemployees for services of at least $600, subject to certain exceptions. The burden created by this requirement grows with the size of the business because larger businesses would need to file more 1099-MISC forms. However, while a larger business may have more transactions, it may also have an accounting system designed to identify transactions of more than $600 that a smaller business might not have.

Another characteristic that affects third-party reporting requirements is entity type. For example, partnership entities are required to report the distributive shares of their partners on Schedule K-1. However, other entity types such as sole proprietorships do not have similar requirements.

Additionally, a small business may have many industry-specific requirements related to excise taxes. IRS administers several broad categories of excise taxes, including environmental taxes, communications taxes, fuel taxes, retail sale of heavy trucks and trailers, luxury taxes on passenger cars, and manufacturers' taxes on a variety of different products. For example, a small business in the trucking industry that makes deliveries over public highways is required to file Form 2290, Heavy Highway Vehicle Use Tax Return.

IRS's Compliance Burden Models' Estimates Provide Valuable Insights

IRS has developed several models to provide information for assessing the impact of the tax code and IRS programs on taxpayers. These models also help IRS assess the role of compliance burden and comply with requirements by the Office of Management and Budget for information on

burden under the Paperwork Reduction Act.[15] In the past 15 years, IRS has developed a number of burden models for individual and business taxpayers—both small and large.[16]

Estimated Recordkeeping and Filing Burdens Vary with Characteristics of Businesses and Complexity of Returns

Estimates of business compliance burdens that IRS's models have produced over the years indicate that burdens increase with the size of businesses, whether measured in terms of assets, receipts, or employment; however burden per dollar of assets or receipts or per employee decline with size due to economies of scale. For example, a small business owner who does his own taxes may create a spreadsheet to compute the business's taxes and keep track of the employment taxes he owes for each employee. The effort the small business owner makes to build that spreadsheet is a fixed cost—a cost that does not change with an increase or decrease in the amount of goods or services that are produced. As the small business owner's sales grow and as he hires more employees, he doesn't have to repeat that effort; he just has the small additional cost of adding new data on income and employees to the spreadsheet. As this business grows, its total compliance costs decline both as a proportion of sales and on a per-employee basis. For these reasons, the costs per dollar of receipts or per employee are larger for small businesses than for larger ones.

IRS measured money and time burden as a portion of total business receipts, total assets, and burden per employee. Across all three measures, IRS results are consistent with the assumption that small businesses face significant fixed compliance costs combined with decreasing marginal costs as the business grows (see appendix III, tables

[15]44 U.S.C. §§ 3501–3520. For additional information on IRS methodologies see the following studies: Donald DeLuca, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar, "Aggregate Estimates of Small Business Taxpayer Compliance Burden," IRS Research Bulletin (2007) pp. 147-184; Arnold Greenland, Erica Layne Morrison, David Conners, John L. Guyton, and Michael Sebastiani, "IRS Post-filing Processes Simulation Modeling: A Comparison of DES With Econometric Microsimulation in Tax Administration," Proceedings of the 2007 Winter Simulation Conference (IEEE, 2007) pp. 1268-1274; Donald DeLuca, Arnie Greenland, John Guyton, Sean Hennessy, and Audrey Kindlon, "Measuring the Tax Compliance Burden of Small Businesses," IRS Research Bulletin (2005) pp. 75-95; Donald DeLuca, Arnold Greenland, Sean Hennessy, Audrey Kindlon, and Michael Stavrianos, "The Tax Compliance Burden of Small Businesses-A Profile of 50 Businesses," IRS Research Bulletin (2004) pp. 97-137.

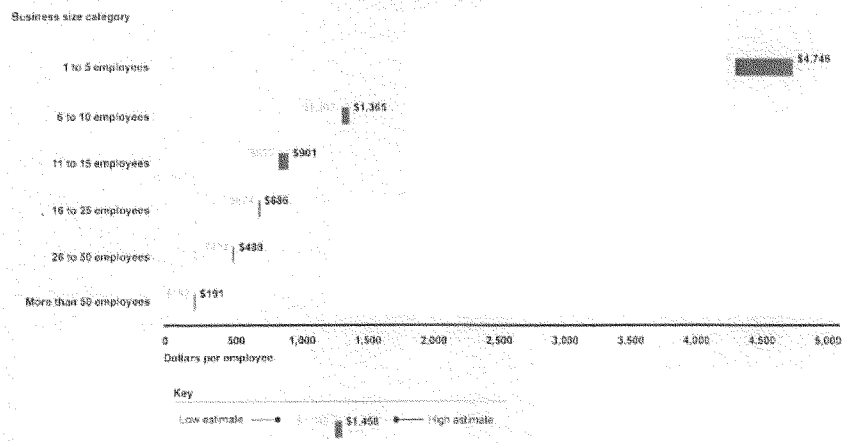
[16]See appendix III, figure 12 for a more detailed discussion of IRS models.

9 through 11).[17] When looking at total receipts and asset size across all businesses, estimated total monetized business compliance costs by business entity type varied depending on the type of entity and the entity's gross receipts. This variation is one reason why compliance burden on small businesses is a concern (see appendix III, table 12).

Figure 7 shows IRS's estimates of compliance costs per employee for S corporations, C corporations, and partnerships. According to the estimates, costs for corporations and partnerships with 1 to 5 employees range from $4,308 to $4,746, compared to $182 to $191 per employee for businesses with 50 or more employees. IRS conducted this research using 2002 taxpayer data. Estimates using more recent data have not been produced. A number of factors would likely affect these estimates if they were produced using current data, including inflation, accounting software improvements, and tax law changes.

[17] Donald DeLuca et al., "Aggregate Estimates of Small Business Taxpayer Compliance Burden."

Figure 7: Estimated Tax Compliance Burden per Employee for S Corporations, C Corporations, and Partnerships (2002)



Source: Donald Bentley et al., "Aggregate Estimates of Small Business Taxpayer Compliance Burden," IRS Research Bulletin (2007). | GAO-15-513

Note: Results include C corporations, S Corporations, and partnerships with assets totaling $10 million or less and do not include sole proprietorships. It is important to note that the imprecise nature of each size measure to accurately capture a taxpayer's size of business activities may exaggerate the ratio for the smaller-sized categories. For example, a business with low total assets and high total receipts would have a very different ratio of compliance burden per unit of size depending on which classification scheme is used. However, the general trend holds consistent across IRS measurements of size in that average burden decreases as the size of the business increases.

Estimates from IRS's compliance burden models also show that burdens vary by industry. According to IRS, the retail trade industry incurs the largest pre-filing and filing time burden—businesses in this industry spent an average of between 325 and 331 hours per year on such activities. Manufacturing incurred the largest pre-filing and filing monetary burden, with businesses spending an average of $2,740 to $2,813 per year on these activities. Agriculture, forestry, and fisheries incurred the smallest

average time spent on tax compliance activities (180 to 184 hours) and second smallest average compliance costs ($1,489 to $1,590).[18] Some industries have higher time and monetary compliance costs because the nature of those businesses may affect the complexity of tax activities. For additional information on industry burden, see table 13 in appendix III.

IRS and Treasury researchers have used both the business and individual taxpayer burden models to estimate the influence of specific business characteristics on compliance burdens. Their estimates suggest that recordkeeping and filing burdens increase as the volume of complex compliance activities undertaken by businesses increases, regardless of the size or other characteristics of those businesses. The results for the full population of individual taxpayers were similar.[19] Activities are categorized into varying levels of complexity based on an overall complexity of extracting information from the entity's financial books, items that may require a separate recordkeeping system or a process with potentially separate rules for each item, and tracking records across years.

IRS has not yet attempted to separately measure the compliance burden costs for small businesses associated with filing information returns. However, in a previous report, we found compliance cost per form decreased as the number of forms handled increases. Specifically, two information return preparers reported the cost per transaction for preparing and filing Forms 1099 with IRS of about $10 per form for 5

[18]IRS reported aggregate estimates for the total small business population using sample weights. To address extreme outlier values, IRS reported ranges in burden estimates to account for any potential bias due to response errors. The low end of the range reflects treating outliers as missing and imputing responses. The high end of the range reflects an approach that caps the extreme values at five standard deviations from the mean for the responses.

[19]These results are presented in Rosemary Marcuss, et.al., "Income Taxes and Compliance Costs: How Are they Related?", National Tax Journal, December 2013, 66 (4), pp. 833-854 and George Contos, et.al., "Taxpayer Compliance Costs for Small Businesses: Evidence from Corporations, Partnerships, and Sole Proprietorships," (2009) Proceedings of the One Hundred Second Annual Conference on Taxation pp. 50-59. National Tax Association, Washington, D.C.

forms to about $2 per form for 100 forms, with one of them charging about $.80 per form for 100,000 forms.[20]

Audits and Other Compliance Contacts Can Be a Significant Source of Burden for Taxpayers, but Research Is Limited

IRS has not conducted research to estimate the compliance costs of audits and other post-filing compliance contacts for small businesses. However, IRS conducted preliminary research on compliance costs for individual filers that can provide some insights into the sources of burden that would affect some small businesses that report business income on individual tax returns. From the taxpayer perspective, post-filing begins when the taxpayer receives notice of an issue with an already filed tax return and concludes when the issue has been resolved. Post-filing compliance costs include any time spent on resolving an issue or money spent on things ranging from postage to paying a tax professional. IRS's preliminary data on individual post-filing compliance costs provide information on the time and money spent on post-filing activities such as an audit—a review of accounts and financial information to ensure information is being reported correctly—or collections—receiving a bill for not paying taxes in full when a tax return was filed.

For individual filers, IRS research indicates that the level of compliance costs are highly dependent on the approach IRS takes in how it contacts the taxpayer to address potential underreporting or underpayment of tax obligations. IRS's preliminary estimates, based on survey data from 2011, indicate that the average post-filing compliance costs were the highest for a field exam—an audit conducted at an individual's home or place of business—at $4,800, followed by office exam—an audit conducted at an IRS office—at $2,165. A notice informing the taxpayer that they did not report all of their earnings had the lowest estimated average post-filing compliance costs at $230. IRS's research on the magnitude of audit costs for individual filers likely includes individual filers who are small business owners. Those businesses are likely to have more complicated returns and, as a consequence, their burden is likely to be at least as great as the averages show for individual filers. For more details concerning post-filing compliance costs, see figure 13 in appendix III.

[20]GAO, Tax Administration: Costs and Uses of Third Party Information Returns, GAO-08-266 (Washington, D.C.: Nov. 20, 2007).

According to IRS, the audit rate for small business taxpayers is higher than the rate across all individual taxpayers because small businesses historically have higher noncompliance than other taxpayers.[21] Table 2 provides detailed information on the audit rates across small business types.

Table 2: Audit Rates Across Small Business Types (Fiscal Year 2014)

Business Category	Size	Audit Rate
Individual Nonfarm Business Returns[a]	Gross receipts < $25,000	1.0%
	Gross receipts $25,000 < $100,000	1.9%
	Gross receipts $100,000 < $200,000	2.4%
	Gross receipts $200,000 or more	2.1%
Individual Farm Business Returns[a]		0.5%
Individual Business Returns with total positive income of at least $200,000 and under $1,000,000[b]		2.7%
Small Corporations[c]	Total assets < $250,000	0.9%
	Total assets $250,000 < $1,000,000	1.2%
Partnerships[d]	Total	0.4%
S Corporations[d,e]	Total	0.4%

Source: IRS Data Book 2014. | GAO-15-513

Notes:

[a]Total gross receipts is the sum of gross receipts from farm and nonfarm businesses without earned income tax credit.

[b]Total positive income is the sum of all positive amounts shown for the various sources of income reported on the individual income tax return and, thus, excludes losses.

[c]Includes returns with assets of less than $10 million.

[d]Nontaxable returns are filed for entities that generally do not have a tax liability, but pass through any profits and losses to the underlying owners who include these profits or losses on their income tax returns.

[e]Includes most Forms 1120S, which are filed by qualifying S corporations electing to be taxed through shareholders.

While we did not examine post-filing costs, in a past report on correspondence audits, we found a number of issues which contribute to taxpayer compliance burden. These issues included IRS backlogs in responding to taxpayers who provide documentation in response to IRS's audit notices and unrealistic audit time frames set by IRS.

[21]GAO, Small Business: Taxpayers Face Many Layers of Requirements, GAO/T-GGD-99-76 (Washington, D.C.: Apr. 12, 1999).

IRS's Decision-Making Framework Includes Consideration of Small Business Compliance Burden

IRS's Strategic Goals and Internal Revenue Manual Describe the Agency-wide Approach to Taxpayer Burden Reduction

One of IRS's goals in its strategic plan is to deliver high quality and timely service to reduce taxpayer burden and encourage voluntary compliance.[22] Under this goal, IRS has identified seven objectives that further define how it intends to achieve the goal. One objective is to reduce taxpayer burden and increase return accuracy at filing through timely and efficient tax administration processing. IRS outlined performance measures for each strategic goal and objective in a supplement to its financial statement for fiscal years 2013 and 2014.[23] In this supplement, IRS describes some of the initiatives launched or continued and progress made in achieving performance goals. IRS also includes a discussion of goals missed. Several of these goals, if achieved, could have a positive impact on reducing small business compliance burden. For example, responding more quickly to telephone calls, correspondence, and requests for in-person service, as well as enhancing the online experience for customers, could benefit small businesses by requiring them to expend less time and fewer resources for IRS outreach.

In addition to the goals and objectives that focus on burden reduction in the strategic plan, IRS listed general guiding principles for reducing burden in the Internal Revenue Manual 22.24.1 - IRS Servicewide Burden Reduction Activities. The guiding principles are intended to support the consideration of compliance burden as part of tax administration. According to the manual, IRS carries out its mission to achieve significant reduction in unnecessary burden by considering taxpayer burden when

[22]IRS, Strategic Plan: FY2014-2017 (Washington, D.C.: 2014).

[23]IRS, Internal Revenue Service: Management's Discussion and Analysis, Fiscal Year 2014 (Washington, D.C.: 2014)

implementing and reviewing policies and procedures. See table 3 for a list of the guiding principles.

Table 3: General Guiding Principles and Items Employees Consider When Assessing Burden

Guiding Principle	Considerations
Leverage Technology	• Will a new requirement preclude the taxpayer's ability to e-file? • Is there an electronic submission alternative other than paper (e.g. web technology or e-mail)? • Can fillable forms be created?
Leverage Existing Data	• Are there opportunities to leverage information already being requested by another IRS function, government, or from accessible third-party data to limit the information collection burden on the taxpayer (inquire through web research, third parties, or impacted stakeholders)? • Are there opportunities to coordinate with third parties to reduce the burden to taxpayers in meeting the requirements (e.g., consolidate data collection resulting in one form versus two)?
Consider Pre-decisional Stakeholder Input	• Do the procedures/requirements conform to current external business processes or recording/reporting practices? • Are your documents in plain, coherent, and unambiguous terminology?
Benefit Must Outweigh Burden	• Are you requiring documentation that is not necessary to comply with the law and/or which may not actually be reviewed by IRS (or rarely reviewed)? • Are there consequences to the taxpayer for failing to provide the data? If not, how sure are we that they will provide accurate information? • If there are multiple options for legislative implementation, which options are expected to provide the greatest benefit to tax administration for the public cost imposed? • Can the procedure be optional versus mandatory? • Can a short form, or other simplified method, be created for some of the population? • Can a safe harbor procedure be offered to mitigate burden, especially for low income taxpayers and small businesses? • Can the frequency of information collection be limited/reduced? • Should transition relief be offered?

Source: IRS Internal Revenue Manual 2315 | GAO-15-513

According to the Internal Revenue Manual, the mission to reduce taxpayer burden and improve service is embedded in the IRS culture and a responsibility of all divisions. Though staffed to the Small Business and Self-Employed division, a senior advisor serves as the single point of contact for taxpayer burden reduction initiatives across all divisions. The manual states that this arrangement is intended to provide a link across the agency to ensure burden reduction is incorporated within decision-making frameworks. The advisor also acts as a liaison with external stakeholders.

IRS Has Worked with Internal and External Stakeholders to Identify and Reduce Small Business Tax Compliance Burden

IRS officials provided examples of efforts made to engage with internal and external stakeholders to reduce small business tax compliance burden. To engage internal stakeholders, employees can suggest ways to reduce burden by using Form 13285, Taxpayer Burden Reduction Referral. This form allows employees to note an issue causing taxpayer burden, describe the affected population, and propose a solution. Employees can also explain who needs to be involved in making the change, the resources needed, taxpayer benefits, compliance risks, and suggestions for how to measure burden reduction savings (e.g., reduced costs to the taxpayer or reduced costs to IRS). One notable example of a burden reduction initiative at IRS was developing a simplified method for determining the Office in the Home tax deduction.

Simplified Office in the Home Deduction Illustrates How IRS Considers Burden When Implementing Initiatives

IRS officials offered an example of how the agency considered compliance burden principles when implementing new or changed tax laws or administrative procedures with the introduction of a simplified method for small businesses to calculate their Office in the Home Deduction. This method was introduced in 2013 and generally allows filers to receive a deduction of $5 per square foot of office space, up to a maximum area of 300 square feet. The alternative method involves a more complex calculation of property depreciation.

Although the Department of the Treasury (Treasury) and IRS officials reported considering this proposal as early as 2006, in July 2012, Treasury and IRS redoubled their efforts in response to an Office of Management and Budget request to identify initiatives that would eliminate at least 2 million hours in annual burden. To meet this request, IRS reached out to employees and Senior Executive staff, and also reviewed prior submissions, form burden statistics, and other suggestions that had been considered in the past. The group reviewed the proposals and made a final determination that this initiative should be implemented. IRS officials told us that they considered burden and compliance risk within this decision-making process and discussed tradeoffs of their decisions. IRS received external stakeholder input from representatives of the small business community, such as the U.S. Chamber of Commerce and the National Federation of Independent Business, who have recognized this as a positive development. IRS said the process of working collaboratively across the organization, with external parties, and with Treasury allowed them to consider the interests and concerns of all parties. This helped IRS weigh tradeoffs of decisions that could affect both compliance and compliance burden.

Source: GAO analysis of IRS information. | GAO-15-513

Other internal activities include providing employees with an online burden risk estimator tool designed to aid employees in determining whether certain decisions about the design of tax forms for individuals (Form 1040 and associated schedules and forms) could impose significant burdens on taxpayers. This tool is an Excel spreadsheet that uses some of the data used in the more elaborate burden estimation

models discussed previously in this report. The tool provides staff with an estimate of the number of taxpayers who would be affected by a specific potential tax form change, as well as a rough indication of whether the effect on compliance burden would be significant. Divisions can use this tool to identify decisions that merit more in-depth evaluations, potentially involving the full burden estimation model.

IRS undertakes a number of activities to engage external stakeholders such as providing information on its website and holding forums with small business representatives. IRS has a website page that defines taxpayer burden, provides links to submit ideas for burden reduction, and outlines how IRS selects burden reduction initiatives. Another example of IRS outreach to the small business community is the quarterly Small Business Forum. IRS officials told us that they use the information from these forums to inform their decision-making process for practices and policies that affect small businesses. For example, IRS used feedback from forum participants to refine the language used in burden surveys it administers to the business community, and used what was learned to inform its current burden models. Similar to internal stakeholders, external stakeholders can make burden reduction suggestions using Form 13285-A, Reducing Tax Burden on America's Taxpayers (Referral Form for Use by the Public), which allows them to describe the issue causing taxpayer burden, the affected population, and the proposed solution.

Small Business Representatives We Spoke with Identified Areas That Contribute to Compliance Burden

We also interviewed small business representatives (external stakeholders) who acknowledged IRS's external stakeholder outreach efforts and how they have been effective in identifying opportunities to reduce compliance burden. However, they also described a number of areas where small business compliance burden could be further reduced.[24] These areas include issues related to IRS customer service, filing requirements, lack of or delayed official guidance, and compliance contacts. According to these representatives, when they call IRS, they can have long wait times, be disconnected, or be directed to IRS staff who are unable to provide the needed assistance. We have recently reported on these issues as well.[25]

[24]See appendix I for a more detailed description of our interviews.

[25]GAO, Tax Filing Season: 2014 Performance Highlights the Need to Better Manage Taxpayer Service and Future Risks, GAO-15-163 (Washington, D.C.: Dec. 16, 2014).

Further, several representatives shared the perspective that complex filing requirements contribute to compliance burden. While small businesses sometimes anticipate significant tax relief through tax credits and deductions such as the small employer health care credit and mileage and vehicle deductions, some small businesses may not be claiming these credits due to the time, cost, and complexity associated with claiming them. One concern we heard from small business representatives was that after a tax practitioner expends resources to compile the necessary documentation and calculate the credit, their client (the small business) is ineligible to claim the credit. This could result in additional taxpayer burden if tax preparers bill their clients for calculating the credit when it is not claimed.

In addition to facing burdens due to new and complex tax provisions, representatives we spoke with also expressed concern over the compliance burden associated with delayed or missing official guidance, particularly for the Patient Protection and Affordable Care Act employer mandate.[26] Representatives also noted that deadlines for responding to certain IRS notices can be difficult for small businesses when the requested information is not readily available. We recognize that IRS is aware of many of these concerns and, through various initiatives, has made efforts to address these issues. However, continued attention to these areas will be key to effectively reducing burden.

We routinely issue reports on aspects of IRS's enforcement and administrative operations, some of which may impact small business tax compliance burden. In many cases we have made recommendations that, if implemented, could help to reduce these burdens. Selected recommendations that have yet to be implemented are listed in appendix IV.

[26]The employer mandate is a requirement that all businesses with 50 or more full-time equivalent employees (FTE) provide qualifying health insurance to 95 percent of their full-time employees, or pay a tax penalty if one full-time employee receives the premium tax credit, 26 U.S.C. § 4980H. The employer mandate itself was delayed, in part, to reduce compliance burden. Despite that delay, IRS guidance was still finalized later than initially planned, which representatives said created additional burden.

IRS's Overall Evaluation of Its Payment Card Pilot Has Several Strengths, but Does Not Fully Address All Elements Necessary to Effectively Assess Results

New Payment Card Data Provide Opportunities to Improve Voluntary Compliance and Have Potential to Help IRS Better Identify Noncompliant Small Business Taxpayers

Beginning in tax year 2011, payment settlement entities were required to send IRS Forms 1099-K to report gross merchant payments in which a payment card or a third-party payment network was used as the form of payment.[27] Payment settlement entities report the gross amount of all reportable transactions a merchant made through them, for the calendar year, without regard to adjustments for credits, cash equivalents, discounts, fees, refunds, or other deductions.

