Office of Advocacy
www.sba.gov/advo

Advocacy: the voice of small business in government

Testimony of

The Honorable Thomas M. Sullivan
Chief Counsel for Advocacy
U.S. Small Business Administration

U.S. House of Representatives
Committee on Small Business

Date:	April 5, 2006
Time:	10 A.M.
Location:	Room 2360 Rayburn House Office Building Washington, D.C.
Topic:	IRS' Latest Enforcement: Is the Bulls-eye on Small Businesses?

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 Chairman Manzullo and Members of the Committee, I thank you for this opportunity to appear before you today. My name is Thomas M. Sullivan and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). The Committee invited us here today to discuss the recent proposals by the Department of the Treasury (Treasury) related to increased information reporting and withholding as a means to improve tax collection from small businesses and self-employed taxpayers. When I say "small business" I mean that term to include sole proprietors, self-employed, independent contractor or any other form of business that meets the SBA size standards. Congress established the Office of Advocacy to represent the views of small business before Congress and Federal agencies. The Office of Advocacy is an independent office within the SBA, and therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. This statement was not circulated to the Office of Management and Budget (OMB) for comment.

I would like to take a moment to commend Commissioner Everson and the staff of the Small Business and Self-Employed Division (SB/SE) on their efforts to increase outreach to the small business and self-employed community. In the past year, SB/SE has expanded its "Small Business Forums" to include forums across the country. These forums bring small businesses and their representatives in contact with state and Federal agencies in addition to creating a venue for addressing Federal tax issues.

Last year around this time, we were sitting in this same place. The Commissioner and I were here discussing the 2001 tax year <u>estimated</u> tax gap. Since your last hearing on the tax gap, Treasury and the Internal Revenue Service (IRS) have finalized the tax gap results and reported that the 2001 tax year had a net gap of $290 billion. Today we are here to talk about the measures Treasury and IRS have suggested for improving their collection ability. The small business community has communicated with Advocacy to express concern about the impact that these measures may have on small businesses. First, I will focus my testimony on the need to strengthen the compliance assistance and taxpayer education provided by the IRS and then on the enforcement proposals that require increased reporting and withholding by third parties.

The IRS often uses its motto of "service plus enforcement" to explain its relationship with taxpayers. Advocacy believes this is a fine goal; and we believe that the IRS must continue to work to ensure that there is balance between service and enforcement. The Commissioner has spoken frequently on the tax gap issue, and the small business community is concerned that the primary focus of these discussions has been on increasing enforcement.[1] The associations and industry groups with whom we have discussed tax enforcement issues believe the best approach to improved taxpayer compliance should include balanced measures of compliance assistance, taxpayer education and enforcement.

Small business industry groups have expressed to Advocacy concern that the IRS has focused on small entities as a primary means of improving tax compliance. News

[1] See generally, *Everson Says IRS Could Collect Up to $100 Billion More Per Year*, 2006 TNT 32-1 (February 16, 2006) and *Everson Speaks at the National Press Club*, 2006 TNT 50-40 (March 14, 2006).

articles illustrate the reason why trade groups view IRS' focus to be trained on their members. On March 20, 2006 *Tax Notes Today* reported that the IRS increased its number of audits primarily through a spike in small business audits.[2] In recent testimony before the Senate Committee on the Budget, Commissioner Everson highlighted the return on investment for resources spent on enforcement: each dollar spent generated $4 in additional taxes collected.[3] A similar analysis of how the service function of IRS realizes a return on investment would go far to demonstrate the balance of service plus enforcement.

Research shows that the connection between enforcement and tax compliance is not as clear as some would like to think. In fact, a report by economists Bruno Frey and Lars Feld suggests that excessive enforcement can lead to less compliance.[4] Obviously enforcement is an important method for maintaining a compliant tax paying public. As the IRS attempts to improve taxpayer compliance it is imperative that taxpayer education and compliance assistance be included to balance an appropriate level of enforcement.

Nina Olson, National Taxpayer Advocate (NTA) has on numerous occasions, and recently at a hearing held by the Senate Committee on the Budget, encouraged the IRS to "recognize the central role taxpayer service plays in achieving compliance and do more to study the optimal ways to deliver taxpayer service and the magnitude of the impact."[5] The Government Accountability Office (GAO) has encouraged the IRS to conduct research on the reasons for taxpayer noncompliance.[6] In 1996 GAO made similar recommendations.[7] This type of research can guide the IRS' education and taxpayer compliance programs.

Now let me turn my attention to some of the specific proposals which Treasury has developed to add to IRS' enforcement tools as part of the FY 2007 Budget proposals. I will focus on two of the Treasury proposals, as well as proposals put forth by the NTA. All of the proposals require third party reporting and increased withholding requirements.

The Administration has proposed that payment card issuers (debit and credit cards) annually report reimbursements made to merchants. Under this proposal, card issuers would be required to withhold taxes on payments made to merchant taxpayers if the card issuer does not have a valid tax identification number (TIN) for the merchant taxpayer.

