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**Testimony of
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**U.S. House of Representatives
Committee on Small Business**

Date: April 27, 2005
Time: 2:00 P.M.
Location: 311 Cannon House Office Building
Topic: Closing the Tax Gap and the Impact on Small Business

Chairman Manzullo and Members of the Committee, good afternoon and thank you for giving me the 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 has asked for Advocacy's view on the Internal Revenue Service's (IRS) assessment of the federal tax gap, and for suggestions on how the IRS intends to deal with the portion of the tax gap attributable to small business and self-employed filers. Congress established the Office of Advocacy to represent the views of small entities before Federal agencies and Congress. 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.

The tax gap is the difference between the taxes owed by all taxpayers and the taxes actually received by the IRS. The Office of Advocacy shares with the IRS the view that the tax gap is a serious problem. Even though the difference between what is owed and what is paid is bound to diminish as more funds are received by the IRS from late payments and existing enforcement activities, a significant portion will always remain outstanding. This differential between what is owed and what is paid is a cost to the Federal government, and a resource that could help fund government operations. The funding shortfall is not the only problem created by the tax gap; as National Taxpayer Advocate Nina Olson stated in her 2004 Testimony before the Senate Committee on Finance, "it comes down to a simple issue of fairness."¹ The fact that 85 percent of taxes are paid in full reinforces the view that the remaining 15 percent needs to be paid by those who owe it. The Office of Advocacy, however, does not agree with the view that

¹ Testimony of Nina Olson, National Taxpayer Advocate, before the Senate Committee on Finance on *the Tax Gap and Tax Shelters*, 21 July 2004.

prioritizing enforcement will necessarily close the tax gap. We believe a balanced approach, relying on a combination of compliance assistance, taxpayer education, and enforcement is likely to close the gap in an efficient manner.

Most small businesses pay their taxes in full and on time. However, doing so is never easy for them, as the costs of complying and the difficulty in following the tax code can be overwhelming. In 2001 Advocacy released a report on the regulatory costs faced by small firms that contained an estimate of tax paperwork compliance costs. In 2000 the typical small business with fewer than 20 employees spent over \$1,200 *per employee* to comply with tax paperwork, recordkeeping, and reporting requirements.² This is over two times the compliance cost faced by larger firms. But the estimated burden hours for filling out forms do not tell the whole story of how difficult compliance can be for small business. Most small firms do not have full time personnel to handle tax compliance issues; many hire outside assistance and many more small business owners devote valuable time to taxes that is then not available for running their business.

This Committee certainly knows the contribution of small business to the U.S. economy. Small businesses, as defined by the SBA size standard, make up over 99% of all U.S. businesses and employ over one-half of the American workforce. Perhaps even more importantly, small firms create over two-thirds of the net new jobs annually, and recently led the

² *The Impact of Regulatory Costs on Small Firms*, Crain, W.M., and Hopkins, T.D., October 2001, U.S. Small Business Administration, Office of Advocacy (SBAHQ-00-R-0027), available at <http://www.sba.gov/advo/research/rs207tot.pdf>.

American economy out of a recession.³ Yet, small business accomplishes this even while facing a regulatory compliance burden that is roughly 60 percent greater per employee than that faced by larger firms, and a tax compliance burden more than twice as large.⁴

At issue then is how compliance can be improved and the tax gap narrowed without adding to the burden of small business. My office favors a balanced approach-- one that includes commensurate doses of education, compliance assistance, and enforcement. In other words, IRS must be careful to produce an appropriate carrot to go with the stick. Ms. Olson suggested that, “[I]n developing a long-term strategic approach towards noncompliance, the IRS must remember that the “stick” is not the only effective tool for addressing the tax gap; the “carrot” has a critical role to play, too.”⁵

In order to focus its efforts, the IRS developed the National Research Program (NRP) to measure reporting, filing, and payment compliance for different types of taxes and different groups of taxpayers.⁶ The final report on the NRP is not yet available, but IRS has published 17 pages of preliminary results. The release has generated a flurry of comments, coinciding with the weeks preceding April 15th when federal tax filings are due. We should be clear that that the results are preliminary.

³ U.S. Small Business Administration, Office of Advocacy, *Small Business Frequently Asked Questions*, available at <http://www.sba.gov/advo/stats/sbfaq.pdf>.

⁴ *Supra* note 2.

⁵ Testimony of Nina Olson, National Taxpayer Advocate, before the Senate Committee on Finance on *the Tax Gap*, 14 April 2005, p. 6. Also see the Environmental Protection Agency Small Business Ombudsman’s *Small Business Compliance Policy* (SBO Items #I-13 and B-22) and *Enforcement Response Policy* (SBO Item #I-13), available at <http://www.epa.gov/compliance/incentives/smallbusiness/index.html>.