A copy of the 1099-K is also sent to the taxpayer. The reporting of this information to both IRS and the taxpayer can encourage voluntary compliance by small businesses in at least two ways. First, since taxpayers know IRS is also receiving this income information, they are more likely to include it on their tax return. Second, taxpayers have another source of information they can use to help calculate or verify business income.

Payment card reporting also provides IRS with an information source it can use to compare against the income reported by small business

[27] 26 U.S.C. § 6050W; 26 C.F.R. §§ 1.6050W-1, 1.6050W-2. Section 6050W requires payment settlement entities to provide IRS with merchants' tax identification number and tax filing name. There are two types of payment settlement entities: merchant acquiring entities, such as credit card companies, and third-party settlement organizations, such as PayPal and certain toll road providers. Unlike payment card transactions, third-party network transactions are only reportable if a merchant's aggregate amount of such payments for the year exceeds $20,000 and if the aggregate number of transactions exceeds 200.

taxpayers on their tax returns. As such, it can serve as a tool for identifying noncompliant taxpayers, including those who failed to file a tax return at all and those who underreported their income. This type of comparison is a common IRS enforcement technique. For example, IRS can directly compare information it receives on a taxpayer's Form W-2, Wage and Tax Statement, against a tax return to determine if the taxpayer reported earnings and withheld taxes correctly.

However, matching is more complicated for Forms 1099-K than Forms W-2 because IRS cannot directly match the line items on 1099-Ks to line items on tax returns. The Form 1099-K reports the gross amount of payment card and third party network transactions made through a payment settlement entity. This does not match the gross receipts line on tax returns because Form 1099-K transactions may include items like sales tax, gratuities, and cash back, all of which are not income. Furthermore, tax return gross receipts can include cash and check revenue, which is not captured on Form 1099-K. To leverage Form 1099-K data, IRS researched and tested ways in which the new data can be used to most effectively and efficiently improve voluntary compliance, detect noncompliance, and identify those who did not file returns.

The Payment Card Pilot includes six activities to test three methodologies for selecting cases, as described in table 4.

Table 4: Description of Payment Card Pilot Activities

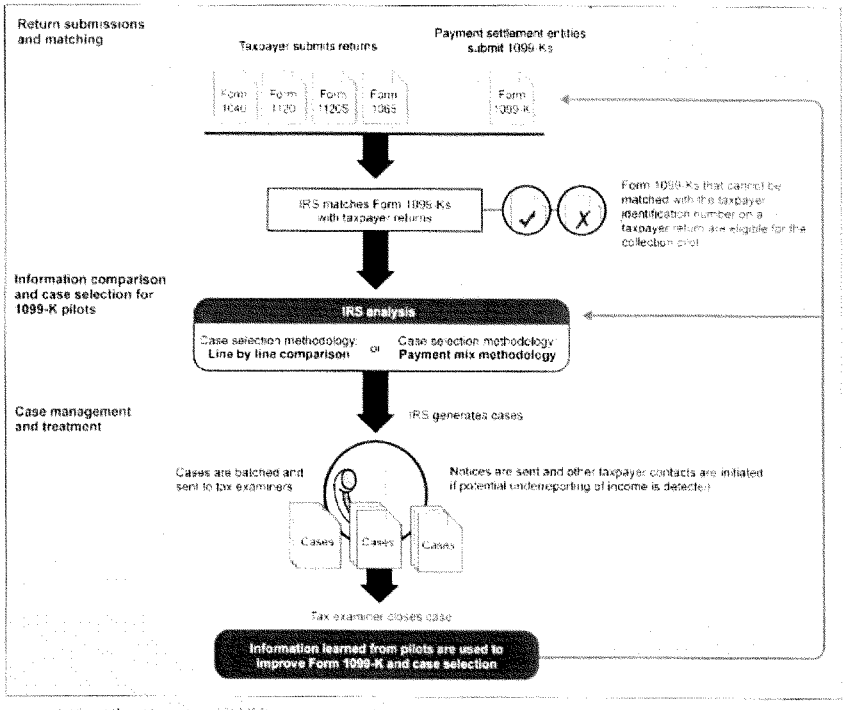
Case selection methodology	Pilot program activities
Collection IRS uses Form 1099-K data to identify nonfiler taxpayers and taxpayers with unpaid assessments.	Collection IRS uses Form 1099-K information to identify nonfiler taxpayers, prioritize casework, and calculate taxpayer income.
Line by Line Comparison IRS compares Form 1099-K data with tax returns. A notice is sent if card receipts are greater than what the taxpayer has reported.	Automated Underreporter IRS compares the gross amount of the total reportable payment card/third-party network transactions for the calendar year to individual tax returns (Form 1040 Schedules C/E/F).
	Business Underreporter IRS compares the gross amount of the total reportable payment card/third party network transactions for the calendar year to business tax returns (Forms 1120, 1120S, and 1065).
Payment Mix Methodology IRS compares the relative cash and card revenues of similar businesses by setting thresholds for identifying	Alternative Notice IRS issues taxpayer a letter asking them to review their books and records to ensure all gross receipts are reported.

Case selection methodology	Pilot program activities
underreporters.	Technical Audit IRS tests the effectiveness of this compliance treatment using Form 1099-K data in a correspondence audit.
	Field Audit IRS tests the effectiveness of this compliance treatment using Form 1099-K data in a field audit.

Source: GAO analysis of IRS pilot documentation. GAO-15-513

In all of the pilot activities, IRS uses taxpayer identification numbers to first match Forms 1099-K with the correct tax returns. IRS then compares Form 1099-K information with business income reported on individual and business tax returns. This process is detailed in figure 8. In the two underreporter pilot activities, IRS compares line by line the gross dollar amount of payments listed on Form 1099-K to gross receipts reported on the tax return to identify potential underreporting of payment card and third-party network revenue.

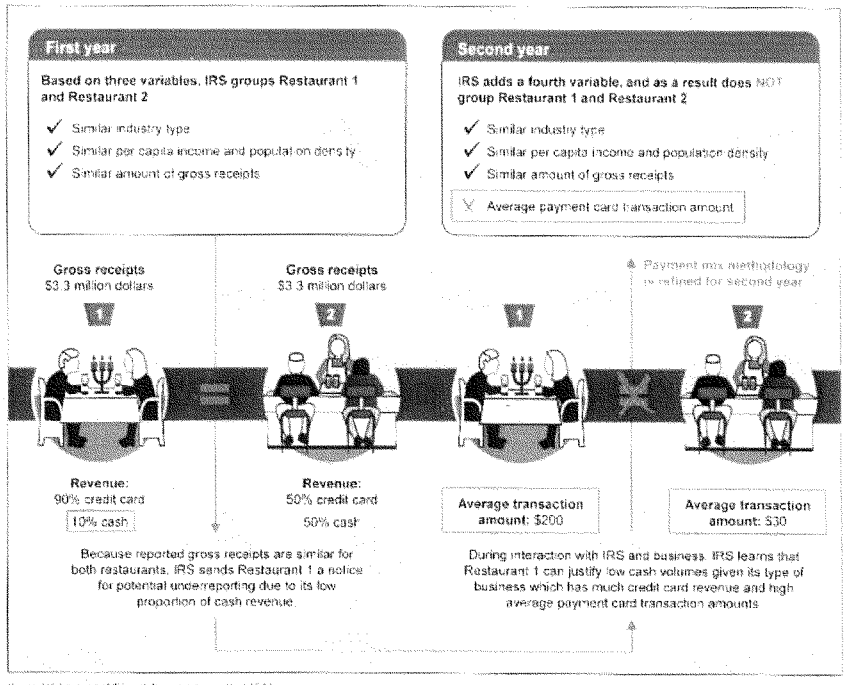
Figure 8: IRS Form 1099-K Test and Learn Process



The payment mix methodology aims to identify potential underreporting of gross receipts from both card and cash sources. For this methodology, IRS first calculates a payment mix—the relative ratio of cash and card revenues of similar businesses. IRS determines this ratio by dividing the gross payment amount on Form 1099-K by gross receipts on the tax

return. IRS then computes the amount of potential underreporting by comparing this payment mix to that of similar businesses based on variables including industry type and size, population density, per capita income, and average transaction sizes. As part of the test and learn process, IRS has expanded the number of variables to refine identification of possible underreporting taxpayers. One example of this is illustrated in figure 9.

Figure 9: Illustration of How IRS Changes the Payment Mix Methodology to Improve Identification of Noncompliant Taxpayers



Source: GAO analysis of IRS and Restaurant data. | GAO-15-513

If implemented successfully and properly evaluated, the payment card pilot could allow IRS to determine which, if any, pilot activities are effective enough to justify broader expansion, including integration with or replacement of other compliance enforcement efforts.

IRS's Evaluation Plan Enabled It to Rapidly Test, Learn from, and Adapt Pilot Activities, but Does Not Include Key Elements for Assessing Overall Pilot Performance

To assess IRS's plan for evaluating the payment card pilot we used our previously developed guidance to identify key elements for designing quality evaluations.[23] Addressing each element at the overall pilot and pilot activity levels can provide program managers with objective information to iteratively assess program performance. The five key elements we identified for quality evaluation design are described in table 5.

Table 5: Elements of a Program Evaluation Framework

Element	Characteristics
Clarify understanding of the program's goals and strategy.	• Program activities. • Program stages. • Expected short-, medium-, and long-term impact. • Resource investments. • External factors that could affect the outcome.
Develop relevant and useful evaluation questions and an analysis plan.	• Objective and answerable evaluative questions. • Clearly defined criteria.
Assess the relevance and quality of available data sources.	• Description of the information or data and sources needed to assess the program against the evaluation criteria. • Description of how the information will be gathered. • Description of the tools developed to obtain these data and how they are assessed. • A data reliability assessment.
Address data, scope, and methodology limitations.	• Documentation of assumptions, procedures, and modes of analysis. • Assess that the evaluation fits available time and resources. • Determination that data are free of bias and errors.
Facilitate the use of the evaluation results in program management decision-making.	• Demonstrate leadership support. • Build a strong body of evidence. • Engage stakeholders throughout the evaluation process.

Source: GAO | GAO-15-513

IRS's evaluation plan for pilot activities integrated many characteristics of a well-designed evaluation. As a result, IRS was able to make rapid,

[23]Criteria were developed from GAO, *Program Evaluation: Strategies to Facilitate Agencies' Use of Evaluation in Program Management and Policy Making*, GAO-13-570 (Washington, D.C.: June 26, 2013), and *Designing Evaluations: 2012 Revision*, GAO-12-208G (Washington, D.C.: January 2012).

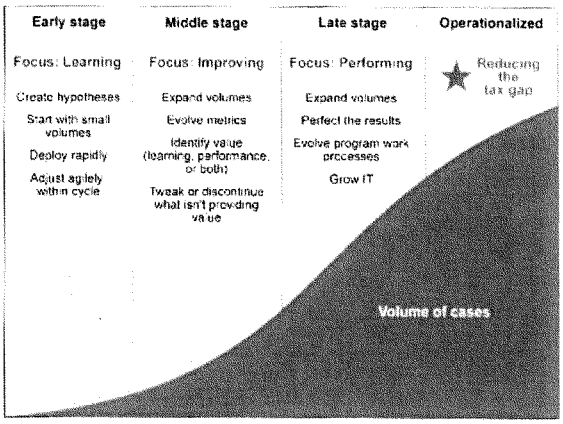
ongoing assessments of pilot activities and continually incorporate changes based on what was learned. This approach allowed IRS to test many hypotheses simultaneously while limiting the number of small business taxpayers affected by the pilot.

However, the overall evaluation plan for the pilot lacked characteristics of each element that are necessary to ensure a quality evaluation. If IRS does not address these gaps, it risks not having the evidence needed to effectively decide whether, how, and when to integrate pilot activities into broader small business compliance improvement efforts.

Clarify Understanding of the Pilot's Goals and Strategy

IRS clearly defined the overall pilot goal, which is to use Form 1099-K data to identify and reduce underreported and unreported income. IRS outlined and detailed the specific program activities it tested and documented pilot planning and results in a strategic planning document and several other executive-level updates. These documents detailed various actions, including internal meetings, assessments, outreach, training, and information technology activities, during the early stages of the pilot. IRS's strategic planning document also provided a conceptual representation of the different stages of the pilot and the growth of compliance case volume at each stage, as seen in figure 10.

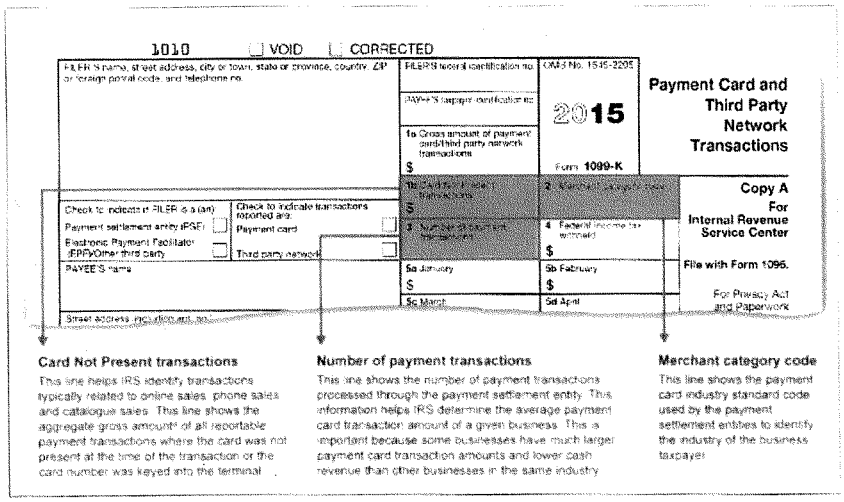
Figure 10: IRS's Conceptual Timeline of Pilot Stages



Source: GAO analysis of IRS pilot documentation. | GAO-15-513

IRS has generally documented the expected short-, medium- and long-term impacts of the pilot. One important short-term impact included learning about the small business population to improve identification of noncompliant taxpayers. For example, IRS realized an issue was arising because some small businesses—such as high-end restaurants—have lower cash revenue than other similar businesses. To address this issue, IRS added a line to Form 1099-K to collect data about the number of payment transactions (see figure 11). IRS uses this information to determine the average payment card transaction amount. In the medium term, IRS sees the potential for improved taxpayer voluntary compliance. After the first year of the pilot, IRS tested compliance levels of taxpayers before and after the introduction of the pilot and found that almost half of taxpayers increased their reported gross receipts, and about 60 percent of those contacted reported their income more accurately the following year. In the long term, IRS sees these activities helping to reduce the tax gap.

Figure 11: IRS Changes to Form 1099-K as a Result of Pilot Learning



[a]The gross amount refers to the total dollar amount of reportable transactions without regard to adjustments including credits, cash equivalents, discount amounts, fees, or refunds.

While IRS has defined high-level pilot goals, such as improving voluntary compliance and reducing the tax gap, it did not establish performance measures for these goals and has not decided on a time frame for developing them. IRS has defined broad stages for pilot implementation, but has not clearly identified measures or indicators to determine when the pilot has moved or will move from one stage to the next.

IRS identified pilot staffing needs. In June 2012, IRS estimated the number of full-time equivalents (FTE) it would need to conduct field exams. IRS officials also said they track resources for some of the pilot activities, including the implementation of the payment mix methodology pilots. However, IRS's evaluation plan has not fully identified and tracked

resource needs or use, including the actual numbers of FTEs hired or management resources to design and monitor test and learn pilots.

IRS identified external factors that could affect the progress or effectiveness of the overall pilot. It identified potential hurdles, including possible litigation and access to necessary technology solutions. However, IRS has not articulated how these factors affect the future of the pilot and what decisions it will make to address them under different scenarios.

Develop Relevant and Useful Evaluation Questions and an Analysis Plan

IRS evaluated pilot activity results, but there is no clear documentation of its evaluation questions or analysis plan. However, these can be inferred based on the evaluation results. According to IRS officials, one of the evaluation goals was to learn why some compliant taxpayers were identified as potential underreporters of income. IRS examined the results of closed cases to learn how to better identify compliant and noncompliant taxpayers. An example of this analysis and resulting change is described in more detail in the text box.

IRS Test and Learn Approach to Improve Identification of Noncompliant Taxpayers

One IRS pilot learning goal is to test a new case selection methodology called the payment mix methodology. IRS is learning how to improve this methodology to better identify noncompliant taxpayers.

When analyzing results of the first year of the pilot program, IRS found that a significant percentage of online-only businesses—which do not accept cash—were falsely identified by the payment mix methodology as potential underreporters of cash income. To decrease the likelihood that compliant online-only businesses were selected in future years, IRS added a line to Form 1099-K that allows the payment settlement entity to specify the aggregate gross amount of all reportable payment transactions during the calendar year where the card was not present at the time of the transaction or the card number was keyed into the terminal. Typically, this relates to online sales, phone sales, or catalogue sales. Because IRS reduces the probability that compliant small business taxpayers are identified as potential underreporters of income, the overall burden for compliant taxpayers is reduced.

Source: GAO analysis of IRS documentation. | GAO-15-513

IRS evaluated the results of all pilot activities. IRS compared the average time to complete an audit and the average dollars assessed in additional tax for each case against existing compliance and enforcement efforts. IRS could use this information to decide which pilot activities to implement in a full compliance program.

IRS did not have evaluative questions and criteria to assess whether the overall pilot or the pilot activities achieved the intended goals or produced

the intended results. Understandably, as IRS tests and adapts different approaches, it has learned and will continue to learn which approaches demonstrate the most promise in efficiently and effectively identifying noncompliant taxpayers. Clearly articulated evaluative questions and related analysis plans would allow IRS to determine whether the overall pilot and pilot activities are achieving results that would signal what next steps should be taken. These may include deciding the pilot can move beyond the learning stage, be expanded, or, ultimately, moved from pilot to full implementation as a compliance program. Conversely, the determination could be that the pilot and pilot activities are not achieving the intended results and should be discontinued or modified.

Assess the Relevance and Quality of Available Data Sources

During the early stages of the pilot, part of IRS's evaluation of pilot activities involved assessing Form 1099-K data quality. IRS monitored potential errors that payment settlement entities could make when filling out the form, including invalid or missing taxpayer identification numbers. Such data entry errors could negatively affect IRS's efforts to compare the data with information reported on small business taxpayer returns. When errors were identified IRS contacted the payment settlement entities to make corrections. IRS officials told us that because of this effort, accuracy rates for matching rose from 90.3 percent for tax year 2011 to 95.4 percent for tax year 2013. IRS officials have told us that analysis of Form 1099-K data is ongoing.

Since IRS lacks evaluative questions and an analysis plan for assessing the overall pilot, it does not have complete descriptions of the information or data and sources needed to assess the overall pilot against evaluation criteria, how that information will be gathered, and an assessment of data reliability. Because IRS addressed the relevance and quality of data sources in some of the early evaluations of some pilot activities, this information could feed into the development of the broader evaluation plan.

Address Data, Scope, and Methodology Limitations

IRS documented certain assumptions of its analysis. For example, in the alternative notice pilot, IRS sent assessments to taxpayers who did not respond to the notice and those who admitted to underreporting. IRS referred cases to IRS field work when taxpayers sent insufficient responses or communicated that a review of books and records was necessary.

Furthermore, in the early stages of the pilot, IRS showed evidence that it checked that data were free of errors. In the first year of the pilot, officials

took steps to ensure that compliance examiners understood and consistently applied decision rules to determine compliance results.

IRS provided evidence that it estimated timelines and relative resource needs to move from the test and learn phase to a full compliance program. IRS outlined three scenarios to achieve a given level of compliance at program implementation. However, these scenarios were developed without a program level evaluation. Until IRS conducts an evaluation, it will not have the information it needs to determine which approach to take.

Although IRS showed evidence that data, scope, and methodology limitations were considered and addressed for certain pilot activities, these limitations were not fully addressed for the overall pilot. IRS would first need to develop evaluative questions, assessment criteria, and an analysis plan for the overall pilot before it could clearly assess data, scope, and methodology considerations. An assessment of design limitations would include stating any limitations of pilot scope, determining comparisons against which to assess pilot results, and assessing whether the evaluation fits available time and resources. Asking these questions would help clarify the potential impact of any project design limitations when determining whether to move pilot activities toward full program implementation.

Facilitate Use of the Evaluation Results in Program Management Decision Making

IRS provided evidence that leadership from multiple offices across the agency—the Small Business and Self-Employed Division, Office of Compliance Analytics, and the Information Technology Organization—demonstrated commitment to using evaluation data to inform pilot decision making for the beginning of the pilot. Senior officials from each of these offices met weekly during the early stages of the pilot. The leadership actively engaged internal stakeholders and developed strategies to internally communicate information about pilot program activities. These strategies included organizing employee focus groups, training, and leadership updates on pilot progress. For example, in October and November of 2012, IRS provided an update on project communication status to communication directors across all operating divisions.

In addition, IRS leadership engaged with external stakeholders before launching the pilot. In October 2011, IRS addressed small business representatives' concerns about paperwork burdens by announcing that it would not require taxpayers to reconcile gross receipts and merchant card transactions. IRS also worked to address tax practitioner questions

about the use of the payment mix methodology for case selection. As a result of the outreach, for example, IRS developed and tested a tool to help tax practitioners determine if their clients would be at risk for underreporting cash transactions.

Conclusions

IRS's payment card matching program has the potential to enhance the agency's ability to identify noncompliant small business taxpayers. Better identification of noncompliance would reduce the burden placed on honest taxpayers because the likelihood they would be selected for costly and time-consuming audits or other compliance contacts could be reduced. Further, more effective identification of noncompliant taxpayers means IRS can more efficiently use limited resources.

IRS's Payment Card Pilot shows promise in producing these results. However, IRS has a long road ahead to figure out whether and how the pilot, and its many activities, can be fully implemented. IRS has not clearly defined the stages of the pilot or measurable goals that it can use to determine when the pilot has moved from one stage to the next, or if it should. Without defining the stages and establishing related metrics, IRS will not be able to articulate the pilot's status at critical points in time. Further, it will not be able to justify the investment of additional resources if it cannot demonstrate progress toward those goals. In addition, IRS has not developed a full evaluation plan that will allow for a systematic assessment of the overall pilot against evidence-based criteria. Such a plan is necessary so IRS can ensure that it is making informed decisions about moving forward. Following key elements of evaluation design will help ensure that the results of the evaluation are valid and reliable. Finally, documenting the plan's limitations will reduce the risk that IRS will draw conclusions that are beyond what can be supported.

Recommendations

To improve the evaluation of the payment card pilot, the Commissioner of Internal Revenue should take the following actions:

- Clearly define the stages of the payment card pilot and establish measurable goals for determining when the pilot advances from one stage to the next.
- Develop an evaluation plan for the overall pilot and building on pilot activities to inform decisions about whether, how, and when to integrate pilot activities into overall enforcement efforts. This plan should include
  - evaluation questions,

- evidence-based evaluative criteria,
- an analysis plan,
- a complete description of data to be collected,
- a data reliability assessment, and
- documentation of evaluation limitations.