---

[2] Audits Up, Costs Of Tax Collection Down, IRS Data Book Reveals, 2006 TNT 53-2 (March 20, 2006).
[3] Testimony of Mark Everson, Internal Revenue Service Commissioner, before the Committee on the Budget United States Senate on *The Tax Gap and How to Solve It*, 15 February 2006.
[4] Frey, B.S. and Lars, PF. "Deterrence and Morale in Taxation: an Empirical Analysis." *CESifo Working Paper No. 760, 2002*, available at http://www.cesifo.de/pls/guestci/download/CESifo%20Working%20Papers%202002/CESifo%20Working%20Papers%20August%202002/760.pdf.
[5] Testimony of Nina E. Olson, National Taxpayer Advocate, before the Committee on the Budget United States Senate on *The Tax Gap and How to Solve It*, February 15, 2006.
[6] Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).
[7] Government Accountability Office, GAO/GGD 96-109, *Tax Research: IRS Has Made Progress but Major Challenges Remain* (June 1996).

Second, the Administration has proposed to require information reporting and back-up withholding on all non-wage payments made by Federal, state and local governments to government contractors.

An unintended consequence of increased withholding will be its harm to the cash flow of small businesses. In general, cash flow, i.e. liquidity, is one of the most significant constraints small entities face in managing their business.[8] According to a recent National Federation of Independent Business (NFIB) survey, cash flow issues ranked in the top ten of important problems faced by small businesses. Small entities have a more difficult time paying their bills when their cash flow is interrupted. Small businesses must either borrow additional capital or forego early payment discounts to manage cash flow shortfalls.[9] Both alternatives increase small entities' costs of running the business.

Another unintended consequence of increased withholding is that tax deductible expenses of small entities may unnecessarily be taxed. Payments received by small entities for the services and products they provide include both their expenses and profits. Expenses are generally tax deductible, while profits are subject to tax.

Before Treasury and IRS impose new reporting and withholding requirements, it is important to determine the impact that small card issuers and small local governments will need to absorb. For instance: What impact will annual reporting and withholding have on small payment card issuers and small local governments? What type of system changes will be required for small payment card issuers and local governments? I pose these questions because these types of proposals impose burdens in two directions: those entities affected by the increased scrutiny and those entities charged with additional reporting and withholding requirements.

The National Taxpayer Advocate has proposed other reporting and withholding regimes.[10] First, the self-employed could volunteer to have their payors withhold taxes on the payments they are due. Second, the IRS could actively encourage self-employed taxpayers to participate in the Electronic Federal Tax Payment System (EFTPS).[11] Self-employed taxpayers who have a history of noncompliance would be required to have payors do backup withholding. Finally, the NTA has recommended that the IRS issue "Compliance Certificates" to self-employed taxpayers who have a history of tax compliance. Presenting the Compliance Certificate to a payor would exempt the self-employed from backup withholding. Without the Compliance Certificate, payors would be required to withhold taxes from payments due the self-employed taxpayer.

---

[8] *Small Business Problems and Priorities*, Bruce D. Phillips, National Federation of Independent Business Research Foundation (June 2004).
[9] *Getting Paid*, National Federation of Independent Business Small Business Poll, Vol. 1 Issue 7 (2001).
[10] Olson, supra note 5.
[11] EFTPS is an IRS system that allows taxpayers to have their tax payments made by electronic funds transfers. EFTPS is voluntary for small taxpayers and mandatory for large taxpayers.

These types of proposals, while presented as voluntary, really impose additional administrative burdens on small businesses that contract with self-employed taxpayers. 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.[12] Additionally, requiring the payors of self-employed taxpayers to withhold may distort the line between being an employee versus being an independent contractor. Payors of self-employed taxpayers may become vulnerable to employer liability issues such as workman's compensation and unemployment taxes.

A reliable cash flow stream is important to the viability of the self-employed. To mitigate variability in cash flow, the self-employed would rely on credit. Yet, Advocacy data shows that the fixed rate loan terms are more favorable for larger sized loans. In other terms, the smaller the loan value the higher the interest rate applied.[13] Thus, increased withholding has the potential unintentional effect of increasing the expenses of the self-employed taxpayer.

America's small businesses succeed because of their ingenuity and innovation. Research sponsored by Advocacy continues to show that the cost of tax compliance is 67 percent higher in small firms than in large firms.[14] What can the IRS do to limit this disproportionate burden? The IRS can evaluate the service they provide taxpayers so that the importance of taxpayer service is not lost as they attempt to improve tax compliance. And, this hearing is an opportunity for IRS to consider some alternatives that may minimize the unintended impact of some proposals on small businesses.

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

---

[12] *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), available at http://www.sba.gov/advo/research/rs264tot.pdf (tax compliance cost large firms $780 per employee).

[13] *The Small Business Economy: A Report to the President*, Table 2.1 Published by the U.S. Small Business Administration, Office of Advocacy (2005). See also generally, *Overcoming the Self-Employed Stigma When Applying for Business Loans*, Moss Jeffery, National Federation of Independent Businesses (January 24, 2003) available at https://www.nfib.com/object/3649352.html

[14] Crain, supra note 12.