



Advocacy: the voice of small business in government

Statement of

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***U.S. Department of the Treasury
and
Internal Revenue Service***

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Washington, D.C.
Topic: Tax Gap Roundtable

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit <http://www.sba.gov/advo>, or call (202) 205-6533.

Good morning Assistant Secretary Solomon and Commissioner Everson, fellow panelist and members of the audience. I thank you for this opportunity to participate in this roundtable discussion. My name is Thomas M. Sullivan, and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA) Office of Advocacy. The Department of the Treasury and Internal Revenue Service (IRS) invited us all here today to discuss four particular areas surrounding the tax gap, in particular 1) sources of the tax gap, 2) solutions to the tax gap problem, 3) challenges faced in addressing the problem and 4) ways for measuring progress regarding efforts to address the tax gap.

Congress established the Office of Advocacy (Advocacy) to independently represent the views of small business¹ before Congress and Federal agencies. One of Advocacy's main responsibilities is to ensure agency compliance with the Regulatory Flexibility Act (RFA). The RFA's main purpose is to make certain that small entities are given due consideration when agencies promulgate regulations. Because of the independent nature of Advocacy, the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. Advocacy takes its direction from small businesses; therefore, my remarks will be a reflection of what small business groups have shared with Advocacy. This statement was not circulated to the Office of Management and Budget (OMB) for comment.

Over the past year Advocacy has had several meetings with Treasury and IRS in an effort to improve our working relationship, and I believe we are on the right path. Since October 2006 we have had a number of RFA training sessions with IRS staff. These trainings are paying off, in that Advocacy has been contacted on several rules early in the rule writing process to ensure that small entities are being taken into account as the regulations are being drafted. This roundtable discussion is yet another step in a positive direction demonstrating Treasury's and IRS' concern for small entities and the impact that tax policies have on small entities.

Small Businesses and Tax Compliance Burdens

Those involved in this discussion know the contribution of small business to the U.S. economy. Small businesses, as defined by the SBA size standards, make up over 99 percent of all U.S. businesses and employ over one-half of the American workforce. Over the past decade, small business net job creation fluctuated between 60 and 80 percent. Small businesses make valuable contributions to the U.S. economy despite being saddled with a disproportionate federal regulatory compliance burden.² The disproportionate burden is most stark when comparing the smallest firms to the largest firms.³

¹ The Regulatory Flexibility Act in section 601(6) defines "small entities" as small businesses as defined by the Small Business Act section 3, small organizations (not-for-profit enterprises) and small governmental jurisdictions with populations less than 50,000. Throughout my statement I will use small business and small entities interchangeably.

² *The Impact of Regulatory Costs on Small Firms*, Crain, W. M., September 2005, U.S. Small Business Administration, Office of Advocacy (SBHQ-03-M-0522).

³ *Id.* Firms with less than 20 employees incur federal regulatory costs of \$7647 per employee as compared to \$5282 per employee for firms with 500 or more employees. Small firms with less than 20 employees

A recent Tax Foundation study revealed that individuals, businesses, and nonprofits spent over \$265 billion complying with the Federal income tax code.⁴ The largest share of tax compliance burden falls on businesses which incur 56 percent of the total compliance cost.⁵ Small businesses currently shoulder exceedingly high tax compliance costs. In fact, according to a recently updated Advocacy sponsored cost of regulations study, tax compliance costs employers with less than 20 employees a total of \$1304 per employee as compared to employers with 500 or more employees which incur \$780 per employee to comply with Federal taxes.⁶ Put another way, small entities pay 40% more for tax compliance than employers with 500 or more employees.

Having outlined the significant burdens taxpayers incur to meet their Federal tax responsibilities, Advocacy and the small business interest groups that we have talked to are concerned that the tax gap remediation measures put forth to date by Treasury and IRS will simply add to that burden. The return on investment received for the additional burdens does not appear to be justified. Treasury and IRS have estimated that the proposed additional reporting requirements will reduce the estimated tax gap by one percent. These burdens will be disproportionately imposed on small entities. If an RFA analysis were required for legislative proposals; Advocacy would request that an analysis be done to show affected taxpayers what costs they will have to bear for each reporting proposal. Small businesses have asked Advocacy to ensure that the Administration understands that the additional burdens are excessive as compared to the rate of return.

Broad Tax Policy Concerns

In 2001 and 2003, Congress passed and the President signed tax legislation that cut taxes for businesses generally and for small businesses specifically with hopes that the U.S. economy would grow. The economy did grow. As presented earlier, small businesses held up their end of the bargain. Small businesses have indeed grown and have helped keep the economy on a stable growth path. In 2005, small businesses continued to represent half of private sector employment and were at the center of output and productivity.⁷

In early 2005, the estimated tax gap figures were released. Treasury and IRS have spent a considerable amount of time explaining the source of the gap, which usually ends with the conclusion that small businesses and sole proprietors are to blame for the largest share of the gap. Small businesses see themselves as a sitting target for a mighty, big government. Small business taxpayers have expressed great skepticism with the proposals put forth to date. In their view, honest small business taxpayers are especially

incur \$1304 per employee for tax compliance; firms with 500 or more employees incur \$780 per employee for tax compliance.

⁴ *The Rising Cost of Complying With the Federal Income Tax*; Fax Foundation, Special Report No. 138 (January 10, 2006).

⁵ *Id.*

⁶ Crain (2005).

⁷ *The Small Business Economy: A Report to the President 2006 for Data Year 2005* (December 2006).

at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture those who do not fulfill their tax obligations.

Neither small business groups nor Advocacy wants to shield deliberate noncompliance. Nor do small businesses want to bear additional burdens to help sniff out the 14 in 100 taxpayers who are noncompliant.⁸ From a small business perspective, the proposals that have been presented to date appear to punish the honest taxpayer by imposing ever increasing compliance burdens.

One of the reasons for the disparate compliance cost between very small employers and large employers is complexity. In 2005 Advocacy published its yearly *Small Business Economy: A Report to the President*.⁹ In that issue Drs. Saade and Johnson successfully argue that increasing the simplicity of the tax code will decrease uncertainty.¹⁰ Decreasing uncertainty is vitally important because uncertainty has a deterrent effect on small business hiring and investment.¹¹ Consequently, Advocacy urges Treasury and IRS to advocate for real tax reform that results in a less burdensome tax code.

Existing Information Returns

Current law requires a significant amount of information reporting. In tax year 2005 the IRS received approximately 1.5 billion information returns.¹² This information comes in many forms: paper, electronic and magnetic tape. Small businesses want to know what the IRS is doing with this information. Do the current information reporting proposals reflect a yet undefined problem with the current information reporting system? Is there a problem with the information IRS currently receives that the public needs to understand? Advocacy would like to offer our assistance to educate the small business community about the IRS usage of information returns, in the hope that small businesses can understand how the current proposals remedy specific problems with the current system.

In closing, we know there is a tax gap. We do not know the full extent or the reasons for noncompliance. I would like to reiterate the need for a more comprehensive data matrix, and a robust effort to simplify the tax code.

Thank you for allowing me to present these views. I am happy to answer any questions.

⁸ The IRS estimates are discussed in Government Accountability Office, "Tax Compliance," GAO-07-391T, January 23, 2007. See also U.S. Department of Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006.

⁹ The Small Business Economy: A Report to the President 2005 for Data Year 2004 (2005)

¹⁰ *Id.* at Chapter 6.

¹¹ *Id.*

¹² IRS Data Book, FY 2005, Publication 55b. Also, Small Business/Self Employed, Campus Compliance Services, Campus Reporting Compliance, Operations SE:S:CCS:CRC:O.