Agency Comments

We provided a draft of this report to the Commissioner of Internal Revenue and the Secretary of the Treasury for their review and comment. IRS's Deputy Commissioner for Services and Enforcement provided written comments, which expressed appreciation to GAO for recognizing IRS's efforts to consider taxpayer burden when implementing processes and procedures. In its response to the draft, IRS agreed to incorporate an evidence-based assessment of the payment card pilot that includes identifying clearly defined pilot stages and implementing an evaluation plan with measurable goals. IRS stated it will provide a more detailed response to our recommendations after this report has been released. These comments are reprinted in appendix V. IRS also provided us with technical comments, which we incorporated into the report as appropriate. Treasury did not provide comments.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. In addition, this report will be available at no charge on GAO's website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or by email at mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix VI.

James R. McTigue, Jr.

James R. McTigue, Jr.
Director, Tax Issues
Strategic Issues

Appendix I: Objectives, Scope, and Methodology

The objectives of this report are to: (1) describe the characteristics of the small business population; (2) describe how characteristics of a small business affect compliance burden; (3) describe how the Internal Revenue Service (IRS) integrates small business compliance burden considerations in decision making; and (4) assess IRS's plan for evaluating its payment card pilot.

To describe general characteristics of the small business population such as the number of small businesses and total income, we reviewed taxpayer data from IRS Statistics of Income (SOI) and studies with access to taxpayer data. We reviewed SOI documents about data reliability and sampling methodology, and interviewed officials in SOI. We reviewed reports from researchers at the U.S. Department of Treasury, Office of Tax Analysis (OTA). We interviewed two of the OTA authors about their methodology for identifying the small business population. We performed data reliability tests by comparing OTA estimates for all filers against SOI estimates and by comparing OTA estimates for tax year 2007 and 2010. We found the estimates from researchers at OTA were sufficiently reliable for our purposes of describing general characteristics of the small business population. See appendix II for a more detailed discussion of OTA researchers' methodology and assumptions.

To describe how characteristics of a small business affect compliance burden, we conducted a literature review where we reviewed IRS research papers and conference presentations, academic studies, and our prior work on taxpayer compliance burden. We searched relevant databases such as ProQuest, Accounting & Tax, EconLit, ABI/Inform, Nexis.com, and Tax Notes. We identified and reviewed selected IRS studies on tax compliance burden conducted over the last 11 years. We also asked IRS officials from the Research, Analysis, and Statistics (RAS) division to identify any additional IRS research assessing small business tax compliance burden and post-filing burden. To obtain information related to federal small business tax requirements, we reviewed IRS taxpayer guidance found on the IRS website including the 2015 tax calendar. We interviewed relevant IRS officials to clarify our understanding of the research and models, and to verify our analysis.

To describe how IRS integrates small business compliance burden considerations in decision making, we examined IRS's strategic plan and relevant goals and objectives related to taxpayer burden. We also reviewed IRS's Internal Revenue Manual, which outlines, among other things, guiding principles for considering burden reduction. We interviewed IRS officials in the Small Business and Self-Employed

division (SB/SE), RAS, and the Office of Taxpayer Burden Reduction about other activities IRS conducts related to taxpayer burden reduction, tools it uses to manage burden reduction efforts, and initiatives it implemented. In addition, we interviewed tax practitioners, associations, and other liaisons to the small business community to identify areas of burden associated with interactions between IRS and the small business community, and discuss what might alleviate burden. We conducted unstructured interviews with a non-generalizable sample of 12 organizations based on their knowledge of small business tax policy resulting from historical involvement and relationships with the small business community and IRS. We reviewed supporting documentation, where available. We selected these organizations to represent a variety of perspectives and groups within the small business community.

To assess IRS's plan for evaluating the payment card pilot, we reviewed and summarized documentation that included IRS's Information Reporting and Document Matching Strategic Roadmap; Communication, Outreach, and Education Strategic Plan; and IRS internal presentations to the IRS Commissioner. We interviewed IRS officials from SB/SE and Office of Compliance Analytics divisions on the pilot to link IRS's test and learn approach to defining strategic goals, evaluation questions, an analysis plan, and the ability to track benefits of the pilot efforts. We compared these efforts to our guidance on program evaluation design and applied criteria adapted from the guidance to both the overall pilot and pilot activities.[1]

We conducted this performance audit from July 2014 to June 2015 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[1]Criteria were developed from GAO, *Program Evaluation: Strategies to Facilitate Agencies' Use of Evaluation in Program Management and Policy Making*, GAO-13-570 (Washington, D.C.: June 26, 2013), and *Designing Evaluations: 2012 Revision*, GAO-12-208G (Washington, D.C.: January 2012).

Appendix II: Description of Methodology and Reliability of Data Used to Produce Small Business Population Estimates

For our analysis, we use estimates from researchers at the U.S. Department of the Treasury, Office of Tax Analysis (OTA), to describe the characteristics of the small business population, such as the number of small businesses and total income.[1] There are no universally accepted criteria for defining the small business population. OTA estimates address some of the limitations of describing the small business population using estimates based solely on the type of tax return that is filed by excluding certain tax returns that may not be actual businesses. Not all tax returns that report business income represent business entities with the principal purpose to generate revenue or to engage in substantive business activity. For example, some C corporations can serve as investment vehicles that engage in little or no business activity. Further, partnerships may be created to redistribute profits generated by another partnership and may not generate income themselves.[2] Filers of Form 1040, Schedule C, may be independent contractors who may more closely resemble employees than small businesses. Additionally, rental income for some individuals may be incidental and not represent business activities. Uncertainty within OTA estimates can come from: (1) assumptions that were made to distinguish small businesses engaged in substantial and substantive business activities from other entities that file the same tax return; and (2) that the estimates are based on sampled taxpayer data and subject to sampling error. Consequently, results that are slightly higher or lower than those reported in this particular analysis may be equally valid for describing the numbers of businesses in each subgroup and the size of their incomes. We found the estimates from the researchers at OTA were sufficiently reliable for our purposes of describing general characteristics of the small business population.

Throughout this report, we refer to the estimated number of small business filers as the number of small businesses. Using these estimates

[1]We use estimates from OTA researchers to describe the characteristics of the small business population. We refer to the estimated number of small business filers as the number of small businesses. See Richard Prisinzano, Jason DeBacker, John Kitchen, Matthew Knittel, Susan Nelson, and James Pearce, "Identification of Small Businesses Using Tax Data: 2010 Update" (presented at the 2013 National Tax Association's Spring Symposium, May 17, 2013); Office of Tax Analysis, Department of the Treasury, Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, *Methodology to Identify Small Businesses and Their Owners*, Technical Paper 4 (August 2011).

[2]GAO, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance*, GAO-14-453 (Washington, D.C.: May 14, 2014).

may understate the number of small businesses where individual taxpayers can own multiple small businesses. For example, individual taxpayers can file multiple schedules to report business activity (profit, loss, and supplemental income and loss from rental real estate activity) from different lines of business.[3] The number of schedules filed is greater than the number of Form 1040 tax returns to which these schedules are attached due to some returns having multiple schedules.[4] The total income estimates are the sum of all business income reported on tax returns, including gross receipts, rents, dividends, capital gains, royalties, and interest.[5] Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule to avoid attributing income from pass-through entities or from royalties to these businesses.

The OTA analysis had access to taxpayer data made available by IRS Statistics of Income (SOI).[6] Available data from SOI samples indicate that the sampling errors for the total number of filers and total business receipts for each type of taxpayer is less than +/- 6 percent at the 95 percent confidence level. Sampling errors of subpopulations may be higher where tax returns have been sampled at lower rates. Data were not available to determine sampling errors for the OTA total income measure; however, business receipts make up such a substantial portion of the OTA total income that we would not expect the sampling error to be

[3]This information is filed on the following forms: Schedules C (Form 1040), *Profit or Loss From Business*; Schedule E-Part I (Form 1040), *Supplemental Income and Loss*, with rental real estate activity; and Schedule F (Form 1040), *Profit or Loss From Farming*.

[4]An alternative approach to estimating the number of small businesses is to treat each schedule attached to Form 1040 returns as a separate business. This alternative approach could help inform about the unique burdens associated with filing specific schedules. For an example that takes a similar approach, see Edith Brashares, Matthew Knittel, Gerald Silverstein, and Alexander Yusavage, "Calculating the Optimal Small Business Exemption Threshold for a U.S. VAT," *National Tax Journal*, vol. 67, no. 2 (June 2014): 283–320. Comparing the methodologies from Brashares et al. and Prisinzano et al. applied to filers of Form 1040 Schedule C in tax year 2007, the number of qualifying Schedules C filed is 25.5 million compared to 23.1 million total taxpayers filing at least one Schedule C.

[5]This total income measure serves as a proxy for total business activity and is not the same as taxable income. In particular, costs of doing business are not deducted and business losses are not used to offset other types of income.

[6]OTA researchers developed estimates from tax return data from SOI samples and applying minimal business activity tests and other methodologies to identify unique business entities. The methodologies and assumptions used in this research are important to consider when interpreting these data.

significantly greater for the OTA total income estimates than it is for the SOI estimates for business receipts. For C corporations, S corporations, partnerships, and sole proprietorships in 2010, the OTA number of filers is within +/- 2 percent of SOI estimates of the number of filers.[7] OTA total income estimates are higher (within + 20 percent) of SOI total receipts estimates for these filers because OTA's total income measure includes types of income other than business receipts.

The estimates used in this report are based on thousands of returns from the 2010 SOI Individual, Corporate, and Partnership Studies. Although we do not know the exact number of records used for each estimate, the Individual sample has 50,464 Form 1040 returns with a Schedule C with a sample selection amount of less than $10 million and 5,804 Form 1040 returns with Schedule F but without a Schedule C. The sample selection amount is the greater of indexed negative income and indexed positive income. The Corporate sample has 20,085 Form 1120 returns with total assets less than $10 million and size of proceeds less than $2.5 million where proceeds is defined as the larger of the absolute value of net income (deficit) or absolute value of cash flow (which includes net income, depreciation, and depletion). The Corporate sample also has 15,741 Form 1120S returns that have total assets less than $10 million and size of proceeds less than $2.5 million. The Partnership sample has 35,744 returns with total assets or current activity measure less than $10 million. Current activity measure is the maximum of the absolute value of receipts and income/loss. In this situation, receipts is the sum of the net receipts, rental income, gross income, portfolio interest income, dividend interest income, royalty income, and net long-term capital gain/loss. Income/loss is the sum of ordinary income, net income, net income from the balance sheet, portfolio interest income, royalty income, and net long-term capital gain/loss.

Table 6 shows SOI estimates for the total number of filers and total income by type of tax return for tax year 2010 (as reported by Prisinzano

[7] The OTA data for Schedule E renters differs from estimates in SOI publicly published data tables due to OTA's limitation to only individuals with rental real estate activity on Schedule E, Part I. The OTA data for Schedule F farmers differs from SOI estimates due to the inclusion of individuals filing Form 4835 in addition to those filing Schedules F.

et al.).[8] The OTA analysis and Prisinzano et al. apply two tests to exclude tax returns filed that do not represent filers that generate substantial income or engage in substantive business activity. The first test is a de minimis activity test that requires taxpayers to report total income or total deductions greater than $10,000, or that their sum be greater than $15,000. The second test requires total deductions be greater than $5,000, which indicates substantive business activity based on expenses related to employees, inventories, and investment, among other things. The application of these two tests results in the exclusion of 46.7 percent of the 44.6 million total tax returns, but only 0.6 percent of the total $33.3 trillion in total income represented by these tax returns.[9]

[8]Access to SOI micro-level data allows researchers to identify populations based on characteristics of tax returns and to create unique measures of income. This results in studies with access to SOI micro-level data reporting different values for the same taxpayer types. For example, Prisinzano et al. defines the population of Form 1040, Schedule E-Part I landlords using tax returns that report rental real estate activity on Part I. Publicly available SOI data tables estimate the number Form 1040 filers with income from either rent or royalties. Despite the different approach to identify taxpayers with rental income, the 2010 Prisinzano et al. estimate is within -6 percent of the SOI estimate. In contrast, the Prisinzano et al. estimate of Form 1040, Schedule F farmers includes tax returns of farm land owners that file Form 4835, *Farm Rental Income and Expenses*. The resulting estimate is within +25 percent of the SOI estimate of Form 1040 tax returns with Schedule F. The Prisinzano et al. estimates for the number of S corporations, partnerships, and sole proprietorships are the same as SOI estimates, while the estimate for the number of C corporations is within 2 percent of the SOI estimate.

[9]The inherent risk of setting these thresholds is that some of the tax returns excluded from the data may be small businesses of interest when considering tax compliance burdens. Without access to taxpayer data we cannot assess the efficacy of the de minimis test and test for substantive business activities. OTA researchers said they performed sensitivity tests based on different definitions of small businesses, which did not impact their findings.

Table 6: Estimates for the Total Number of Filers and Total Income by Type of Tax Return for Tax Year 2010

	Number of filers (in thousands)	Percent of All Filers	Total income (in billions of dollars)	Percent of Total Income for All Filers
Schedule C Sole Proprietors				
All filers	23,005	100	1,191	100
Small businesses	9,855	42.8	999	83.9
Larger businesses	3	0*	94	7.9
Schedule E-Part I Landlords				
All filers	10,102	100	274	100
Small businesses	4,944	48.9	223	81.4
Larger businesses	0*	0*	5	1.8
Schedule F Farmers				
All filers	2,444	100	154	100
Small businesses	1,451	59.4	144	93.5
Larger businesses	0*	0*	8	5.2
Partnerships				
All filers	3,248	100	5,646	100
Small businesses	2,398	73.8	1,118	19.8
Larger businesses	70	2.2	4,472	79.2
S corporations				
All filers	4,128	100	5,844	100
Small businesses	3,531	85.6	2,287	39.1
Larger businesses	84	2	3,548	60.7
C corporations				
All filers	1,671	100	20,228	100
Small businesses	1,377	82.4	1,133	5.6
Larger businesses	68	4	19,091	94.4

Source: GAO analysis of data from Richard Prisinzano et al., "Identification of Small Businesses Using Tax Data: 2010 Update," (presented at the 2013 National Tax Association's Spring Symposium, May 17, 2013). | GAO-15-513

Notes: We refer to the estimated number of business and small business filers as the number of businesses and small businesses. The number of individual filers with business income includes taxpayers filing multiple schedules. Small businesses represent tax returns that pass the two tests of the OTA researchers and have $10 million or less in both total income and total deductions. Larger businesses represent tax returns that pass the two tests of the OTA researchers and have more than $10 million in either total income or total deductions. Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest. Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule.

*These values are rounded and do not equal zero (i.e., the number of filers is less than 500 or the percentage of total filers is less than 0.05 percent for each of these values).

Using this threshold of $10 million or less in both total income and total deductions, small businesses represent 99 percent of tax returns

generating substantial income and engaged in substantive business activities (and more than 95 percent of tax returns for each type of tax return). Small businesses account for 17.8 percent of the total income for these tax returns (and more than 91 percent of total income for each type of individual filer and between 5 and 40 percent of total income for each type of corporation and partnership).

Table 7 shows the OTA small business estimates are consistent across the years 2007 and 2010, and are similar to corresponding estimates for all filers. In addition to the measurement errors discussed above, OTA estimates for these tax years are affected by other factors, including changing economic conditions. In spite of these factors, small business estimates for 2010 are within +/- 11 percent of 2007 values for number of filers and within +/- 18 percent of 2007 values for total income. For each type of filer, the percent change from 2007 to 2010 for small businesses is similar to the percent change for all filers (the difference in percent change is within +/- 10 percentage points). We found similar relationships for other subpopulations reported within this report.[10] While we do not have sampling errors for these estimates, we consider estimates of percentages that differ by more than 30 percentage points or totals that differ by more that 100 percent to be different.

[10]For each type of filer and for both number of filers and total income, the difference in percent change from 2007 and 2010 for businesses and for all filers is within +/- 7 percentage points. These differences in percent change for small business employers and all filers are each within +/- 12 percentage points.

Table 7: Estimates for Total Number of Filers and Total Income by Type of Tax Return for Tax Years 2007, 2010

	Number of filers (in thousands)		Percent change	Total income (in billions of dollars)		Percent change
	2007	2010		2007	2010	
Schedule C Sole Proprietors						
All filers	23,128	23,005	-0.5	1,369	1,191	-13.0
Small businesses	10,669	9,855	-7.6	1,136	999	-12.1
Schedule E-Part I Landlords						
All filers	9,636	10,102	4.8	253	274	8.3
Small businesses	4,592	4,944	7.7	208	223	7.2
Schedule F Farmers						
All filers	2,510	2,444	-2.6	133	154	15.8
Small businesses	1,468	1,451	-1.1	126	144	14.3
Partnerships						
All filers	3,096	3,248	4.9	6,107	5,646	-7.5
Small businesses	2,219	2,398	8.1	1,175	1,118	-4.9
S corporations						
All filers	3,990	4,128	3.5	6,317	5,844	-7.5
Small businesses	3,460	3,531	2.1	2,424	2,287	-5.7
C corporations						
All filers	1,865	1,671	-10.4	22,089	20,228	-8.4
Small businesses	1,555	1,377	-11.4	1,386	1,133	-18.3

Source: GAO analysis of data from Richard Prisinzano et al., "Identification of Small Businesses Using Tax Data: 2010 Update," (presented at the 2013 National Tax Association's Spring Symposium, May 17, 2013). | GAO-15-513

Note: We refer to the estimated number of small business filers as the number of small businesses. The number of individual filers with business income includes taxpayers filing multiple schedules. Small businesses represent tax returns that pass the two tests of the OTA researchers and have $10 million or less in both total income and total deductions. Total income is generally defined as gross receipts, rents, dividends, capital gains, royalties, and interest. Total income for Schedule E filers is limited to rental real estate activity from Part I of that schedule.

Appendix III: Additional Information on Small Business Compliance Burden

The figures and tables in this appendix supplement those in the second objective providing additional information on small business tax-related activities, IRS burden model methodology, and results from IRS burden models.

Table 8 provides a detailed description of tax-related activities that may create burden for small businesses. These activities are grouped by income taxes, employer-related taxes, and third-party information reporting and industry-specific tax activities.

Table 8: Common Sources of Tax Compliance Burden

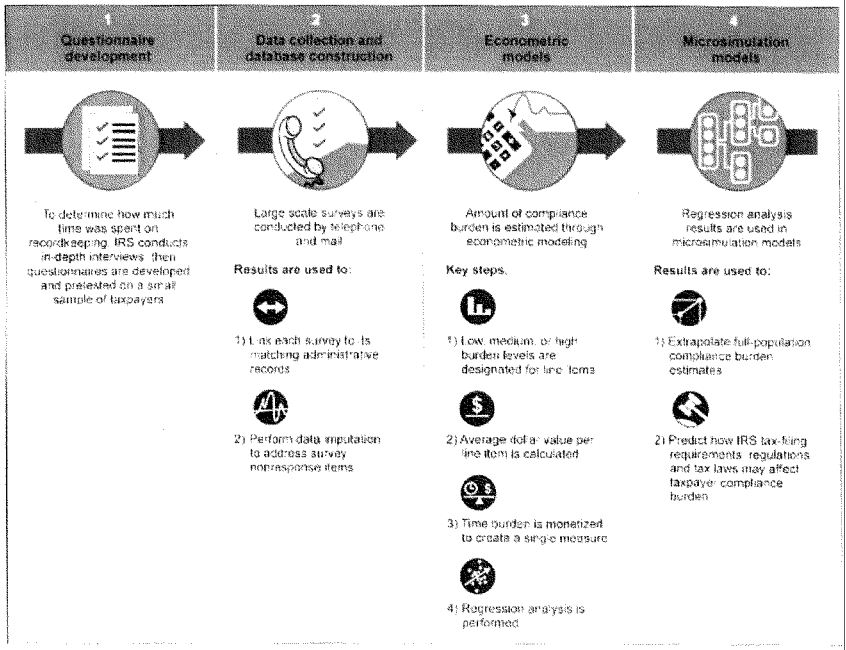
Income tax activities	
Filing income tax return	File an annual income tax return. Business type determines which form is filed: • Sole proprietors: Form 1040, *U.S. Individual Income Tax Return*, and Schedule C, *Profit or Loss from Business* • C Corporations: Form 1120, *U.S. Corporation Income Tax Return* • S Corporations: Form 1120S, *U.S. Income Tax Return for an S Corporation*, and Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.* • Partnerships: Form 1065, *U.S. Return of Partnership Income*, and Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*
Paying income and self employment taxes	Deposit income and estimated self-employment taxes on a quarterly basis. Entity type determines which form is filed: • Sole proprietors: Form 1040-ES, *Estimated Tax for Individuals* • C Corporations: Form 1120-W, *Estimated Tax for Corporations* • S Corporations: Form 1120-W, *Estimated Tax for Corporations*, and shareholders file Form 1040-ES, *Estimated Tax for Individuals* • Individuals in Partnersh ps: Form 1040-ES, *Estimated Tax for Individuals*
Employment tax activities	
Withholding and depositing federal employment tax	Withhold and deposit employment tax monthly or semi-weekly. Employment tax liability determines which form is filed: • Report quarterly the amount of personal income tax withheld and Federal Insurance Contributions Act (FICA) paid for each employee on Form 941, *Employer's Quarterly Federal Tax Return*. • Deposit income tax withheld and FICA taxes either monthly or semi-weekly.
Reporting and depositing federal unemployment tax	Report annually and deposit quarterly Federal Unemployment Tax Act (FUTA) tax.
Providing employees with Form W-2	Provide a copy of Form W-2 for calendar year 2014, no later than February 2, 2015.