⁶ See <http://www.irs.gov/privacy/article/0,,id=131231,00.html> for an overview of the NRP.

Let me also caution that the connection between enforcement and compliance is not necessarily clear. Research by economists Bruno Frey and Lars Feld suggests that excessive enforcement can lead to less compliance.⁷ Compliance cannot be increased only through enforcement, but rather by the more balanced approach I am suggesting here today.

Advocacy and others have long held that the complexity of the tax code is a prime reason why compliance rates are not higher. Indeed, those with the most complicated individual filings, small business owners, *should* be expected to have higher non-compliance rates if in fact non-compliance is increasing with complexity. Furthermore, the complexity of the tax code has been increasing each year, which should further be expected to drive up non-compliance rates, and enhance the need for greater taxpayer education and assistance. Advocacy urges the IRS to investigate whether measured non-compliance today might not be better explained by the complexity of the code, especially for complicated small business returns.

I would like to suggest that simpler tax rules and greater taxpayer assistance are complementary, and that some mix of the two would greatly enhance the ability of small businesses to comply with tax regulations. It would be helpful to receive data on the effects of the taxpayer assistance programs that IRS has enacted over the past several years, for many small business groups believe data could demonstrate that education and assistance programs produce increased compliance.

⁷ 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>.

The GAO Controller General, along with National Taxpayer Advocate Nina Olson, recently testified that simplification was the top priority for fixing what ails the tax code and increasing tax compliance.⁸ The Office of Taxpayer Burden Reduction within the IRS has also recognized the need for burden reduction, and I would like to take this opportunity to recognize their efforts in listening and investigating the complaints of small businesses about harsh and unfair burdens resulting from IRS policies.⁹

The Treasury Inspector General also cited simplification of the tax code as a priority. In the Inspector General's (IG) internal audits of IRS compliance assistance personnel, they found that only 62% correctly answered compliance questions that an individual filer might face. The IG laid the blame for this poor performance not on inadequate training of IRS personnel, but on the complexity of the tax code and the difficulty in determining "one" correct answer for many tax questions.¹⁰ Simply put, in many cases there are no single correct answers, or if there are, even the experts cannot identify them with regularity across all cases. This widespread ambiguity leads many small business filers to make a seemingly rational choice: when there are two or more possible outcomes that appear correct, choose the one that minimizes the taxes you owe. The IRS defines this as underreporting, but it is better described as confusion brought about by the difficulty even experts have in determining how to comply with the tax code.

⁸ Hearing of the United States Senate Committee on Finance on "The \$350 Billion Question: How to Solve the Tax Gap." April 14, 2005

⁹ See <http://www.irs.gov/irm/part22/ch04s01.html> for a description of the mission and responsibilities of the Office of Taxpayer Burden Reduction.

¹⁰ *Supra* Note 10.

Although tax rates have declined over recent years, the cost of complying with taxes has increased. Non-compliance is a more subtle hidden cost of tax complexity, but the direct costs in time and effort to maintain the necessary records and complete the proper forms is the more obvious direct cost. According to OMB paperwork burden estimates, the number of hours Americans spend on taxes has grown by 24% over the last 10 years. Much of that burden may stem from an increase in the number of filings, but a significant portion emanates from increased complexity faced by each individual filer. Importantly, only 24% of the total burden is directly attributable to Form 1040, further demonstrating that small businesses, who must file many additional forms, pay much of the cost of compliance.¹¹

As I already mentioned, it costs small firms more than two times as much per employee as larger firms to comply with the tax code. However, it is the uncertainty and confusion in how to comply that creates the biggest compliance burden. It is also this uncertainty that increases non-compliance rates for small business filers over what they would be under a simpler code. The best way to ensure that small business compliance rates increase is to simplify the tax code, thereby removing the ambiguity filers face when determining what to report, and to increase education and assistance programs aimed at informing small business owners what the IRS expects them to do when preparing their taxes.

Conclusion

¹¹ “A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens,” National Taxpayers Union, NTU Policy Paper 116. Calculation of total burden hours increase is based on the change in annual hours in 1995 to projected annual burden hours in 2004, the most recent year for which information is available. Data taken from Office of Management and Budget, *Information Collection Budget*, various years.

I believe in the honesty of the majority of small businesses and their willingness to comply with the tax code and contribute their fair share. Additional taxpayer education, compliance assistance, and a more simple tax code are key ingredients to increased compliance. If small businesses are able to understand and easily follow the rules, they probably will. Increasing education and assistance will remove ambiguity, while simplifying the rules will reduce the costs of compliance.

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