Reporting and disclosing retirement plan information	Report the following information related to retirement plans annually. Number of employees determines which form is filed: • File Form 5500, *Annual Return/Report of Employee Benefit Plan*. Must be filed electronically. • If a plan has fewer than 100 participants, file Form 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan*. • If there is only one participant, file Form 5500-SF electronically or the paper-only Form 5500-EZ.
Reporting healthcare information	Report information related to health care as determined by number of employees and entity type: • If filing income tax withholding, S corporations are the only entity that must include the value of health insurance benefits in the wages of S corporation employees who own more than 2% of the S corporation (2% shareholders). • Beginning in 2016, employers with 50 or more full-time employees need to file Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage*, and Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*. Employers must provide a Form 1095-C to each of its full-time employees.
Third-party information reporting and industry-specific tax activities	
Reporting excise tax	Some small businesses report applicable excise taxes, such as environmental taxes, communications taxes, fuel taxes, retail sale of heavy trucks and trailers, luxury taxes on passenger cars, and manufacturers' taxes on a variety of different products. The type of form used depends on the type of small business industry and tax: • File Form 720, *Quarterly Federal Excise Tax Return*, during April, July, October, and January. • File Form 730, *Monthly Tax Return for Wagers*, and pay the tax on wagers accepted during the previous month. • File Form 2290, Heavy *Highway Vehicle Use Tax Return*, and pay the tax annually (or more frequently if vehicles are first used during multiple months of same year).
Reporting miscellaneous income	If required, some small businesses report miscellaneous income. Reporting depends on small business industry number of 1099-MISC forms: • If reporting fewer than 250 1099-MISCs, submit paper forms which are due to IRS by the end of February, along with a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*. • If reporting 250 or more 1099-MISCs, submit the forms electronically. Electronic submissions due at the end of March can be submitted through IRS's Filing Information Returns Electronically system.
Tax planning and recordkeeping	Tax planning and record keeping are done throughout the year. The complexity of these activities can vary by entity type, number of employees, and total assets. Some of the activities are as follows: • Stay current with changes in tax laws and requirements • Hire a tax professional • Adjust for withholdings • Obtain and organize tax-related records and receipts, including deductible expenses • Monitor the progress of your business • Prepare your financial statements • Prepare your tax returns and support items reported on tax returns

Source: GAO analysis of IRS documents. | GAO-15-513

Figure 12 illustrates a simplified depiction of IRS pre-filing and filing burden models. Essentially, IRS uses the data from its compliance burden surveys, combined with data that IRS obtains from the tax returns of survey respondents in econometric models. These models estimate the relationship between taxpayer characteristics and reported burden; the models can then be used to estimate total compliance burden.

Figure 12: Simplified Depiction of IRS Pre-Filing and Filing Burden Models



Source: GAO analysis of IRS information. | GAO-15-513

IRS then uses estimates of these relationships in simulation models to predict how potential IRS administrative decisions, such as those relating to tax form design and recordkeeping requirements, may affect taxpayer burden. Although such simulation results may provide useful insights, it is difficult to assess the reliability of those results; consequently they should be used with caution. We found IRS research estimates were reliable for our purposes of obtaining an overview of small business tax compliance costs. One difficulty is that to be able to simulate the effect of burden, IRS needed to develop a complicated methodology for apportioning aggregate burden across all of the different types of pre-filing and filing activities. There are no formal statistical tests to estimate the margins of error around the ultimate simulation results.

The following tables and figure are results from IRS burden models. The data were taken from IRS studies concerning how small business characteristics such as size and industry affect small business compliance costs.

- Tables 9 through 11 examine the estimated pre-filing and filing monetized burden per employee, as a percentage of total receipts, and as a percentage of total assets.
- Table 12 provides information on total monetized business compliance costs by business entity type and total gross receipts across all businesses.
- Table 13 shows the estimated average pre-filing and filing time and money burden by industry.
- Figure 13 provides the estimated post-filing compliance costs for individual filers.

Table 9: Total Monetized Burden per Employee (2002)

	Taxpayers (thousands)		Time and Money Burden (Time monetized at $25/hr)		Time and Money Burden (Time monetized at $40/hr)	
			Per employee		Per employee	
	N	Percentage	Low	High	Low	High
All businesses	7,243	100%	$1,346	$1,458	$1,944	$2,103
Number of employees						
1 to 5	5,680	78.4%	$4,308	$4,746	$6,233	$6,861
6 to 10	662	9.1%	$1,307	$1,365	$1,694	$1,982
11 to 15	310	4.3%	$822	$901	$1,168	$1,271
16 to 25	261	3.6%	$674	$686	$968	$982

	Taxpayers (thousands)		Time and Money Burden (Time monetized at $25/hr)		Time and Money Burden (Time monetized at $40/hr)	
			Per employee		Per employee	
	N	Percentage	Low	High	Low	High
26 to 50	204	2.8%	$474	$488	$684	$701
More than 50	126	1.7%	$182	$191	$261	$274

Source: Donald DeLuca et al., "Aggregate Estimates of Small Business Taxpayer Compliance Burden," *IRS Research Bulletin* (2007). | GAO-15-513

Table 10: Total Monetized Burden as a Percentage of Total Receipts (2002)

	Taxpayers (thousands)		Time and Money Burden (Time monetized at $25/hr)		Time and Money Burden (Time monetized at $40/hr)	
			Percentage of receipts		Percentage of receipts	
	N	Percentage	Low	High	Low	High
All businesses	7,243	100%	0.9%	1.0%	1.3%	1.5%
Total receipts						
$0 or less	895	12.4%	n.a.	n.a.	n.a.	n.a.
Less than $10,000	815	11.3%	152.8%	154.5%	216.4%	219.0%
$10,000 to $20,000	303	4.2%	31.6%	32.6%	46.5%	47.5%
$20,000 to $50,000	677	9.3%	17.3%	18.6%	25.4%	26.9%
$50,000 to $100,000	715	9.9%	9.3%	10.9%	13.6%	15.9%
$100,000 to $500,000	2,029	28.0%	3.2%	3.3%	4.6%	4.8%
$500,000 to $1 million	705	9.7%	1.3%	1.4%	1.9%	1.9%
Over $1 million	1,104	15.2%	0.3%	0.3%	0.4%	0.5%

Source: Donald DeLuca et al., "Aggregate Estimates of Small Business Taxpayer Compliance Burden," *IRS Research Bulletin* (2007). | GAO-15-513

Table 11: Total Monetized Burden as a Percentage of Total Assets, by Asset Size (2002)

	Taxpayers (thousands)		Time and Money Burden (Time monetized at $25/hr)		Time and Money Burden (Time monetized at $40/hr)	
			Percentage of assets		Percentage of assets	
	N	Percentage	Low	High	Low	High
All businesses	7,243	100%	1.60%	1.80%	2.4%	2.6%
Total assets						
$0 or less	1,394	19.2%	n.a.	n.a.	n.a.	n.a.
Less than $10,000	872	12.0%	146.6%	178.35%	213.6%	259.1%
$10,000 to $20,000	399	5.5%	38.3%	39.3%	54.4%	55.6%
$20,000 to $50,000	783	10.8%	19.6%	22.2%	28.3%	32.2%
$50,000 to $100,000	780	10.8%	9.8%	10.2%	14.1%	14.5%
$100,000 to $500,000	1,684	23.3%	3.6%	3.7%	5.3%	5.4%

	Taxpayers (thousands)		Time and Money Burden (Time monetized at $25/hr)			Time and Money Burden (Time monetized at $40/hr)	
			Percentage of assets			Percentage of assets	
	N	Percentage	Low		High	Low	High
$500,000 to $1 million	515	7.1%	1.3%	1.4%		1.8%	1.9%
Over $1 million	816	11.3%	0.4%	0.5%		0.6%	0.7%

Source: Darrel DeLuca et al., "Aggregate Estimates of Small Business Taxpayer Compliance Burden," *IRS Research Bulletin* (2007). [GAO-15-513]

Table 12: Business Income Tax Compliance Costs by Size of Receipts, Using a Variable Moderation Rate (2009)

Total Receipts (Millions)	C Corporations	S Corporations	Partnerships	All
Average Compliance Costs ($)				
0 to 0.10	4,700	3,900	6,700	5,300
0.10 to 1	13,000	9,800	18,100	12,500
1 to 10	35,700	27,600	43,500	34,000
10 to 500	157,800	89,800	134,600	128,200
500 and more		504,000	645,800	925,400
All receipt sizes			13,400	11,600
Total Compliance Costs ($ Billions)				
0 to 0.10	3.7	7.9	14.2	25.9
0.10 to 1	8.8	16.6	14.9	40.3
1 to 10	6.9	9.6	8.7	25.1
10 to 500	4.2	2.2	4.3	10.7
500 and more	1.7	0.0[a]	0.4	2.1
All receipt sizes	25.3	36.3	42.5	104.1

Source: Rosemary Marcuss et al., "Income Taxes and Compliance Costs: How Are they Related?" *National Tax Journal*, vol. 33 no. 4, (December 2013), pp. 933-954. [GAO-15-513]

[a]Tax compliance cost is less than $50 million.

Table 13: Estimated Average Small Business Pre-Filing and Filing Time and Money Burden by Industry (2002)

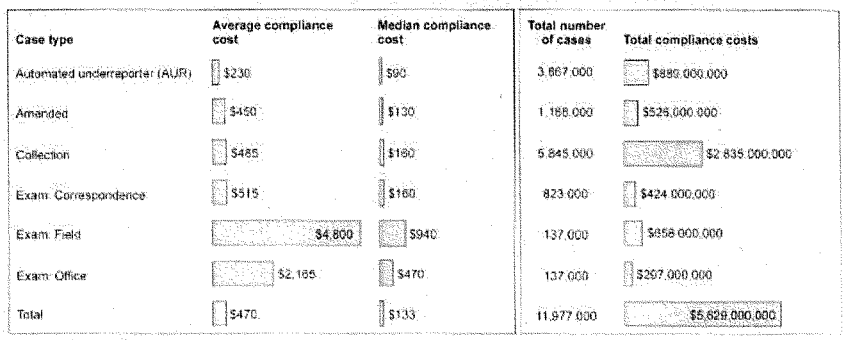
	Taxpayers (thousands)	Average time burden (hours)		Average money burden (dollars)	
		Low	High	Low	High
All business industry	7,243	236	256	$2,068	$2,226
Agriculture, forestry, and fisheries	314	180	184	$ 1,489	$1,590
Mining and Utilities	53	196	210	$1,503	$1,506
Construction	644	311	312	$2,202	$2,558
Manufacturing	323	304	310	$2,740	$2,813
Wholesale trade	334	279	312	$2,306	$2,647
Retail trade	734	325	331	$2,033	$2,208

	Taxpayers (thousands)	Average time burden (hours)		Average money burden (dollars)	
		Low	High	Low	High
Transportation and warehousing	163	233	284	$2,371	$2,465
Professional and scientific	1,357	200	206	$2,172	$2,222
Finance, insurance and real estate	1,946	196	219	$2,172	$2,480
Education and health	394	217	220	$2,128	$2,225
Arts and entertainment	798	254	259	$1,453	$1,686
Industry n.e.c[a]	182	180	444	$1,666	$1,674

Source: Donald DeLuca et al., "Aggregate Estimates of Small Business Taxpayer Compliance Burden," *IRS Research Bulletin* (2007). | GAO-15-513

[a]n.e.c. = not elsewhere classified

Figure 13: Estimated Post-Filing Compliance Costs by Originating Function for Individual Filers (2011)



Source: John Guyton and Richard Hodge, "The Compliance Costs of IRS First-Filing Processes," (paper presented at the Economic and Social Research Council's 2014 International Tax and Analysis Conference, January 2014). | GAO-15-513

Appendix IV: Selected Open GAO Recommendations to IRS That May Affect Small Business Taxpayer Burden

Benefit to Small Businesses	Open recommendations	Status
Improving telephone service lowers compliance burdens for taxpayers, including small business taxpayers. Better management of IRS risks and resources would benefit all taxpayers, including small businesses that may need and use these services more often.	The Commissioner of the Internal Revenue should direct the appropriate officials to take the following three actions: (1) Systematically and periodically compare its telephone service to the best in business to identify gaps between actual and desired performance. (2) Include specific countermeasures or options in risk management plans that could guide a response when an adverse event occurs. (3) Develop outcomes that are measurable and plans to analyze service changes that allow valid conclusions to be drawn so that information can be conveyed to Congress, IRS management, and others about the effectiveness of IRS's service changes and impact on taxpayers. **Report:** *Tax Filing Season: 2014 Performance Highlights the Need to Better Manage Taxpayer Service and Future Risks*, GAO-15-163 (Washington, D.C.: Dec 16, 2014).	(1) IRS disagreed with this recommendation, noting in February 2015 that it is difficult to identify comparable organizations with a size or scope similar to that of the IRS to identify performance gaps, and that such efforts would not yield improved results over the benchmarking process currently used by IRS. We disagree that IRS's telephone operations cannot be compared to others. We believe this recommendation remains valid and should be implemented. (2) IRS agreed with this recommendation and, in February 2015, reported it has already included specific countermeasures or options in risk management plans for those risks ranked highest in likelihood and impact. IRS also reported it considers such efforts to be ongoing as it develops new risk management plans over time. (3) IRS agreed with this recommendation and, in February 2015, reported it is developing outcome measures and plans for analysis to identify and report on the effect of service changes during the 2015 filing season. IRS also reported it anticipates completing this analysis by the end of fiscal year 2015.
Better focusing IRS's measures, goals, and objectives could increase identification of select noncompliant small businesses and decrease the burden on compliant taxpayers allowing them to better use their scarce resources. Tracking and documenting data can help IRS make better decisions concerning the correspondence audit program. This will help IRS know if the program is efficient and effective. This can also help IRS determine whether its	To reduce the need for taxpayer calls, ensure that IRS is providing taxpayers with more realistic time frames on when IRS will respond, and more efficiently use IRS resources, the Commissioner of the Internal Revenue Service should: (1) Collect data to analyze whether IRS is responding within the time frames cited in the revised audit notices. (2) If IRS delays are continuing, further revise the notices to provide more realistic response times based on the data and take other appropriate actions to ensure efficient use of IRS tax examiner resources. To clarify the desired results of the correspondence audit program and its linkages to IRS-wide activities, the Commissioner of the Internal Revenue Service should: (3) Establish formal program objectives. (4) Ensure that the program measures reflect those objectives. (5) Clearly link those measures with strategic IRS-wide	According to IRS officials: (1) Correspondence audit program officials analyzed fiscal years 2012-2015 data to provide a monthly breakdown of the volumes of taxpayer correspondence worked in less or more than 75 days. Supporting documentation from IRS is pending. (2) Analysis of fiscal years 2012-2015 data on volumes of taxpayer correspondence worked in less or more than 75 days led correspondence audit program to conclude they needed to provide taxpayers better information on expected response timeliness by notice and telephone. Officials said they implemented revised automated phone messages in January 2015. Also, program officials decided to change notices to allow individual correspondence audit campuses to enter a customized response date based on

Benefit to Small Businesses	Open recommendations	Status
decisions have a disproportionate or negative impact on small businesses. Ensuring an effective investment of resources will help IRS identify expected benefits and track whether the benefits were achieved. These efforts will help to balance the allocation of resources between providing taxpayers' telephone assistance and reviewing their correspondence. This could be particularly important for small businesses since this taxpayer group may need or use more of IRS's resources.	goals on ensuring compliance in a cost-effective way while minimizing taxpayer burden. To better inform decisions being made about the correspondence audit program, the Commissioner of the Internal Revenue Service should: (6) Document how the decisions are to be made about the correspondence audit program using performance information. (7) Track and use other program data that have not been used to provide more complete performance information, such as taxpayer burden and experience. To better ensure an effective investment of resources in the Correspondence Assessment Program (CEAP) efforts, the Commissioner of the Internal Revenue Service should: (8) Clearly document the intended benefits of ongoing efforts to address identified problems, and the process for measuring and tracking actual benefits. (9) Develop a plan and timeline for implementing the CEAP contractor's recommendations on possible ways to improve the (a) selection of correspondence audit workload and (b) allocation of resources between providing telephone assistance and reviewing taxpayer correspondence. **Report:** *IRS Correspondence Audits: Better Management Could Improve Tax Compliance and Reduce Taxpayer Burden*, GAO-14-479 (Washington, D.C.: June 5, 2014).	their respective inventory levels at the time notices are sent. The notices are expected to be available and implemented in January 2016 after necessary program updates. Supporting documentation from IRS is pending. (3) through (5) IRS will review current documentation and ensure there is a clear link establishing the correspondence audit program objectives and measures with the overall IRS goals and objectives. Officials also said they will update official guidance as warranted. Actions on these three recommendations are due by March 2016. Supporting documentation on timeframes for specific actions related to these recommendations is pending. (6) IRS will thoroughly document the original plan development process. Action on this recommendation is due by March 2016. Supporting documentation on timeframes for specific actions related to these recommendations is pending. (7) IRS will evaluate the methodology used in several existing studies to determine the most productive use of collectability data. Officials also said IRS will evaluate the feasibility of collecting and using additional data. Action on this recommendation is due by March 2016. Supporting documentation on timeframes for specific actions related to these recommendations is pending. (8) IRS will document the expected benefits of ongoing changes. Action on this recommendation is due by June 2016. Supporting documentation on timeframes for specific actions related to these recommendations is pending. (9) IRS will continue to pursue efforts with research functions to further improve workload selection and maximize resource usage. Action on this recommendation is due by June 2016. Supporting documentation on timeframes for specific actions related to these recommendations is pending.
This could streamline the process for entering installment agreements.	The Commissioner of Internal Revenue should develop a set of standardized account entries and eliminate unnecessary redundancy when entering installment	IRS agreed that adopting standardized account entries, as we recommended in December 2013, has benefits. However,

Benefit to Small Businesses	Open recommendations	Status
These efficiencies could reduce compliance burdens of taxpayers, including small business taxpayers by decreasing the time it takes IRS to handle installment agreement cases.	agreement data into accounts. **Report:** *2013 Tax Filing Season: IRS Needs to Do More to Address the Growing Imbalance between the Demand for Services and Resources*, GAO-14-133 (Washington, D.C.: Dec. 18, 2013).	since the agency changed its installment agreement program, it has decided to evaluate those changes before exploring whether adopting our recommendation will yield increased efficiencies and lower costs without adversely impacting tax administration. IRS officials stated they will provide a status update in October 2015.
This could provide easier access to information and could reduce taxpayer burden, including for small businesses, by enabling examiners to find critical data and documents quicker during the examination.	To increase the effectiveness of IRS's examinations of individual tax returns, the Commissioner of the Internal Revenue Service should: (1) Transcribe data from paper-filed Form 1040 Schedules C and E that are not currently transcribed and make those data available to Small Business and Self-Employed division (SB/SE) examiners for classification. If IRS has evidence that the costs related to transcribing all such data on Schedules C and E are prohibitive, IRS could do one or both of the following actions: (a) transcribe less data by transcribing only the missing data for selected line items, such as certain, large expense line items; or (b) develop a budget proposal to fund an initiative for transcribing Schedule C and E. (2) Make all data collected from electronically submitted Form 1040s available to examiners conducting classification. **Report:** *Tax Administration: IRS Could Improve Examinations by Adopting Certain Research Program Practices*, GAO-13-480 (Washington, D.C.: May 24, 2013)	As of March 2015, IRS agreed to study: (1) whether to increase data transcription of additional tax return information as GAO recommended in May 2013. The agency also agreed to study whether to use more data from electronically-filed returns. IRS's study is scheduled to be completed by November 2015, and is expected to weigh the benefits to the agency and the impacts on taxpayers who file returns electronically. (2) expanding the use of electronic data to enhance return classification while weighing the benefits of increased information against the risks of potential impacts to electronic filing
Improving telephone and correspondence services, decreasing wait time, and enhancing taxpayer contacts lowers compliance burdens for taxpayers, including small businesses that may need and use these services more often.	The Commissioner of Internal Revenue should: (1) Outline a strategy that defines appropriate levels of telephone and correspondence service and wait time, and lists specific steps to manage service based on an assessment of time frames, demand, capabilities, and resources. (2) Tailor appropriate and timely interventions with taxpayers who file balance due returns by pilot testing risk-based approaches that could include (a) implementing the Advanced Consolidated Data Analytics plan, and (b) using more data-driven methods to identify the most appropriate method for contacting a taxpayer. **Report:** *2012 Tax Filing: IRS Faces Challenges Providing Service to Taxpayers and Could Collect Balances Due More Effectively*, GAO-13-156 (Washington, D.C.: Dec. 18, 2012).	(1) IRS has taken steps to modify services provided to taxpayers, but has not yet developed a strategy outlining IRS's customer service goals. (2) IRS agreed with our December 2012 recommendation to pilot more risk-based approaches for contacting taxpayers who have a balance due. However, IRS has reported that because that project was not funded, it used an alternative model to conduct analysis. IRS implemented its updated model in late April 2014. In October 2014, IRS reported that better (more productive) cases will be assigned to select work streams. Further, in January 2015, IRS officials said they will be placing revised models into production in fiscal year 2015

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This could help IRS better use its resources for examinations that are needed and justified. This would minimize the chances of a compliant small business being subjected to an unnecessary exam.	To help ensure that IRS uses its examination resources efficiently, the Commissioner of the Internal Revenue Service should: (1) Document and analyze the results of examinations involving the Small Employer Health Insurance Tax Credit to identify how much of those results are related to the credit versus other tax issues being examined, what errors are being made in claiming the credit, and when the examinations of the credit are worth the resource investment. (2) Related to the above analysis of examination results on the credit, identify the types of errors with the credit that could be addressed with alternative approaches, such as soft notices. **Report:** *Small Employer Health Tax Credit: Factors Contributing to Low Use and Complexity*, GAO-12-549 (Washington, D.C.: May 14, 2012).	(1) As of October 2014, SB/SE analyzed a statistical sample of 2010 examination results for the Small Employer Health Insurance Tax Credit. As a result of the research, SB/SE concluded that the findings do not justify selecting a specific number of returns for examination with the Credit as the primary issue. Instead, they will identify issues as part of the normal classification process, and prepare guidelines for classifiers to reference when selecting returns for examination. (2) As of October 2014, IRS told us that Math Error Authority, fully implemented in January 2014, addresses many of the common errors claiming the Credit. Therefore, there is not an immediate need for alternative approaches, such as soft notices. However, IRS will still consider alternatives.
Developing metrics, goals, and strategies to plan and gauge progress in enhancing taxpayer assistance can help IRS determine where it could improve service delivery. This could lead to overall taxpayer burden reduction, including for small businesses.	The Commissioner of the Internal Revenue Service should: (1) Develop a new refund timeliness measure and goal to more appropriately reflect current capabilities. (2) Complete an Internet strategy that (a) provides a justification for the implementation of online self-service tools, and includes an assessment of providing online self-service tools that allow taxpayers to access and update elements of their account online; (b) acknowledges the cost and benefits to taxpayers of new online services; (c) sets the time frame for when the online service would be created and available for taxpayer use; and (d) includes a plan to update the strategy periodically. **Report:** *2011 Tax Filing: Processing Gains, but Taxpayer Assistance Could Be Enhanced by More Self-Service Tools*, GAO-12-176 (Washington, D.C.: Dec. 15, 2011).	(1) As of October 2014, IRS has yet to develop a new refund timeliness measure. However, IRS has taken steps to identify the number of days it takes to issue a refund in addition to the percentage of refunds received in daily increments from 5 to 60 days. (2) IRS has made progress in improving its Internet online services strategy. In September 2012, IRS provided us with an updated version of that strategy. However, IRS still needs to take a number of steps to more fully develop its long-term online strategy. As of February 2015, IRS officials reported that it does not have a separate online services strategy.
Sharing expected release dates for Information Reporting and Document Management (IRDM) regulations and formal guidance will improve implementation of cost basis and transaction settlement reporting. IRDM's components include aspects of other	To improve implementation of cost basis and transaction settlement reporting, the Commissioner of the Internal Revenue Service should: Work with Treasury to share with the public its plans and expected release dates for IRDM regulations and formal guidance. IRS could consider including information similar to what is posed on the Department of Transportation's or the Financial Industry Regulatory Authority Web sites. IRS should also include other pertinent information regarding IRDM implementation, such as upcoming informal guidance, frequently asked	As of June 2014, the IRS web page on information reporting does not provide information on upcoming information guidance, upcoming outreach, or a description of the private letter ruling process. IRS officials said information on letter rulings is found elsewhere on www.irs.gov. Regarding coordination with the Department of the Treasury on sharing potential release dates for regulations and formal guidance, IRS did not provide any evidence of this

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systems and pilots that administer programs focused on small businesses.	questions, upcoming outreach, and description of the letter ruling process. **Report:** *Information Reporting: IRS Could Improve Cost Basis and Transaction Settlement Reporting Implementation*, GAO-11-557 (Washington, D.C.: May 19, 2011).	coordination. However, IRS officials said they share with external stakeholders the general timeframes for upcoming guidance.
Improving telephone and correspondence services lowers compliance burdens for taxpayers, including small businesses that may need and use these services more often.	To gain efficiencies and improve taxpayer service, the Commissioner of Internal Revenue should direct the appropriate officials to: (1) Determine a customer service telephone standard, and the resources required to achieve this standard based on input from Congress and other stakeholders. (2) Assess business units' needs for holding Contact Analytics calls beyond 45 days and store calls for this period or document that the costs of doing so exceed the benefits. (3) Establish a performance measure for taxpayer correspondence that includes providing timely service to taxpayers. **Report:** *2010 Tax Filing Season: IRS's Performance Improved in Some Key Areas, but Efficiency Gains Are Possible in Others*, GAO-11-111 (Washington, D.C.: Dec. 16, 2010).	(1) As of August 2014, IRS's position remained that its measure of telephone service does not need to be revised and the current process for establishing IRS telephone plans is sufficient. However, we continue to believe that a telephone standard would serve as a means of communicating to Congress and others what IRS believes would constitute good service. (2) IRS disagreed with this recommendation. As of August 2014, IRS officials continue to maintain that increasing the recorded call storage beyond 45 days would not be a low cost effort. However, we continue to believe that storing calls for extended periods would allow IRS to better identify trends and taxpayer concerns, thus offsetting the costs. (3) IRS agreed with this recommendation and started using more detailed performance measures that includes an overaged/timeliness measure for its correspondence beginning in fiscal year 2011. However, in April 2014, we reported that overaged correspondence increased from 25 to 47 percent; thus, we continue to believe that elevating this measure to IRS's suite of balanced measures would help provide more visibility and ultimately better service.

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(1) It will allow IRS to develop a cost-effective strategy to identify payers that never submit 1099-MISCs. This could alleviate the burden on compliant taxpayers, including small businesses. (2) By knowing more about these characteristics IRS can develop more effective strategies to increase 1099-MISC submissions. This could also alleviate the burden on compliant taxpayers, including small businesses.	To gauge the extent of 1099-MISC payer noncompliance and its contribution to the tax gap, we recommend that the Commissioner of the Internal Revenue Service, as part of future research studies: (1) Develop an estimate of 1099-MISC payer noncompliance. (2) Determine the nature and characteristics of those payers that do not comply with 1099-MISC reporting requirements so that this information can be factored into an IRS-wide strategy for increasing 1099-MISC payer compliance. **Report:** *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238 (Washington, D.C.: Jan. 28, 2009).	(1) According to IRS, developing such an estimate requires a multi-pronged approach and a large amount of coordinated effort. As of September 2014, IRS estimates results will be available in December 2015. (2) IRS researchers are collecting data on 1099-MISC reporting as part of its National Research Program study on employment taxes, a program that involves examinations of a sample of tax returns expected to culminate in 2015. As of September 2014, IRS estimates results will be available in December 2015.

Source: GAO analysis of prior reports. | GAO-15-513

Testimony of

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Washington, D.C.

Committee on Small Business

United States House of Representatives

Hearing on

"How Tax Compliance Obligations

Hinder Small Business Growth"

July 22, 2015

Chairman Graves, Ranking Member Velazquez and Members of the Committee, thank you for the opportunity to testify on the need to alleviate the federal tax compliance costs on small business.

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 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 CPAs, experienced accountants, attorneys and others who wish to expand their knowledge of our nation's tax law. Our course offerings not only include 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 IRS practice and procedure that address the compliance issues of this hearing.

In addition, for the past 25 years I have had my own tax preparation and tax planning practice, LaMonaca & Williamson, CPAs, in Falls Church, Virginia. In my professional practice I prepare many tax returns for small businesses and represent taxpayers daily before the IRS examination and collection divisions.

I. Emerging Entrepreneurs and the Kogod Tax Policy Center

As part of my responsibilities at American University, I am also the Executive Director of the Kogod Tax Policy Center which conducts nonpartisan research on tax issues affecting small business and entrepreneurs. The Center develops and analyzes proposed solutions to tax-related problems faced by small business and promotes public dialogue concerning tax issues critical to small businesses.

Currently, the Center is focused on developing research on the tax and compliance issues impacting "Emerging Entrepreneurs," who are America's latest iteration of small business owners. Emerging Entrepreneurs are the workers who are powering the evolving on-demand digital economy. These Emerging Entrepreneurs are renting rooms, providing ride-sharing services, running errands, and selling goods for consumers in business transactions coordinated online and through app-based platforms developed by companies such as Airbnb, Flipkey, Onefinestay, Uber, Lyft, Taskrabbit and Instacart. Emerging Entrepreneurs need maximum flexibility to grow their businesses and enhance their contributions to this dynamic new sector of the American economy. But, as reported by the *Wall Street Journal* earlier this year, some Emerging Entrepreneurs are facing penalty and audit exposure, despite the fact that in some cases income earned from short-term residential rentals coordinated through a platform provider (e.g., Airbnb, HomeAway, Onefinestay and Flipkey) is, in fact, tax free.

Our preliminary research has identified these and other related issues as unnecessary burdens notwithstanding that most Emerging Entrepreneurs "want to be honest and pay what they owe, but the tools and resources don't exist." Derek Davis, in discussion with the author, April 9, 2015. The predominantly electronic nature of transactions conducted by this new sector of our economy offers opportunities to reduce the burden on and increase the compliance of Emerging Entrepreneurs. In the coming months, we will publish tax research and corresponding policy recommendations for the Committee to review.

II. Complexity of the Law

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 almost annual amendments to the Internal Revenue Code that has a profound, even paralyzing affect on small businesses resulting in their inefficient operation and impeding their ability to grow and create jobs.

In fact, since 2001, there have been approximately 5,000 amendments to sections of the Internal Revenue Code, about one per day on average. Consequently, not only small business persons but

their tax advisers are overwhelmed by the complexity resulting in steady increases in fees these 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 meeting tax filing requirements, the equivalent of 1.25 million full-time jobs. In meeting these requirements 70% of small businesses use paid tax return preparers at a cost of more than $16 billion for the services of attorneys, accountants and other professionals. While generating a lucrative "cottage industry" for tax professionals, our nation suffers from this burden that diverts time and resources to activities that neither encourages business growth nor creates jobs.

Because most small business owners do not understand the law they increasingly turn their tax filing obligations to outside advisers for planning and return preparation of both their income taxes as well as their employment tax obligations. A survey conducted by the National Federation of Independent business found that professional tax return preparers prepared, at least in part, 91% of all tax returns filed by its members. When small business owners believe they are unable to file their own tax returns or understand the tax law, resentment towards the "system" arises creating a cynicism and disrespect toward our tax law that will foster non-compliance and ultimately fraud.

Compounding this complexity and further increasing the cost of compliance and inefficiency upon small business is the annual crisis of the so called "tax extenders." Over thirty business provisions of the Internal Revenue Code periodically expire, being reenacted, often retroactively, for an additional year or two. Rules relating to the treatment of qualified small business stock, bonus depreciation, S corporation built-in gains tax, and most importantly, § 179 expensing are vital to the small business community and Congress should make these provisions permanent. In the case of bonus depreciation and § 179 expensing, small businesses today must make decisions regarding the purchase of equipment without certainty of what the deduction will be for such acquisitions. Aside from the additional compliance costs associated with such uncertainty, tax planning is impossible thereby undermining growth in the small business economy that provides most of the new jobs in our country.

III. Legislative Recommendations

To reduce the compliance costs of small businesses in the filing of their tax returns the Kogod Tax Policy Center advocates two legislative proposals, i.e. a simplified cash method of accounting and a unified rate schedule for all businesses regardless of their legal form.

A. Simplified Cash Method of Accounting

Liberalizing the law to permit more small businesses to adopt the cash method of accounting, rather than the more burdensome accrual method, will reduce record keeping and tax compliance costs with a minimal loss of accuracy or tax revenue to the government. Even where the law currently permits a small business to use the simpler cash method of accounting, the requirement to maintain inventory records creates compliance burdens that may only influence by a few months the timing of a small business's taxable income.

Therefore, we urge Congress to not only expand the number of businesses eligible to use the cash method of accounting as discussed in the Senate Finance Committee Working Group Report on Business Income Tax but to enact a "simplified" cash method of accounting for small businesses that will further reduce unnecessary record keeping and compliance burdens. We believe such simplification will neither adversely affect the accuracy of tax returns nor impact the ability of the IRS to collect tax.

1. Cash Method vs. Accrual Methods of Accounting

Before describing our proposal for a simplified cash method, I would like to explain, for the benefit of the members of the Committee who may not be familiar with tax accounting rules, the two major tax accounting methods used by businesses, i.e. the cash method and the accrual method. I believe this explanation will highlight why for small businesses the accrual method is more burdensome than the cash method; and demonstrates that while the accrual method may in some cases more accurately measure economic net income, why the complexity and cost of any additional precision is unnecessary and ultimately provides no greater tax revenue for the IRS.

Once a business adopts a tax year, and for most small businesses this will be the calendar year, it must adopt an accounting method which will determine the time at which the business recognizes an item of income or may deduct an expense. It is important to note that a business's accounting method only affects the timing of when a business reports income or deductions on a tax return. The accounting method a business uses does not determine whether an item of income is taxable or an expense deductible and does not affect the total income and deductions a business will recognize over its lifetime.

Publicly traded corporations and many large businesses generate financial statements for the SEC or commercial banks based on generally accepted accounting principles (GAAP). Small businesses usually do not keep their books and records in accordance with GAAP, almost always relying upon their tax returns to provide lenders and owners with sufficient information to determine the success and credit worthiness of the business.

Under the Internal Revenue Code a small business is only required to choose an accounting method that "clearly reflects income" and apply that method consistently from year to year. Consistent with this requirement, most small businesses adopt the

cash method of accounting unless the law requires them to use the accrual method.

a. Cash Method

A business adopting the cash method of accounting recognizes income when it receives actual payment for the goods or services sold, regardless of when the business sells the good or performs the service. Similarly, a cash method business is entitled to a deduction on its tax return only when payment for an ordinary and necessary business expense is actually made. However, even cash method businesses may not deduct certain types of payments when made. For example where a business incurs a cash expenditure that creates an asset with a useful life of more than one year, the business must "capitalize' the cost and depreciate (deduct) that cost over a prescribed "recovery period" in which the tax law presumes the asset will be consumed in the business. There are other types of cash payments subject to similar treatment. Thus, even the cash method adopts certain principles of the accrual method described below resulting in a mismatch of the time an expenditure is made and the time at which it can be deducted.

(1) Judicial Doctrines of Income

In addition to requirements to capitalize certain expenditures there are several other technical requirements for a business computing taxable income under the cash method that are unnecessarily complex. Under the judicial doctrine of "constructive" receipt, a cash basis taxpayer must recognize income even when cash has not come into the physical possession of the business but is merely available to the business at its discretion. Similarly, the mere receipt of a promise results in recognizable income under the cash method if the promise is convertible to cash before it matures, in which case the fair market value (that is, the "cash equivalent") of the obligation is recognized at the time of receipt of the promise. Finally, under the "economic benefit" doctrine, a cash method business must immediately recognize income on the receipt of property whenever the business's right to the property is absolute, even if not immediately assignable and even though it cannot be immediately converted to cash.

Such judicial theories that require a business using the cash method to pay tax on income deemed received prior to the receipt of cash unnecessarily imposes a severe cash flow problem on small businesses—a problem that creates only a marginal timing benefit to the IRS, since small businesses would most certainly receive the cash shortly after constructive receipt, economic benefit, or a cash equivalent arises. While these concepts offer comfort to theorists, small businesses must pay next month's bills, and the acceleration of any taxable income before the receipt of cash under these theories requires small businesses to use their operating cash to pay tax on amounts they have not yet received instead of using that cash to run their businesses.

(2) Accounting for Expenses

An even more challenging problem encountered by small businesses using the cash method of accounting is the compliance costs and complexity associated with computing deductible expenses. Generally, the cash method permits a deduction for ordinary and necessary business expenses when actual payment is made. Thus, a promise to pay is not deductible until payment is actually made.

In addition to the natural confusion surrounding when and if a payment has been made, small businesses confront even greater difficulties when computing allowable deductions under the cash method because of four exceptions to the general rule that a deduction is permitted when payment is made, i.e. prepayments, depreciation, inventory and capitalization of some expenses. Prepayments for property or services are not deductible if the goods or services are provided more than one year after the prepayment. Costs exceeding $5,000 associated with creating a new business are not deducted when paid but amortized over 15 years. For inventory, the costs of its acquisition or production are deducted only when the inventory is sold. Similarly, property with a useful life of more than one year is generally subject to depreciation, requiring its deduction be spread over recovery periods ranging from three to 39 years.

These examples demonstrate that the current cash method of accounting is too often not based upon cash receipts and disbursements, but rather on principles that attempt to match costs with income similar to the accrual method. For small businesses that have no government regulators to whom financial statements must be submitted and have no banks or other creditors in need of profit and loss determinations that conform to the rules of GAAP, tax rules based on the accrual method serve no practical purpose when economic success and taxable income can simply be measured on cash receipts and expenditures—that is, cash flow. In short, while the current cash method is substantially simpler than the accrual method, certain refinements to the current rules could make the cash method even simpler and more easily enable small businesses to comply with tax record keeping and reporting requirements without the loss of accuracy on their tax returns.

b. Accrual Method

The other major accounting method, the accrual method, attempts to determine the time at which "all events" occur that give rise to the right to income and the amount of that income can be determined with reasonable accuracy. Similarly, an expense may be deducted when the obligation to pay an expense is fixed, the amount of that obligation can be determined with reasonable accuracy and economic performance has occurred. Thus, businesses must report income on their tax returns when earned and may deduct expenses when incurred without regard to the receipt or payment of cash.

The accrual method and its "all events" test creates substantial complexity in an effort to better identify the financial success or failure of a business. This complexity calls for small businesses, whose every day well being centers upon its cash position, to deter-

mine its financial well-being in a manner that adds no value to its success. From the perspective of the IRS, while the timing of income and expense reported under the accrual method may provide some acceleration of tax upon income that must be recognized before any cash is received, such acceleration is clearly unfair if the cash is never received, and may only accelerate tax collection by no more than one year if the cash is subsequently receive shortly after the accrual.

The complexity of the accrual method is illustrated by prepayments. In the case of prepaid rent or interest received, income must be reported immediately upon receipt even if "all events" entitling the business to the income have not occurred. Similarly, where goods or services have not been delivered but cash payment has been received, the general rule under the accrual method that delays reporting the cash receipts on the business's tax return until "all events" have occurred, i.e. the goods are delivered or services performed, is disregarded. Thus, in the case of prepayments a business otherwise on the accrual method finds itself using the cash method for prepayments. Not an easy concept for a small business owner to understand.

Another complexity of the accrual method is the necessity to account for bad debts when a business reports as income an account receivable for which it never receives actual payment. Each year businesses on the accrual method must determine which previously reported receivables are uncollectible and claim them as tax deductions. This can be a time consuming, confusing and expensive process. Businesses using the cash method do not deduct bad debts because they do not include receivables in taxable income.

Finally, even when a business on the accrual method meets the "all events" test with respect to an expense, a deduction may be claimed only when "economic performance" occurs. Therefore, in the case of receiving goods and/or services from another party, the business may deduct the obligation to pay the other party only as the goods or services are received regardless of when the business pays for the goods or services, subject to an exception permitting deduction in the year of prepayment if the other party provides the goods or services within three and one-half months of the next taxable year. Again, not an easy concept for small businesses to understand.

The above illustrations of the complexity required by the accrual method of accounting demonstrate that in the case of small businesses the purported technical accuracy resulting from these rules offers no practical benefit to the business in measuring its economic performance, and over the life cycle of the business, offers no additional tax revenue to the government.

2. Tax Accounting for Inventories

Regardless of whether a business is on the cash or accrual method of accounting, if inventory is a material income producing factor, the business must account for gross profit, i.e. sales minus cost of goods sold, using the accrual method, even if they have adopted the cash method as their overall accounting method. Thus, a business

cannot deduct the cost of the inventory (finished goods) to the extent it has not sold the product by the end of the business's taxable year. Businesses selling inventory must maintain records documenting their cost of unsold, finished goods, partially finished goods and "raw" materials on hand that will be used in the future to manufacture or product inventory. In addition, inventory cost accounting principles call for the deduction of indirect costs (overhead) associated with manufacturing or producing the inventory only when the inventory is sold.

In determining its cost of inventory, a business must adopt an inventory costing method, i.e. the first-in, first-out (FIFO) method, the last-in, last-out (LIFO) method or the specific identification method. The FIFO and LIFO methods relieve businesses of the need to keep track of the cost of each item they sell, but where the items are unique or relatively high-cost, low volume products (e.g., jewelry, antiques, cars, etc.) the specific identification method is used.

As an exception to the requirement to maintain inventory accounts, the IRS (not the Internal Revenue Code) permits a cash method business to use the cash method to account for their gross profit from the sale of inventory if the business's average annual gross receipts for the three year period prior to the current year do not exceed $10,000,000 and the business's primary activity is to provide services to customers but also offers a product for sale incidental to the performance of services. Thus, a veterinarian using the cash method of accounting need not use the accrual method to account for the sale of medicines or other goods associated with the business of caring for animals because such sales are incidental to the veterinarian's professional practice. But when the average gross receipts of the business exceeds $10,000,000, businesses must not only account for inventory using the accrual method, but also must apply certain "uniform cost capitalization" (UNICAP) rules that require an allocation to inventory of an array of indirect costs beyond those ordinarily associated with producing goods. Thus, under the UNICAP rules, a business must add to the cost of inventory a portion of compensation paid to employees who may not be involved in producing the inventory but may merely indirectly support the production process.

A final illustration of the complexity of the accrual method deals with the perceived abuse of an accrual method business accruing (deducting) an amount owed to a related party using the cash method. In this case the business using the accrual method nay not deduct the amount owed to the related party until the amount is actually paid and recognized as taxable income by the cash method party. This issue frequently arises where a business employs the owner or a relative of an owner. Related parties, for this purpose, include family members and certain businesses owned by the same individual(s).

3. Comparison of Cash and Accrual Methods

As the above descriptions demonstrate, the primary advantages of the cash method over the accrual method are its clarity and

flexibility in measuring income and expenses and its less cumbersome bookkeeping and record keeping requirements. While the accrual method is generally considered a more accurate reflection of a business's financial condition, the price of this accuracy is mind numbing complexity and inevitably increased compliance and record keeping costs.

However, the Internal Revenue Code limits the adoption of the cash method to the following businesses: (1) sole proprietorships; (2) S corporations; (3) certain corporations engaged predominantly in the performance of services by their owners, (4) corporations with average gross receipts over the preceding three years of $5,000,000; (5) partnerships with no corporate shareholder whose gross receipts exceed $5,000,000; and (6) farms.

Suggestions for simplifying and liberalizing the use of the cash method were made by the Treasury Department in 2007, the Bowles-Simpson Commission in 2010 and most recently the options proposed by former Senator Baucus and Representative Camp described in the Senate Finance Committee's Bipartisan Tax Working Group Report on Business Income Tax. These proposals simplify the reporting of income and expenses on tax returns filed by small businesses that will then reallocate resources otherwise spent on compliance to more productive purposes, ultimately stimulating job growth. In addition, the IRS Taxpayer Advocate has consistently recommended simplifying accounting methods for small business as a way to ease compliance burdens and reduce tax administration.

4. Simplified Cash Method of Accounting ("SCM")—The "Checkbook" Method

Based on this brief description of the accounting methods available to small businesses and the observations of Treasury, IRS and Congressional tax reform studies, small businesses clearly need and deserve legislative relief in measuring and reporting their taxable income and deductible expenses. Therefore, the Internal Revenue Code should be amended to not only permit the adoption of the cash method by more small businesses, but also the adoption of a "simplified cash method of accounting" ("SCM"). This proposed simplification of the existing cash method of accounting will reduce time-consuming, expensive administrative burdens on small businesses in keeping records and reporting their income and expenses on their returns, thereby unleashing resources that will create more productive, job creating activities.

Besides reducing compliance costs the SCM will enable small businesses to better understand their tax returns, thereby reducing the general public's cynicism that the Internal Revenue Code is replete with loopholes only accessible to businesses with resources to employ expensive tax professionals. In short, simplifying reporting on tax returns will increase compliance, ease the burden of tax administration, increase tax revenue and ultimately reduce the gap between what taxpayers should pay and what the IRS actually collects.

Under the SCM the computation of taxable income is reduced to the following formula:

Cash Receipts

Less: Cash Expenses including:

- Inventory
- Prepayments
- Materials/Supplies
- Depreciable Property

Taxable Income

In short, the derivation of taxable income is based solely on amounts actually received or paid during the tax year, by means of examining the business's checkbook for when checks were cut and deposits made. Under SCM, income consists only of cash, property or services received during the tax year without regard to imputed income under the constructive receipt, cash equivalence, or economic benefit doctrines. While determining and valuing the receipt of in-kind goods and services would continue to be a problematic, small businesses would otherwise be able to arrive at their income by adding up their bank deposits for the year. Any timing advantage to businesses from not being subject to the judicial doctrines just mentioned would be minimal given that small businesses cannot, as a practical matter, defer recognition of cash by more than a few months without creating severe cash flow problems for the payment of their own bills. The complexity of the judicial doctrines does not warrant their application to small businesses.

SCM offers even greater simplification for the determination of deductible expenses. Under SCM, all current expenditures, including those for the acquisition or construction of inventory, would be deducted when paid. Although a technical violation of GAAP's matching principle of accounting, GAAP is not a particularly useful concept in measuring the ability of a small business to pay tax, or even stay in business. More than one small business that had a profit under GAAP has failed because of cash flow problems. Allowing for the immediate deduction of the cost of inventory simplifies small business record keeping at relatively little cost to the government. For a small business to say in business, inventory paid for and deducted in one year likely will be sold no later than the next year to ensure sufficient cash flow for business operations. Also, permitting the expensing of inventory before its sale recognizes the fact that by the IRS's own admission, small businesses are not following the rules for the computation of cost of goods sold, in that audits reveal more than 50 percent of cost of goods sold calculations are incorrect.

Finally, permitting the immediate expensing of depreciable property simply adopts a 100 percent bonus depreciation approach for acquired property with a useful life in excess of one year and the current section 179 expense allowance for purchased depreciable property. Thresholds and limitations similar to the present $10,000,000 limitation for uniform capitalization rules and the current IRS allowance for the cash method may be adopted to restrict SCM to small businesses.

With a $10 million threshold for the general adoption of the cash method coupled with an election to adopt the SCM, simplification

would be available to approximately 99% of all businesses in the United States, thereby reducing the tax compliance burden for almost every person owning and operating a business in America.

B. Single Business Tax Rate

Perhaps even more important from the perspective of compliance costs, small businesses need a rate structure that is not dependent on the legal form they adopt. Currently sole proprietorships, partnerships and S corporations are taxed at a maximum rate of 39.6%, while the taxable income of a C corporation is taxed at a maximum rate of 35%. Most of the corporate tax reform proposals focus upon eliminating deductions and credits to broaden the tax base upon which a lower corporate tax rate would apply. If corporate tax reform simply reduces rates on C corporations, unincorporated small businesses will have an increased tax burden relative to C corporation. Additionally, such a result will increase the tax planning and compliance costs of every start-up business in analyzing the tax burden of operating in one legal form or another. Our tax system should not promote inefficiency by incentivizing small businesses to make decisions based on tax considerations, rather than for business reasons.

Therefore, rather than reduce the tax rates only on C corporations, small businesses need a tax rate structure that applies to all businesses regardless of their legal form. While corporate earnings are subject to tax both at the corporate level and the shareholder level (when distributed) and earnings of unincorporated businesses are taxed only once, there are well documented approaches, e.g. integration, beyond the scope of this testimony to ensure tax neutrality in the decision of business entity choice.

A single integrated business tax rate schedule could have graduated rates providing a lesser tax burden to businesses with less taxable income. A single integrated business tax rate schedule would not be difficult to administer because income from follow-through businesses (sole proprietorships, partnerships and S corporations) already separately appears on schedules on individual tax returns, Schedule C for income for sole proprietorships and Schedule E for income from partnerships and S corporations. Individuals would simply total their business taxable income and apply the "business tax rate schedule," a practice no different from the special tax rate schedule that currently applies to qualified dividends and capital gains on Schedules B and D.

In short, what is needed is "business tax reform" not corporate tax reform. A single business rate schedule will create a uniform, comprehensive system of business taxation that taxes all businesses equally without regard to their legal form thereby easing the tax burden on small businesses and increasing simplicity and fairness.

IV. Conclusion

The burden of compliance costs on small business arises from the complexity of the tax law coupled with the almost exponential change in the Internal Revenue Code over the past few decades. As a result, small businesses have outsourced their tax planning and compliance responsibilities to tax professionals whose fees have added to the compliance burden.

The Kogod Tax Policy Center recommends that increasing the availability of the cash method of accounting to small businesses and adopting a uniform tax rate schedule for all businesses regardless of their legal form will reduce the burden small businesses currently bear in complying with their filing responsibilities. These proposals will improve tax compliance at lower administrative costs to businesses with little or no loss of tax revenue to the government. Such reforms are needed for the continued viability of our voluntary tax compliance system.

* * *

Thank you for the opportunity to testify today. I welcome any questions from the Committee or its staff. In addition, I or any others at the Kogod Tax Policy Center would be pleased to respond to any other questions you may have in the future.

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

July 20, 2015

The Honorable Steve Chabot
Chairman
Committee on Small Business
United States House of Representative
2361 Rayburn House Office Building
Washington, DC 20515

The Honorable Nydia Velazquez
Ranking Member
Committee on Small Business
United States House of Representative
2361 Rayburn House Office Building
Washington, DC 20515

RE: July 22, 2015 Hearing on "How Tax Compliance Obligations Hinder Small Business Growth"

Dear Chairman Chabot and Ranking Member Velazquez:

The American Institute of Certified Public Accountants (AICPA) respectfully submits the enclosed statement for the record of the hearing held on July 22, 2015 on "How Tax Compliance Obligations Hinder Small Business Growth." We appreciate the efforts of the Members of the Committee for their commitment to reducing the tax burden, created by the Internal Revenue Service, on small businesses.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 145 countries and a history of serving the public interest since 1877. Our members advise clients on Federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

If you have any questions, I can be reached at (801) 523-1051 or tlewis@sisna.com; or you may contact Melissa Labant, AICPA Director of Tax Advocacy, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

Troy K. Lewis, CPA
Chair, Tax Executive Committee

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

WRITTEN STATEMENT

OF

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

FOR THE RECORD OF THE

JULY 22, 2015

HEARING OF

**THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS**

ON

**"HOW TAX COMPLIANCE OBLIGATIONS HINDER
SMALL BUSINESS GROWTH"**

INTRODUCTION

Chairman Chabot, Ranking Member Velazquez, and Members of the House Committee on Small Business, thank you for the opportunity to testify today on "How Tax Compliance Obligations Hinder Small Business Growth." My name is Troy Lewis. I am the vice president and chief enterprise risk management officer at Heritage Bank in St. George, Utah. I am also a sole tax practitioner, adjunct faculty member at Brigham Young University and Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to testify today on behalf of the AICPA.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 145 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

The AICPA applauds the leadership taken by the Committee to consider ways to reduce the complexity faced by small businesses when preparing their taxes. Small businesses are the foundation of the U.S. economy, employing over half of the private-sector workforce and creating nearly two-thirds of this nation's net new jobs over the past decade and a half.[1]

Unfortunately, compliance with federal tax laws can act as a road block in the growth of small business. Unlike large multi-national corporations, the time spent by small businesses in complying with tax laws is much more costly because small businesses do not have the luxury of critical mass and a large customer base with which to efficiently spread non-value added compliance costs. Time devoted to complying with tax laws has an impact on business creation, job growth and economic prosperity of these small businesses.

At the same time, we recognize that tax compliance is necessary. However, to help small businesses grow, Congress and the Internal Revenue Service (IRS) should seek to lessen these compliance burdens on all small businesses. When evaluating whether or not a tax compliance requirement should be mandated for a small business, a cost/benefit analysis should first be considered. Nowhere is it more important to ask if the end result is worth the effort than in the area of tax compliance for small businesses.

Using this cost/benefit approach, may I suggest a few areas where Congress can act to reduce the burden of tax compliance in a way that allows small businesses to grow without creating undue hindrances.

IRS TAXPAYER SERVICES

[1] Small Business Administration Office of Advocacy, Frequently Asked Questions, September 2012.

It is imperative that small businesses and their tax return preparers have the ability to communicate with the IRS when preparing their taxes and addressing compliance issues. However, there has been increasingly limited access to the agency and, as reported by IRS Commissioner John Koskinen, "abysmal' level of taxpayer service this year.[2]

Our members have expressed their deep concerns regarding their ability to effectively represent small businesses and other taxpayers in an environment where the IRS service levels are so degraded that:

- During the 2015 tax season, the IRS answered only 37% of the telephone calls received from taxpayers seeking to speak with an assistor;[3]
- The average hold time for the Practitioner Priority Service telephone line reached 47 minutes;[4] and
- According to the National Taxpayer Advocate, the IRS's ability to process taxpayer correspondence in a timely manner declined by 16% since 2014, leaving a backlog of almost 79,000 cases.[5]

Through an informal membership survey we conducted earlier this year, we learned that over half of our members were either somewhat dissatisfied or very dissatisfied with the services they received from the IRS this filing season. This is no surprise considering that only 17% of our members responded that the IRS generally answered their telephone calls within 30 minutes. Most of our members were on hold for extended periods of time and other members noted that they generally had to end their own calls because they did not have the time to wait on hold for an IRS agent to answer.

As reported by one of our members, "I was on hold for over an hour and a half. When the IRS agent finally picked up the call, they needed to transfer to another agent. I had to wait on hold for another hour. Finally, I received a recorded message that the office was closed and I needed to call again the following day."

Many of our members also experienced what the IRS refers to as "courtesy disconnects." According to the IRS, they terminate telephone calls from small businesses and other callers, without taking a message or getting contact information, if the caller has been on hold for two hours. As of April 18th this year, approximately 8.8 million calls received by the IRS were subject to their "courtesy disconnect" policy, which represents an increase from approximately 544,000 over last year.[6] Nothing is more discouraging, frustrating

[2] Commissioner Koskinen, Prepared Remarks of John A. Koskinen Commissioner, Internal Revenue Service, Before the National Press Club, dated March 31, 2015.

[3] National Taxpayer Advocate Report, Volume I: FY 2016 Objectives Report to Congress; Part II: Review of the 2015 Filing Season, dated July 14, 2015.

[4] Joint Operations Center, Customer Account Services, Account Management Paper Inventory Reports, Inventory Age Report, (Jan 1 - Apr 6 statistics).

[5] *Id.*

[6] National Taxpayer Advocate Report, Volume I: FY 2016 Objectives Report to Congress; Part II: Review of the 2015 Filing Season, dated July 14, 2015.

or inefficient for a caller (whether they are a small business or a tax preparer calling on behalf of a small business) than being hung up on by the IRS after waiting on hold for two hours.

Our survey also indicated similar, unacceptable patterns with regards to delays in written correspondence. On average over half of the correspondence sent to the IRS is not responded to within 90 days of receipt.[7] Often small businesses are anxiously awaiting a response to a notice. Furthermore, the longer the response tine by the IRS, the more interest and penalties are accrued as the small business attempts to resolve their issue.

We appreciate and understand that the IRS has new initiatives and vital unmet obligations and responsibilities (such as addressing identity theft), but taxpayer service must remain a high priority in order for small businesses to receive the assistance they need on tax issues.

GOOD TAX POLICY

In order to reduce the overall tax compliance burden on small businesses, the AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification, transparency and other Principles of Good Tax Policy.[8] We believe it is important to promote a tax system that is perceived as balanced, fair to all, administrable, economically efficient, transparent, and neutral in its effect on economic activity.

Our current tax system is heavily burdened by complexity. Multiple and duplicative tax calculations, definitions, and preferences lead to taxpayer confusion and, thus, errors and frustration. Attempts to adjust tax liabilities through special rules affecting taxable income rather than the rate schedule add to complexity. Business provisions that require retention of records solely for tax purposes increase compliance costs. We urge consideration of removing duplicative rules and definitions, and reducing recordkeeping and calculations, to achieve simplicity, without adding new complexities.

It is also important for an effective tax system and informed citizenry that taxpayers understand the tax system and how it affects them. Clarity of the tax consequences of taxpayers' regular activities is a must. Transparency also helps improve voluntary compliance.

Additionally, it is critical for taxpayers to have certainty to perform any long-term tax planning. Permanence of tax provisions can have substantial impacts on the growth of small businesses. The uncertainty of tax legislation creates unnecessary confusion, anxiety and administrative financial burdens. Without permanency in the Internal Revenue Code ("Code"), we are concerned about the following consequences:

- Impact on a company's financial accounting and reporting;

[7] Joint Operations Center, Customer Account Service, Account Management Paper Inventory Reports, Inventory Age Report, (Jan 1 - Apr 6 statistics).

[8] AICPA's Tax Policy Concept Statement No. 1: Guiding Principles for Good Tax Policy: Framework for Evaluating Tax Proposals, issued March 2001.

- Complexity and administrative burden for taxpayers and the IRS;
- Adverse impact on small businesses and ultimately jobs and growth;
- Effect on economic decisions and tax payments; and
- Lack of transparency and certainty with short-term, retroactive extensions

We recognize that it is not always possible for each tax provision and the overall tax system to equally meet each of the ten principles of good tax policy. However, it is important to carefully balance these principles to achieve a respected and administrable tax system.

TANGIBLE PROPERTY REGULATIONS

A challenging tax compliance burden that small businesses had to deal with this year was the new final tangible property regulations (TD 9636). These tax rules, which address how businesses should report the acquisition and improvement of tangible property, comprise almost 500 pages of technical guidance and procedures.

While we appreciated that the regulations clarified some rules and provided several small business favorable provisions, we were concerned that they were significantly burdensome for many small business taxpayers because of the required retrospective analysis and reporting requirements.

The AICPA pushed hard for relief and stressed that time was of the essence as a significant portion of the burdens placed on small businesses (and their tax practitioners) would occur prior to filing season. However, despite these pleadings, the IRS issued the much-needed relief, Rev. Proc. 2015–20, on February 13, well into the filing season. Unfortunately, some small businesses and their tax practitioners had already spent time and resources attempting to comply with the new regulations prior to the IRS's issuance of relief. If the IRS had acted in a timely manner, small businesses could have been spared some administrative burden.

Currently, small businesses must prove that expensing such amounts "clearly reflects income" to deduct amounts higher than the $500 threshold. The clear reflection of income test can be challenging for any taxpayer, especially for small businesses. The test is based on the taxpayer's facts, circumstances, and interpretations of those facts and circumstances by the taxpayer and IRS. Thus, it is arbitrary and often difficult to apply. Large businesses (e.g., taxpayer with an AFS), however, are allowed the higher $5,000 threshold. Subjecting small businesses to the clear reflection of income test at merely $500, adds unnecessary complexity and compliance burdens to small businesses.

There are other issues that remain open in regards to the repair regulations. The AICPA recommends that you take immediate action to increase the $500 de *minimis* safe harbor threshold for taxpayers without an AFS to $2,500, and provide for annual adjust-

ments for inflation, to offer meaningful relief to small business taxpayers. To further reduce administrative burden on these rules, we also recommend that you expand the AFS definition to include a reviewed set of financial statements[9] to permit more business to benefit from the higher $5,000 de *minimis* safe harbor threshold.

CIVIL TAX PENALTIES

An additional concern[10] for small businesses is the numerous unfair or untargeted penalty provisions in the Code pertaining to tax compliance. Penalties should deter bad conduct without deterring good conduct or punishing small businesses which are acting in good faith.

Targeted, proportionate penalties that clearly articulate standards of behavior and that are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws. On the other hand, overbroad, vaguely-defined, and disproportionate penalties, particularly those administered as part of a system that automatically imposes penalties or that otherwise fail to provide basic due process safeguards, create an atmosphere of arbitrariness and unfairness that is likely to discourage voluntary compliance.

For example, penalties should apply prospectively to future conduct and not retroactively to conduct that was appropriate at the time the conduct occurred. Good tax policy would also suggest that we avoid strict liability provisions that do not grant the IRS discretion to take into consideration the facts and circumstances of a particular business' situation.

The AICPA points out the following specific penalty-related issues with the current system below.

Repeal Technical Termination Rule

The AICPA recommends a repeal of section 708(b)(1)(B) regarding the technical termination of a partnership as it is a trap for the unwary.[11] Under current law, when a partnership is technically terminated, the legal entity continues, but for tax purposes, the partnership is treated as a newly formed entity. The current law requires the partnership to select new accounting methods and periods, restart depreciation lives, and make other adjustments Furthermore, under the current law, the final tax return of the "old" partnership is due the 15th day of the fourth month after the

[9] For a detailed explanation of the differences between a compilation, a review, and an audit, please reference the AICPA Comparative Overview document.

[10] AICPA comment letter on "AICPA Tax Penalties Legislative Proposals," dated April 11, 2013; and AICPA report on "AICPA Report on Civil Tax Penalties," submitted April 11, 2013.

[11] AICPA submitted letters and written statement on Option 1 and Option 2 of Chairman Camp's Small Business Tax Reform Draft: See Option 1 comments at "AICPA testimony on Small Business and Pass-through Entity Tax Reform," dated May 17, 2013; and Option 2 comments, "AICPA Comments on Option 2 of Chairman Camp's Small Business Tax Reform Discussion Draft" dated July 30, 2013.

month-end in which the partnership underwent a technical termination.[12]

A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Because this 12-month time frame can span a year-end, the partnership may not realize that a 30% change (a minority interest) in one year followed by a 25% change in another year, but within 12 months of the first, has caused the partnership to terminate.

In practice, this earlier required filing of the old partnership's tax return often goes unnoticed because the company is unaware of the accelerated deadline due to of the equity transfer. Penalties are often assessed upon the business as a result of the missed deadline. Although ignorance is not an acceptable excuse, this technical termination area is often misunderstood and misapplied. The acceleration of the filing of the tax return, to reset depreciation lives and to select new accounting methods, serves little purpose in terms of abuse prevention and serves more as a trap for the unwary.

Late Filing Penalties

Sections 6698 and 6699 impose a penalty of $195 per partner related to late-filed partnership or S corporation returns. The penalty is imposed monthly not to exceed 12 months, unless it is shown that the late filing is due to reasonable cause.

The AICPA proposes that a partnership (or S Corporation), comprised of 50 or fewer partners/shareholders, each of whom are natural persons (who are not nonresident aliens), an estate of a deceased partner, a trust established under a will or a trust that becomes irrevocable when the grantor dies, and domestic C corporations, will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 or 6699 if:

- The delinquency is not considered willful under section 7423;
- All entity income, deductions and credits are allocated to each owner; and
- Each partner/shareholder fully reported its share of income, deductions and credits of the entity on its timely filed federal income tax return.

Failure to Disclose Reportable Transactions

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Code. For penalties assessed after 2006, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction (or the decrease that would have been the result if the transaction had

[12] For example, a partnership that technically terminated on April 30 of the current year due to a transfer of 80% of the capital and profits interests in the partnership to be timely filed must file its tax return for that final tax year on or before August 15 of the current year.

been respected for federal tax purposes). If the transaction is a listed transaction (or substantially similar to a listed transaction), the maximum penalty is $100,000 for individuals and $200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the maximum penalty is $10,000 for individuals and $50,000 for all other taxpayers. The minimum penalty is $5,000 for individuals and $10,000 for all other taxpayers.

The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to the penalty. The Commissioner may, however, rescind all or a portion of a penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote efficient tax administration and only after the taxpayer submits a lengthy and burdensome application. In the case of listed transactions, the IRS has no discretion to rescind the penalty. The statute precludes judicial review where the Commission decides not to rescind the penalty.

The AICPA proposes for an amendment of section 6707A to allow an exception to the penalty if there was a reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we propose an amendment of section 6664 to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

9100 Relief

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list[13] of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities. We do not believe small businesses are likely to abuse or exploit hindsight, as the IRS would continue to have discretion as to whether to grant relief for each specific request.

Form 5471 Penalty Relief

On January 1, 2009, the IRS began imposing an automatic penalty of $10,000 for each Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations,* filed with a delinquent Form 1120 series return. When imposing the penalty on corporations in particular, the IRS does not distinguish between: a) large public multinational companies, b) small companies, and c)

[13] AICPA comment letter on "Tax Reform Administrative Relief for Various Statutory Elections," submitted January 23, 2015.

companies that may only have insignificant overseas operations, or loss companies. This one-size-fits-all approach inadvertently places undue hardship on smaller corporations that do not have the same financial resources as larger corporations. The AICPA has submitted recommendations [14] regarding the IRS administration of the penalty provision applicable to Form 5471. Our recommendations focus on the need for relief from automatic penalties assessed upon the late filing of Form 5471 in order to promote the fair and efficient administration of the international penalty provisions of the Code.

MOBILE WORKFORCE

Another burden on small businesses that Congress should address involves the tremendous burden of tracking and complying with the many different state non-resident employee tax withholding and reporting rules for just a few days of work by an employee in a non-resident state. The state personal income tax treatment of nonresidents is inconsistent and often bewildering to multistate employers and employees.

H.R. 2315, the Mobile Workforce State Income Tax Simplification Act of 2015, introduced by Representative Bishop on May 14, 2015, addresses this issue. We are pleased that members of this Committee cosponsor this bill, and hope many others of you will also consider cosponsoring it. The AICPA strongly supports H.R. 2315 and urges Congress [15] to enact this legislation to help small businesses in this country ease their non-resident state income tax withholding and compliance burdens.

Small businesses must understand each of the states' treatment of non-resident employee withholding and assessment of taxes and the unique de *minimis* and definitions. Currently, 43 [16] states plus the District of Columbia impose a personal income tax on wages, and there are many different requirements for withholding income tax for non-residents among those states. There are seven states that currently do not assess a personal income tax.[17] Employees traveling into all the other states are subject to the confusing myriad of withholding and tax rules for non-resident taxpayers.

A number of states have a de *minimis* threshold, or exemption for non-residents working in the state before taxes must be withheld and paid. Others have a de *minimis* exemption based on the amount of the wages earned, either in dollars or as a percent of total income, while in the state. Further complicating the issue is that a number of these states have reciprocity agreements with

[14] AICPA comment letter on "Recommendations - Automatic Penalties assessments Policy with the Late Filing of Form 5471," dated March 26, 2013.

[15] AICPA written testimony before the House Committee on the Judiciary Subcommittee, Regulatory Reform, Commercial and Antitrust Law on Nexus Issues: Legislative Hearing on H.R. 2315, The "Mobile Workforce State Income Tax Simplification Act of 2015," H.R. 1643, the "Digital Goods and Services Tax Fairness Act of 2015," and H.R. the "Business Activity Tax Simplification Act of 2015", dated June 2, 2015.

[16] Note that New Hampshire and Tennessee, which are included in the 43 states, do not tax wages and only subject to tax interest and dividends earned by individuals.

[17] The seven states with no personal income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

other, usually adjoining, states regarding the withholding of non-resident state income taxes.

Where many businesses once tended to be local, they now have a national reach. This change has caused the operations of even small businesses to move to an interstate basis. Because of the interstate operations of these companies, many providers of services to these companies, such as certified public accountants (CPAs), find that they are also operating on an interstate basis. What once were local taxation issues have now become national in scope, and burdens must be eased in order to promote interstate commerce and ensure businesses run efficiently. These burdens take significant resources away from operating their business.

The complex filing rules impact everyone who travels for work. The recordkeeping and the requirement of having to withhold and file many state non-resident tax returns for just a few days of work in various states is overly burdensome and too complicated for both employers and employees. Additionally, the amount of research that goes into determining what each state law requires is expensive and time-consuming. A small firm or business will often be required to engage outside counsel to research the laws of the other states on an ongoing annual basis.

This issue affects all industries—retail, manufacturing, real estate, technology, food, services, etc. The current system as a whole unnecessarily creates complexity and costs for both employers and employees, without yielding a substantive benefit to most states. H.R. 2315 is needed to solve this problem and burden for small businesses.

Having a uniform national standard for non-resident income taxation, withholding, and filing requirements, as H.R. 2315 provides, will enhance compliance and significantly relieve these unnecessary administrative burdens on businesses and their employees. Additionally, H.R. 2315 provides a needed 30-day de *minimis* exemption before an employee is obligated to pay taxes to a state in which they do not reside. Many small businesses need Congress to enact this legislation.

TAX RETURN DUE DATE SIMPLIFICATION

Another challenging compliance issue for small businesses is the current illogical order of due dates for various types of tax returns. Taxpayers and preparers have long struggled with problems created by the inefficient timeline and flow of information. Federal Schedules K-1s are often delivered late, sometimes within days of the due date of taxpayers' personal returns and up to a month after the due date of their business returns. Late schedules make it difficult, if not impossible, to file a timely, accurate return. The current inefficient timeline of tax return due dates is a problem for taxpayers as well as their tax practitioners.

The AICPA strongly supports this provision. It would alleviate the problems mentioned above by establishing a logical set of due dates, focused on promoting a chronologically-correct flow of infor-

mation between pass-through entities and their owners. The proposal includes the changes as follows:

Current Tax Due Dates:

- March 15: S corporation and C corporation Forms 1120S and 1120; and
- April 15: Individual, Trust and Estate, and Partnership Forms 1040, 1041, and 1065

Proposed Tax Due Dates:

- March 15: Partnership Form 1065;
- March 31: S corporation Form 1120S; and
- April 15: Individual, Trust and Estate, and C Corporation Forms 1040, 1041, and 1120

The provision would also revise the extended due dates to be six months after the original filing due dates for all these forms, except the trust and estate Form 1041, which would be extended five and half months.

The AICPA urges you to support this provision to change the dates for tax returns of partnerships, S corporations and C corporations because it would:

- Improve the accuracy of tax and information returns by allowing corporations and individuals to file using current data from flow-through returns that have already been filed rather than relying on estimates;
- Better facilitate the flow of information between taxpayers (i.e., corporations, partnerships, and individuals);
- Reduce the need for extended and amendment tax returns; and
- Simplify tax administration for the government, taxpayers, and practitioners.

CONCLUDING REMARKS

The AICPA has consistently supported tax reform simplification efforts and permanent tax legislation because we are convinced such actions will significantly reduce taxpayers' compliance costs and encourage voluntary compliance through an understanding of the rules. The uncertainty of tax legislation creates unnecessary confusion, anxiety and administrative financial burdens. Good tax policy would promote a tax system that is balanced, economically efficient and transparent.

We encourage you to examine all aspects of the tax code to improve the current rules that have led to compliance hurdles for small businesses and administrative complexity. For example, additional relief is needed for small businesses with regards to the tangible property rules, penalty provisions need to consider their effect on voluntary compliance, and employers operating across state lines need a uniform standard on non-resident income tax withholding rules. The income tax deadlines should also promote an efficient flow of taxpayer information to provide small businesses sufficient time to file timely, accurate returns.

Finally, if small businesses are going to be allowed to grow, it is imperative that the IRS's taxpayer service issues are addressed. Small businesses and their tax preparers need to be able to contact the IRS regarding their compliance issues.

Again, Mr. Chairman, thank you for the opportunity to testify. I would be happy to answer any questions.

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July 20, 2015

Susan Marshall, Clerk
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515

Dear Ms. Marshall and Members of the U.S. House Committee on Small Business:

Thank you for the opportunity to provide commentary to the House on matters affecting small business at the full Committee hearing on Wednesday July 22, 2015.

Background

McGladrey is a leading provider of assurance, tax and consulting services focused on the middle market with nearly 8,000 professionals in 80 cities nationwide. The firm is one that is designed to meet the needs of local and middle market businesses.

We also operate a member network of independent firm's known as The McGladrey Alliance comprised of more than 90 independently owned accounting and business consulting firms in 42 states and Puerto Rico.

The size of our practice and the large concentration of small to medium sized clients in the middle market segment demonstrate our frequent exposure to the compliance challenges facing small businesses today.

Personal Background

My own practice concentration is the smaller end of the middle market that we refer to as the Local Markets Group (LMG). Our Boston LMG practice is made up of approximately 50 professionals. As a practitioner with 40 years of experience working in this sector, my day to day work consistently exposes me to the compliance requirements of my client base which is made up approximately for some 40 small businesses ranging in size from under $5 million to $100 million in revenue with workforces from less than 10 employees up to about 200. All of the clients are privately owned and many are family owned. My client base is representative of the others in my practice made up of a dozen partners and senior managers. We collaborate and share our experiences regularly including sharing of resources, training and researching together.

In that regard, a recent poll of members from the LMG group was conducted in order to obtain some of the more common challenges we face with the current tax code, compliance and reporting requirements. Following are a few of subjects that had recurring themes. On behalf of my firm and the many clients we serve we respectfully submit these subjects for your review and consideration.

Depreciation - TARS Legislation and the De Minimus rules

Depreciation has been around since the beginning of the tax code. In its simplest form it was designed to spread the deduction for a taxpayers acquisition of large capital items over a period of time and over the estimated useful life of the acquired property. Periodically Congress incented businesses to acquire more capital equipment by allowing more generous depreciation deductions. The result was simple, a small business owner would buy equipment and write all of it off immediately and the rest of it off over a reasonable period of time. The rules and reporting are no longer simple, despite that the intended result has not changed.

The de minimus safe harbor limits are provided in Treasury Reg. §1.263(a)-1(f)(1)(ii)(D) for taxpayers without an applicable financial statement (AFS) further prescribed in Rev. Proc. 2015-20. Because McGladrey is one of the largest CPA and advisory firms in the U.S., with offices all over the country we work with thousands of small businesses that DO NOT have an AFS.

In some cases, like the safe harbor rules, a taxpayer can take advantage of the rule by simply putting it into practice. In other cases, an election will need to be filed with a return. However, in order to be in full compliance with the regulations, most taxpayers will need to file a Form 3115 to adopt new accounting methods. Many experts believe that almost all taxpayers with fixed assets or repairs will be required to file at least one accounting method change to be in compliance with the new rules. If a Form 3115 is required, it will need to be filed by the due date (including extensions) of the current year return, assuming the taxpayer is a calendar-year taxpayer. At McGladrey, tax professionals have been advised to recommend preparation of the 3115 which is at great cost and consequence to the taxpayers.

Rather than requiring a Form 3115 to be filed with most returns, an alternative solution might have been to simply change the current Form 4562 to include a series of check boxes, elections and the additional information required by the standards to conform simplifying the entire process.

We also believe in reducing the burden of compliance with these rules by increasing the De Minimus Safe Harbor Amount for Taxpayers without an AFS. From discussions with our business clients that do not maintain an AFS (as defined in Treasury Reg. §1.263(a)-1(f)(4)), we have learned that many have capitalization policies in excess of $500. Historically, these clients rarely have been challenged under IRS examination of maintaining a policy that does not clearly reflect income. As such, a $500 safe harbor does not appear to be a practical solution for taxpayers without an AFS.

To distinguish, one should compare a taxpayer with an AFS to those without. The current rule does not take into consideration the complexity or size or sophistication of the taxpayer and their accounting department. A large closely held business that does not have a financial statement audit could have an accounting department just as sophisticated as that of an SEC company.

However, this similarly situated taxpayer is limited to a capitalization threshold of $500 under the de minimus threshold, rather than the more generous $5,000 amount provided to taxpayers with an AFS.

Granted, a taxpayer without an AFS is not handcuffed by the $500 threshold so long as they can prove under examination that deducting items in excess of $500 is a clear reflection of income. Unfortunately, due to the subjective nature of the "clear reflection of income" determination, taxpayers fear that an IRS examining agent may have a different opinion as to whether or not the expenditures are a clear reflection of income, which could lead to lengthy and costly disputes at the examination and appeal level—or even litigation—over an item that is nothing more than a timing difference. Increasing the safe harbor amount for taxpayers without an AFS would reduce taxpayer anxiety and potential future conflicts under examination.

We suggest increasing the de minimus safe harbor threshold for taxpayers without an AFS. Potential alternatives include a general increase in the amount across all business types, different thresholds based upon industries or a threshold based upon a certain percentage of average gross receipts for the three preceding tax years. Regardless of the method selected to increase the de minimus safe harbor, the threshold for taxpayers with and without an AFS should be indexed for inflation.

Reviewed Financial Statements Included as an AFS

In the preamble of Treasury Decision (T.D.) 9636, Treasury states that it does not believe reviewed financial statements as defined in the AICPA's Statement of Standards for Accounting and Review Services "provide sufficient assurance to the IRS that such policies are being followed and, accordingly, that the taxpayer is using a reasonable, consistent methodology that clearly reflects income" and should not qualify as an AFS.

A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. While a review is less in scope than an audit, the certified public accountant is performing analytical procedures to provide some assurance, even though it is limited, that they are not aware of any material modifications that should be made to the financial statements. Arguably, such assurance of no material modification supports the position that reviewed financials meet the AFS expectation that a taxpayer is using a reasonable, consistent methodology that clearly reflects income.

We respectfully suggest a review of the current Treasury and IRS provisions and reconsider their position and include reviewed financial statements as an AFS under Treasury Reg. §1.263(a)-1(f)(4) for purposes of the de minimus safe harbor election.

Taxpayer Privacy - Breached IRS Authorization System

The cost and consequence of data breaches today is substantial. Recent data breaches to the IRS system, affecting thousands of taxpayers has magnified the effect of the breaches. Within our own small service line of 50 professionals we recently conducted a poll that indicates we are currently assisting clients with more than 20 cases of breach and compromise. Though we are not professing or prescribing a fix to the data security problem, what is clear is that substantially more resources are needed to stem the tide of this problem in addition to developing a streamlined and comprehensive solution to the problem. We have clients who have been waiting for months to obtain their refunds, while in the meantime the hackers have already taken the money and run.

The current remediation plan is not effective or comprehensive enough. The current program includes notification by the IRS to the taxpayer recommending they obtain Publication 4535, Identity Theft Prevention and Victim Assistance. If the taxpayer has there is a refund pending, there is no mention in the correspondence as to the status of that refund or the likelihood of when the refund will be issued. In the correspondence the IRS attempts to provide comfort to the taxpayer by indicating that their tax return and future returns have been "flagged" to monitor future activity.

The IRS correspondence goes on to inform the taxpayer they are provided the "option" to obtain and "IP Pin #." The taxpayer is further instructed to file a complaint with the Federal Trade Commission (FTC) and to contact the Social Security Administration (SSA) to validate earnings with the Administration. Finally a toll free hotline is also provided to the taxpayer. That is simply not enough.

Given the severity of data breaches today and the amount of compromised information, we believe the IRS should be providing greater guidance around security and prevention measures. We believe that social security numbers now create such a worldwide target that an accelerated plan to cease using them may be in order in an effort to create a more secure alternative. Obtaining an IP Pin should be considered mandatory, not optional. We also suggest the Service consider providing additional instructions to the taxpayers on the additional measures they can take to protect their privacy with things like their bank and investment accounts, credit cards, and related credit and investment arrangements. Those steps require a sense of urgency and should be undertaken immediately. For example the Service should consider advising taxpayers to implement a credit "freeze."

Do what the Hackers do

Our practice recently obtained the services of an expert to speak to our team on the subject. He provided recommendations worth sharing. In summary he suggested that because the system is broken, any individual can access a free annual credit report from a public site, annualcreditreport.com, from each of the 3 most common credit bureaus. Therefore, once a year a taxpayer needs to take 15 minutes and pull their own credit report from the bureaus. In doing so the taxpayer has the opportunity to thwart the hacker from obtaining your credit history thru these free credit reporting sites. If the taxpayer senses foul play, they would be equipped with the information required to prevent further compromise.

Even if the taxpayers credit is "frozen" they still need to take steps like this because existing lines of credit can be taken over by simply calling the issuer and requesting a new card, changing an address, or even adding stolen payment card to a digital technology like ApplePay by leveraging "knowledge based authentication" questions that can only be found in the credit report.

Below is more information on security freezes. Reducing the chances of becoming a victim takes about 15 minutes of effort. We believe the Service would be serving the taxpayers well by recommending measures such as these.

The websites to freeze files are:

https://www.experian.com/freeze/center.html
https://www.freeze.equifax.com/Freeze/jsp/SFF_PersonalIDInfo.jsp
http://www.transunion.com/securityfreeze

Freezing your credit files won't protect you from having your Personal Identity Info used for tax return fraud, thus the reason why obtaining a Tax Pin should be mandatory and done in tandem with credit freezing.

Our firm is spending hundreds or hours of time at taxpayer expense to help them manage the maze to assist them in obtaining refunds and protect them from further fraudulent activity. This problem is severe and therefore requires an equal or greater effort and resources to manage the problem. The toll free number does little to resolve taxpayer fears and resolve status. One often stays on hold for hours before obtaining a live contact. There is no shortcut to this solution, it requires a dedicated team with dedicated resources empowered to help the taxpayer, or their designee), to obtain what is rightfully theirs.

S Corp Loans and Basis – All Loans are Not Created Equal

A burden and a significant risk for many small business owners, specifically the shareholders of S Corporations, is the necessity to invest Capital into the business, often including the need to pledge their personal assets in order to borrow and more often than not, guaranty money borrowed from 3rd parties. Typically a business owner starts a business and continues to fund the business with their own money or borrowed money, which they are "on the hook" for.

This is not a case against the need to track basis, but to simplify the tracking of basis and have the IRS acknowledge and recognize the true economics of a business loan on the same platform as between the 3rd party lender and the business owner. In short, if the shareholder borrows money and puts it into his company, he gets basis. If on the other hand he arranges to borrow money for the business and guarantees the debt including placing his personal assets as collateral, such as a mortgage on his house or property, then the taxpayer does not get basis, despite that he and his corporation still owes the bank.

The Simple Case for Simplification

This is simply a case for simplification. Loans that meet the appropriate criteria can and should be considered basis. This would streamline and simplify the process, reduce audits and eliminate the costs of tax court cases.

Simplifying Calculations

A common burden for small business owners and their tax advisors is computing and carrying forward complex "basis schedules." The basis schedules are designed to track the basis. Basis is typically used to provide the amount by which a shareholder would include in a gain or loss calculation for the sale of their shares of the stock. However, the basis is also used and can limit the losses that a shareholder can take when his business has a loss. Further, the repayment of the shareholders loan can cause unintended income tax consequences when the company pays back the personal loan if the loan lacks basis.

A shareholder's basis in stock owned in, and loans made to, an S corporation must be calculated for various purposes. First, as in the case of a C corporation shareholder, an S corporation shareholder's basis in stock in the corporation is one of the components for calculating the amount of gain or loss to the shareholder on the sale or other disposition of the stock. Second, stock basis must be known to determine whether distributions to the shareholder are taxable. Third, a shareholder's basis in loans to the corporation is used to determine whether gain or loss results on repayment of the loan. Finally, a shareholder's basis must be tracked over time because a shareholder may only deduct losses and other amounts passed through from an S corporation to the extent of basis in the corporation's stock or debt held by the shareholder.

The Code provides that a shareholder's stock basis in an S corporation is used to calculate the amount of gain or loss the shareholder realizes on the sale or disposition of the stock, and to determine the taxation of distributions by the corporation with respect to the stock.

The shareholder's basis in loans made to the corporation is used in determining the amount of gain or loss recognized by the shareholder on repayment of the loans. To this extent, the shareholder's basis in stock of and loans to an S corporation serves the same purposes as a shareholder's basis in stock of and loans to a C corporation. However, an S corporation shareholder's combined basis in stock of and loans to the S corporation also sets the limit on the amount of losses passed through from the corporation that may be deducted by the shareholder. Losses passed through from an S corporation that exceed the shareholder's combined stock and debt basis may not be deducted by the shareholder. Instead, these "suspended losses" carry over indefinitely, and generally may be deducted by the shareholder to the extent the shareholder's basis in stock or debt is increased in a subsequent year.

A shareholder's initial basis in stock of and loans to an S corporation is computed in the same manner as a shareholder's basis in stock of or loans to a C corporation. Each year, however, an S corporation shareholder's basis is adjusted for income, gain, loss, deduction, and other items passed through from the corporation to the shareholder. Distributions with respect to the shareholder's stock and repayments on debt are also reflected in the shareholder's basis.

Only loans that create indebtedness of the S corporation to the shareholder provide the shareholder with basis for deducting losses passed through from an S corporation.

Thus, while direct loans of money by a shareholder to an S corporation result in a basis increase to the shareholder-lender, indirect loans (such as the shareholder's guarantee of the corporation's debt to a third party) generally do not result in an increase in the shareholder's basis.

Once the shareholder's initial basis is determined, it is adjusted each year for additional capital contributions and distributions and for income, gains, losses, deductions and other items passed through to the shareholder from the S corporation.

In addition to stock basis, S corporation shareholders must monitor their bases in loans to the corporation. A shareholder's loan basis is important because items of loss and deduction passed through from the corporation to the shareholder may be deducted only to the extent of the shareholder's stock basis and loans made by the shareholder to the corporation. In addition, a shareholder's basis in loans made to the corporation determines whether any subsequent loan repayments are taxable to the shareholder.

Not all transactions involving the lending of funds from a shareholder to an S corporation result in a basis increase for the shareholder. The critical questions are whether the purported loan involves indebtedness of the corporation to the shareholder, and whether the indebtedness is bona fide under general federal tax principles taking into account all facts and circumstances. If the loan is not actually between the corporation and the shareholder, the shareholder receives no increase in basis despite that he is still clearly on the hook with the bank.

In the situations discussed below, a shareholder's loan to an S corporation should give rise to an increase in the shareholder's basis.

Direct Shareholder Loans to Corporation

A shareholder's direct loan of money to an S corporation creates indebtedness of the corporation to the shareholder and thus creates basis in the indebtedness. However, the "creation" of a loan through a mere bookkeeping entry on the corporation's books, or the agreement by a shareholder to lend additional funds on demand by the corporation, does not necessarily result in a basis increase to the shareholder. In these cases whether indebtedness is bona fide depends on all facts and circumstances under general federal tax principles.

As discussed below, the mere guarantee of an S corporation's debt by a shareholder does not create indebtedness of the corporation to the shareholder. However the shareholders guarantee to his bank or the 3rd party is absolute and enforceable and keeps many business owners awake at night. Indebtedness of the corporation to the shareholder is created, however, when a shareholder who has guaranteed debts of the corporation repays a loan made by a third party to the corporation. When the shareholder pays under the guarantee, he succeeds to the rights of the third-party lender and the indebtedness of the corporation to the lender becomes indebtedness owed to the shareholder. The corporation becomes indebted to the shareholder in the year the shareholder-guarantor pays the indebtedness of the corporation pursuant to the guarantee, and the shareholder receives a corresponding increase in basis at that time.

Direct Shareholder Loans to Corporation with Borrowed Funds

A loan of money by a shareholder to an S corporation of funds that are borrowed by the shareholder from a bank or other lender creates basis for the shareholder. Such a "back-to-back" loan should result in basis to the corporation's shareholders even if the corporation uses the funds to pay off a pre-existing bank loan, and even if the shareholders borrow the funds from the same bank that the S corporation repays. The important fact is that the shareholder has an actual liability to an outside bank and, as a result of that liability, is considered "poorer in a material sense."

If the shareholder borrows and then lends the funds in a circular transaction, the shareholder's basis in debt depends on the bona fide character of the debt. The shareholder's loan in such a situation is not an arm's-length loan, according to some courts. Furthermore, the shareholder is protected against loss and, therefore, has not made an actual economic outlay. These circular transactions are situations in which the shareholder has a liability to a related entity and a receivable from the S corporation, controls both entities.

Substitution of Shareholder Debt for Corporate Payment

Unlike a partnership, an S corporation shareholder does not receive basis for debts that the corporation owes to a third party. If an S corporation has incurred indebtedness to a third party, on the other hand, the shareholder can convert that debt into basis by substituting the shareholder's note for the S corporation's note to the third party. The technique may not succeed, however, if the corporation remains a party on the new note.

§752(a), which increases a partner's basis for his or her share of all liabilities of the partnership but in contrast, §1366(d)(1)(B) includes in an S corporation shareholder's basis only indebtedness of the corporation to the shareholder.

To avoid challenge by the IRS, shareholders who seek to obtain basis by restructuring bank-to-S-corporation loans should refrain from performing a simple substitution. Instead, shareholders should borrow from the bank, lend the proceeds to the S corporation, and have the corporation pay off its loan with the bank. If a simple substitution is made, the shareholders should adhere strictly to the form of the transaction. For example, the corporation should discontinue making payments to the bank on what is

now shareholder debt. In addition, the shareholders should be personally liable to the creditor to establish real economic risk to the shareholders from the substitution.

The fact that some shareholders' assets that are initially pledged as collateral on an existing loan between a bank and an S corporation will continue to be pledged as collateral on a loan between the bank and the shareholders does not protect the other shareholders against risk of loss. Therefore, the shareholders will be at risk for purposes of the at-risk rules.

Anecdotal Information
The Case for Simplification and Reducing the Backlog

As of this writing our firm is currently representing a small restaurant client ($2.5M per year Revenue) on IRS Audit where we have tracked basis and have limited the loss passthrough to the shareholders because the Corp. suffered a series of prior losses thus limiting the ability for the shareholders to take the 2013 loss (and 2014). The owners recently shuttered the operation and closed the business in 2015.

The business was audited because of the large loss reflected on the tax return. Despite that we limited the losses and announced that fact to the auditor, at great time an expense to our client, the auditor proceeded with the audit anyway. The auditor to date has spent 3 days on the audit. We have provided all of taxpayer's records as requested, despite repeated attempts to explain that any change will result in no change.

The taxpayers in this case are on the hook with a bank and with creditors. They understood the rules and borrowed the money personally. They used their capital and personal borrowings as basis, and that still was not enough to save the business, but they are left with the burden of an audit.

Thank you once again for the opportunity to present these examples that challenge taxpayers and their tax professionals.

Sincerely,

Leslie P. Vitale, CPA, MST
Partner Local Markets Group

NATIONAL CONFERENCE OF CAP PRACTITIONERS

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Mr. Chairman and members of the Committee, thank you for inviting me to testify today. My name is Stephen Mankowski. I am a Certified Public Accountant, member of the American Institute of CPAs (AICPA) and the National Executive Vice President and National Tax Policy Chair of the National Conference of CPA Practitioners, (**NCCPAP - the countries' second largest CPA organization**). **NCCPAP** is a professional organization that advocates on issues that affect Certified Public Accountants in public practice and their small business and individual clients located throughout the United States. **NCCPAP** members serve more than one million business and individual clients and are in continual communication with regulatory bodies to keep them apprised of the needs of the local CPA practitioner and its clients. Accompanying me is Ms. Sandra Johnson, National President of **NCCPAP**.

My firm has been preparing tax returns for over 30 years. My firm annually prepares well over 2,000 small business and individual tax returns as well as sales tax, payroll tax returns, highway use tax returns and 1099 informational returns. We are in the trenches with clients discussing their tax, financial and personal issues, and the impact events and proposed tax law changes may have on them. Although our clients are mostly in the Pennsylvania, New Jersey and Delaware area, we serve clients in over 30 states and also provide services to clients in Canada and Europe. In this respect our practice is the same as many members of **NCCPAP** and other smaller CPA firms throughout the United States.

Tax compliance burden has been defined in the GAO report "SMALL BUSINESSES IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts" as the time and money spent by the taxpayer to meet tax obligations. This includes federal, state and local obligations, but NOT liabilities. The time spent on tax compliance related activities can include working with paid professionals, tax planning, record keeping, filing and submitting tax forms, learning tax laws, and working with the IRS and other jurisdictions on tax related issues. The monetary burdens can include the expenses of accounting and tax professionals, tax and accounting software, payroll services, and legal fees. An objective of the Administration and the IRS has been to minimize these burdens and eliminate unnecessary ones. For purposes of my testimony, I will simply use the term taxpayer burden to refer to tax compliance burden.

My first exposure to taxpayer burden was in November 2012. I was invited to represent **NCCPAP** and participate in an IRS panel with other tax professionals at IRS headquarters to discussed compliance burdens for both individuals and small businesses. As a

CPA, I had always viewed my role as one to reduce client burden. I had not viewed my role as a source of taxpayer burden as indicated in the GAO report, which says that CPAs and tax services are part of the monetary burden of business owners. We take many of the above tasks away from the business owner to allow him/her to focus on running their business. So it is easy to see how this team can be easily mistaken. This new appreciation of what comprises taxpayer burden has allowed me to be an even better resource for my clients.

It seems that every year business owners are more in tune with how specific tax legislations could affect their business. Clients often ask how the Tax Extender legislation will affect their operations and what the Section 179 deduction limit is for the current year. While the answers tend to be similar—if you need a piece of equipment, you should buy it—that answer is not always the right answer for a business owner. Often the tax impact of the Sec. 179 deduction can be a deal-breaker. Equipment costing $100,000 could have a net cost of $60,000 with these write-offs. The $40,000 tax savings is often the deciding factor when making the purchase. While the IRS does not have control over which of the Extenders are passed, it is still a significant factor in assessing taxpayer burden.

Over the last few years, there has been a decided change in how business is conducted. As consumers have been more reluctant to carry cash, customers have forced the hand of many businesses that have historically limited payment options to cash or checks to now accept credit cards. Initially, business owners might have added a surcharge for these transactions, but with savvy consumers, credit cards and the related fees have simply become yet another cost of doing business. And another element of taxpayer burden. These business owners quickly realized that they cannot simply apply one rate for these transactions. Even after researching the processing firms to obtain the best processing rates, they learn that MasterCard and VISA have different merchant fees when compared to American Express and Discover. If the consumer uses a credit card that includes member programs or "points", an even higher processing rate may be charged by the merchant bank. In addition, there might also be monthly and compliance fees as well as equipment rental costs. And if that's not enough, the processing companies do not always deposit funds in the same manner. Most will simply deposit the gross amount of the charge and deduct the processing fees as a separate transaction. Yet many companies will deposit the net amount after deducting the processing fees, which makes the merchant's record keeping more complicated.

Most business owners have accepted these changes in how to conduct their business and accurately report their income. The IRS questioned the voluntary compliance of reporting all revenue, especially with the surge in online sales through PayPal. Under a 2008 law, the processing companies had to begin reporting credit card receipts to the IRS and the merchant in 2011 and had to add the reporting of the number of monthly transactions for 2012. This data appears on Form 1099-K, Merchant Card and Third Party Network Payments. This form must be issued once a payment proc-

essor once a merchant annually has 200 transactions and sales of at least $20,000.

Initially, the IRS had added rows onto personal returns on Schedule C and Schedule E as well as the business returns to incorporate the revenue information from Form 1099-K. However, prior to the start of the filing season, the IRS eliminated the requirement to complete these fields because too many issue arose creating much confusion. Specifically, there was confusion on how to treat sales tax, gratuities, cash back and returns on the 1099-K. Those same concerns still exist and are just some of the reasons that the IRS hasn't taken a stronger view on the use of the information on these forms.

The Form 1099-K has been a new source of taxpayer burden for the small business owner. Business owners track revenue by specific categories (i.e. sales, repairs, consulting, rent, etc.). They have not needed to track revenue based on how they are paid. Trying to accurately track revenue in the same way as the 1099-K presents data would result in an accounting nightmare. To further complicate the record keeping, businesses receive a Form 1099-K for each specific payment processor. So, if the business accepts MasterCard/VISA and American Express they would receive a form from MasterCard/VISA and one from AMEX. If they also use Paypal, they would receive a third form. If they changed their payment processing company during the year, additional forms would be received from the new processing company. The overall burden to accurately track revenue by each credit card type can be significant and generate no results that benefit the owner.

Another issue with the Form 1099-K revolved around payments for vendors that would receive a Form 1099MISC. Any payments related to these services would not be included on the Form 1099MISC. This adds a different and unique level of taxpayer burden as this would relate to both the payer and recipient. Just as businesses are not setup to track revenue by payment source, the payer would have an additional burden to exclude credit card payments from the total payment they are required to report on Form 1099MISC to the recipient.

From the IRS viewpoint, however, this form has helped increase voluntary compliance among small businesses. Many virtual businesses that had previously flown under the radar (part of the underground economy) are now filing income tax returns and paying taxes. In addition, the Form 1099-K has allowed the IRS to establish a database whereby they can obtain a better understanding of the revenue sources of a particular industry. Even though the IRS has not been able to assess taxpayers based solely on these databases, the IRS has been sending letters to taxpayers whom they feel have significantly under reported revenue. Initially, the IRS was accepting reasonable responses to these notices, but with the additional data in their databases, the IRS has a better understanding of the egregious filers, specifically those businesses reporting that 100% of their revenue was from credit card transactions.

To assist tax professionals, the IRS instituted a pilot program for the 2015 filing season called the Payment Mix Comparison Tool

(PMCT). **NCCPAP** was invited to participate in the program. This program allows our members to enter selected data from the client's Form 1099-K (Merchant Category Code (MCC), zip code, total transactions and total revenue) along with the total business income into a tool. PMCT accesses the IRS database and compares various ratios for a business with a specific MCC code against the Form 1099-K. The result tells the CPA if the results are within specifications of the database. A common flaw with the Form 1099-K is that if the payment processor applies an incorrect MCC code for a business, the PMCT results could be beyond the standard deviation which nay result in an IRS notice.

The results from the PMCT have been strictly for the benefit of the taxpayer and is for informational purposes only. Currently, the IRS is not capturing data from this tool. The database will continue to improve as the volume of historical data input into the tool increases. The PMCT, unfortunately, did not get the expected usage due to a few practitioner concerns. Specifically, the name of the tool was not the best, many practitioners did not believe that the IRS was not tracking the results and the fact that PMCT did not go live until the beginning of February 2015 after most CPAs have completed their training and had already begun preparing tax returns. In addition, many felt that there should be a better result besides "typical" or "unusual" depending on where in the range their client's data fell. Hopefully, this program will continue next year and will see more usage by tax professionals. If used property, PMCT could actually reduce taxpayer burden by addressing issues of credit card revenue while the data is still fresh in the business owner's mind.

In conclusion, taxpayer burden exists on two primary levels—time and money—to remain in compliance with today's complicated tax codes. Often, both components are viewed as one, except when contacting the IRS. Staffing and budgetary issues have resulted in longer than expected wait times and reaching IRS employees that are not able to address the caller's issues and concerns. Compliance with tax codes and dealing with new forms adds to taxpayer burden. New forms, such as Form 1099-K, are a prime example. The results may be of use to the IRS, but does not have any practical use for the business owner. Businesses do not tracked revenue by number of transactions or type of payment. Any attempt at verifying the data on the Form 1099-K would be fruitless, especially in industries, such as restaurants where customers charges often include gratuities and sales tax, neither of which are revenue to the business.

Accepting credit cards has become the norm. Most businesses historically have included all of their sales, regardless of source. With the information on Form 1099-K, the IRS now has a means to ensure that all business, especially virtual ones, are tax compliant with regard to credit card sales. With this form comes additional burdens to the taxpayer including how to reconcile sales to the revenue reported on these forms. The question that the taxpayer needs to answer is how to best run his or her business. If the business owner has systems in place to accurately track all revenue, the burden of reconciling the Form 1099-K data should be

minimal. It is extremely important that the IRS has the tools to determine tax compliance and reduce the tax gap.

As various states learned that the IRS was beginning the income matching program, many decided to use this as a tool to understand the sales mix of credit cards vs. cash and checks. Currently these states have also indicated that they have no plans to use this information for audit selection or any purpose other than the collection of information. However, neither the IRS nor the participating states have assured the tax practitioners or business communities that this information will not be used in the future as a tool for audit selection despite its flaws.

This program has the potential of a disaster. This is a repeat of warnings from **NCCPAP** and others in the tax practitioner community when the Form 1099-K matching program was first proposed. It is well understood that the IRS should use all tools possible to find tax cheats. However, as the GAO has correctly indicated, this is a flawed system with no real ability of matching gross income with Form 1099-K reports. Additionally, the ratio tools now being used are very imperfect as certain assumptions used (such as NAICS codes) will skew the information.

Thank you for the opportunity to present this testimony.

STEVE CHABOT, OHIO
CHAIRMAN

NYDIA M. VELAZQUEZ, NEW YORK
RANKING MEMBER

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

July 22, 2015

Mr. J. Christopher Mihm
Managing Director, Strategic Issues
United States Government Accountability Office
441 G Street, NW
Mail Stop 2440
Washington, DC 20548

Dear Mr. Mihm:

Thank you for your testimony during today's full committee hearing entitled "How Tax Compliance Obligations Hinder Small Business Growth" before the Committee on Small Business. It is in this regard that I respectfully submit the following questions for the record. I would appreciate a response by COB July 28, 2015 submitted electronically to **sbdcommittee@mail.house.gov**.

> **"Mr. Mihm: Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending. Have you all studied the impact that tax compliance has on minority owned firms and if so, what is the rate of minority owned firms closing their businesses as a result of the difficulty in tax compliance compared to white owned firms? Do minority owned firms have unique challenges with regard to tax compliance?**

Sincerely,

Alma Adams

Alma Adams
Ranking Member
Subcommittee on Investigations, Oversight and Regulations

cc: Ranking Member Nydia Velázquez, Committee on Small Business

GAO U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

July 28, 2015

Ms. Alma Adams
Ranking Member, Subcommittee on Investigations, Oversight and Regulations
U.S. House of Representatives, Committee on Small Business
2361 Rayburn House Office Building
Washington, D.C. 20515-6315

Dear Ms. Adams:

Thank you for your follow-up questions from the committee's hearing last week entitled "How Tax Compliance Obligations Hinder Small Business Growth". We reviewed our past reports on topics involving minority-owned small businesses. We determined that GAO has not specifically examined the impact that tax compliance has on minority-owned firms; the rate of minority-owned firms closing their businesses as a result of the difficulty of tax compliance; or whether minority owned firms have unique challenges with regard to tax compliance.

Sincerely,

J. Christopher Mihm
Managing Director, Strategic Issues
U.S. Government Accountability Office

cc: Ranking Member Nadia Velázquez, Committee on Small Business

STEVE CHABOT, OHIO
CHAIRMAN

NYDIA M. VELAZQUEZ, NEW YORK
RANKING MEMBER

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

July 22, 2015

Professor Donald Williamson
American University
4400 Massachusetts Avenue, NW
Washington, DC 20016

Dear Professor Williamson:

Thank you for your testimony during today's full committee hearing entitled "How Tax Compliance Obligations Hinder Small Business Growth" before the Committee on Small Business. It is in this regard that I respectfully submit the following questions for the record. I would appreciate a response by COB July 28, 2015 submitted electronically to **sbdcommittee@mail.house.gov**.

> **"Professor Williamson: Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending. Have you all studied the impact that tax compliance has on minority owned firms and if so, what is the rate of minority owned firms closing their businesses as a result of the difficulty in tax compliance compared to white owned firms? Do minority owned firms have unique challenges with regard to tax compliance?**

Sincerely,

Alma Adams
Ranking Member
Subcommittee on Investigations, Oversight and Regulations

cc: Ranking Member Nydia Velázquez, Committee on Small Business

AMERICAN UNIVERSITY

WASHINGTON, DC

KOGOD TAX POLICY CENTER

DON WILLIAMSON
EXECUTIVE DIRECTOR

CAROLINE BRUCKNER
MANAGING DIRECTOR

July 28, 2015

The Honorable Alma Adams
Ranking Member
Subcommittee on Investigations, Oversight and Regulations
U.S. House of Representatives
Committee on Small Business
2361 Rayburn Office Building
Washington, D.C. 20515

RE: Questions for the Record From July 22, 2015 Committee on Small Business Hearing

Dear Rep. Adams,

Thank you very much for the opportunity to testify last week at the hearing titled, "How Tax Compliance Burdens Hinder Small Business Growth," before the full Committee on Small Business (the "Committee"). I very much appreciated the opportunity to share with you and the other Committee members my views on specific tax compliance burdens that challenge America's small businesses and recommendations for addressing those challenges. During the hearing, you posed the following questions to me, which you subsequently submittted for the record:

> *"Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending. Have you all studied the impact that tax compliance has on minority-owned firms and if so, what is the rate of minority-owned firms closing their businesses as a result of the difficulty of tax compliance compared to white owned firms? Do minority-owned firms have unique challenges with regards to tax compliance?"*

To date, the Kogod Tax Policy Cener has not studied the tax compliance challenges of minority-owned firms specifically. However, in response to your request, I conferred with my colleagues at American University Kogod School of Business as well as the U.S. Small Business Administration Office of Advocacy ("Advocacy"), which is the offical Federal government source of small business statistics. In addition, our team researched existing studies from the U.S. Government Accountability Office and the National Taxpayer Advocate Service. Following this

full review of the economic literature, it is our conclusion that there has yet to be produced a robust academic economic analysis on the tax compliance issues specific to minority-owned firms.

We suspect that the primary reason for the dearth of economic literature on these issues is that the costs for commissioning the requisite survey information to conduct an comprehensive study precludes smaller academic programs, like ours, from undertaking a study of this magnitude. Unlike other tax-specific related inquiries, tax data specific to minority-owned firms is not readily available through the Internal Revenue Service Statistical Information Service. In order to produce a comprehensive study, an investigative team would need to conduct a fairly extensive survey of minority-owned firms not unlike survey studies produced by the U.S. Census Bureau.

That noted, the U.S. Census Bureau has announced that survey data from its "2012 Survey of Business Owners" is currently being tabulated and will be released later this year. It is our understanding that Advocacy is scheduled to do a demographic study of this data upon its release. Once they are able to analyze this information, they may be able to see patterns emerge by looking at demographics by industry and revenue and see how this could relate to minority-owned firms.

I hope the foregoing information is helpful to you in your efforts to identify tax burdens specific to minority-owned firms. In addition, please do not hesitate to contact me should you need additional information on this or any other small business tax-related issues.

Sincerely,

Professor Don Williamson
Executive Director
Kogod Tax Policy Center
Kogod School of Business
American University

STEVE CHABOT, OHIO
CHAIRMAN

NYDIA M. VELAZQUEZ, NEW YORK
RANKING MEMBER

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

2361 Rayburn House Office Building
Washington, DC 20515-6315

July 22, 2015

Mr. Troy Lewis
Heritage Bank
529 East Willow Springs Lane
Draper, UT 84020

Dear Mr. Lewis:

Thank you for your testimony during today's full committee hearing entitled "How Tax Compliance Obligations Hinder Small Business Growth" before the Committee on Small Business. It is in this regard that I respectfully submit the following questions for the record. I would appreciate a response by COB July 28, 2015 submitted electronically to **sbdcommittee@mail.house.gov**.

> **"Mr. Lewis: Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending. Have you all studied the impact that tax compliance has on minority owned firms and if so, what is the rate of minority owned firms closing their businesses as a result of the difficulty in tax compliance compared to white owned firms? Do minority owned firms have unique challenges with regard to tax compliance?**

Sincerely,

Alma Adams

Alma Adams
Ranking Member
Subcommittee on Investigations, Oversight and Regulations

cc: Ranking Member Nydia Velázquez, Committee on Small Business

American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

July 27, 2015

The Honorable Alma Adams
Ranking Member
Subcommittee on Investigations, Oversight and Regulations
222 Cannon House Office Building
Washington, DC 20515

RE: Committee Hearing on How Tax Compliance Obligations Hinder Small Business Growth

Dear Ranking Member Adams:

The American Institute of Certified Public Accountants (AICPA) thanks you for the opportunity to testify at the Committee on Small Business hearing on July 22, 2015. Following the hearing, we received a written request from you to provide responses to the following questions:

> **"Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending. Have you all studied the impact that tax compliance has on minority owned firms and if so, what is the rate of minority owned firms closing their businesses as a result of the difficulty in tax compliance compared to white owned firms? Do minority owned firms have unique challenges with regard to tax compliance?"**

Our Response: The AICPA has not studied the impact that tax compliance has on minority-owned firms. Tax compliance impacts all businesses. Minority and non-minority.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 145 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

If you have any additional questions, please feel free to contact me at (801) 523-1051, or tlewis@sisna.com; or Melissa Labant, AICPA Director of Tax Advocacy, at (202) 434-9234, or mlabant@aicpa.org.

Sincerely,

Troy K. Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: Ranking Member Nydia Velazquez, Committee on Small Business

STEVE CHABOT, OHIO
CHAIRMAN

NYDIA M. VELAZQUEZ, NEW YORK
RANKING MEMBER

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

2361 Rayburn House Office Building
Washington, DC 20515-6315

July 22, 2015

Mr. Les Vitale
McGladrey, LLP
80 City Square
Boston, MA 02129

Dear Mr. Vitale:

Thank you for your testimony during today's full committee hearing entitled "How Tax Compliance Obligations Hinder Small Business Growth" before the Committee on Small Business. It is in this regard that I respectfully submit the following questions for the record. I would appreciate a response by COB July 28, 2015 submitted electronically to **sbdcommittee@mail.house.gov**.

> **"Mr. Vitale: Minority firms often have an even harder time getting off the ground and then staying afloat than other demographics of small businesses, particularly as it relates to lending. Have you all studied the impact that tax compliance has on minority owned firms and if so, what is the rate of minority owned firms closing their businesses as a result of the difficulty in tax compliance compared to white owned firms? Do minority owned firms have unique challenges with regard to tax compliance?**

Sincerely,

Alma Adams
Ranking Member
Subcommittee on Investigations, Oversight and Regulations

cc: Ranking Member Nydia Velázquez, Committee on Small Business

Dictated but not read

Dear Ms. Adams

I just returned from a business trip and came across your letter and the aforementioned question. My apologies for the delayed, last minute response and the brevity of my remarks. I will do my best to provide you an answer to the excellent question you pose and are interested in getting further into.

I have not studied the impact of tax compliance on small minority owned firms and do not have valuable data on the rate at which small firms are closing based on either the burden of tax law compliance of any other business reasons. I would only be able to provide anecdotal information from what I have experienced and members of my firm have experienced in practice.

Having said that from experience I do believe small minority owned firms have unique challenges that originate from items other than taxes and that is lack of access to capital and lack of knowledge of grant and other special aid programs. Compliance rules in the financial services area are every bit as onerous as the tax rules, and therefore small minority owned businesses are often burdened with complex accounting and finance rules relative to how items of income and expense and capitalized items are to be classified, categorized and recorded in financial and tax reports required of finance agencies such as Banks and the SBA and the IRS in the form of tax returns.

Most of the small minority businesses compliance problems seem to start with a lack of capital that would enable them to attract and hire the best qualified finance people that would be familiar enough with the complex financial and tax regulatory rules to assure compliance. If the financial reporting rules and the tax reporting rules could be relaxed and simplified, small minority owned firms might be able to better prepare reports about their financial condition enabling them to obtain greater access to capital and in turn get them greater access to more talented people, build a stronger business, make more money and ultimately pay their fair share of taxes from being profitable.

I think the problem starts with lack of capital and lack of programs to assist start up small minority businesses pursue their dream. The IRS and Congress can and should provide reduced tax and compliance burdens to small minority owned and non-minority owned businesses. As luck would have it, my cab ride back to the airport provided me an interesting conversation with a bright African American cab driver who also owned a small convenience store blocks away from the state Capitol building. In 15 minutes I learned that he was behind on his store rent 4 months, vendors were shutting him off and he could not afford to keep his part time store clerks, meaning he closed while he was driving the cab. The ingredients for failure were written all over it. He asked me if I had any ideas how to stay afloat. His problem was partly taxes, partly financing and mostly lack of capital. I suggested he contact the SBA but the problem he will find when he gets there is the onerous reporting and qualification requirements. He also told me he had not filed a tax return in 2 years, but it was clear he lost money and would not owe any taxes (he used all his capital to pay his payroll and meals and sales taxes).

So the problem starts with a lack of capital and a lack of programs for the small business owner. Simpler reporting would be helpful, but it is not the one thing or the only thing that would help, but it would be part of the solution.

I hope you find this answer helpful and my apologies for not having more facts and figures to support this argument.

I appreciate the opportunity to have presented to your committee. I found it a fascinating first time experience and would welcome the opportunity to do it again. My hats off to the Committee on Small Business for doing the work you do for American business, an industry I've spent my entire career in. Thank you.

Sincerely,

Les Vitale

Les Vitale, CPA, MST
Partner
Local Markets Group
McGladrey LLP

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