TESTIMONY

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Internal Revenue Service Compliance with the Regulatory Flexibility Act

United States House of Representatives

Committee on Small Business

Thursday, May 1, 2003

Chairman Manzullo, Representative Velazquez and Members of the Committee:

Thank you for this opportunity to testify today. My name is Thomas M. Sullivan and I am the Chief Counsel for Advocacy at the Small Business Administration (SBA). 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 entity within the SBA so the views expressed in this statement may not reflect the views of the Administration or the SBA. Please note, however, that after my testimony was submitted to this Committee, the Office of Advocacy provided a copy to the Department of the Treasury and the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) as a courtesy. My statement was not circulated for comment or clearance.

You have asked that I testify regarding the Internal Revenue Service's (IRS) compliance with the Regulatory Flexibility Act (RFA), the IRS' current interpretation of the law, and actions taken by the IRS in compliance with Executive Order 13272. As background, Congress created the Office of Advocacy in 1976 to serve as the independent voice for small business within the Federal government and to measure the costs and impacts of Federal regulations on small businesses. Congress realized, however, that the creation of the Office of Advocacy, in itself, was not sufficient to sensitize Federal agencies to the fact that there are differences in the scale and resources of regulated entities, and that the disproportionate impact of regulation adversely affected competition, discouraged innovation, and created market entry barriers. Congress enacted the RFA to help alleviate this problem in 1980 and designated the Office of Advocacy to monitor agency compliance and make sure agencies considered less burdensome regulatory alternatives.

In 1996, after reviews by this Committee and others revealed gaps in agency compliance with the requirements of the RFA, Congress added "teeth" to the RFA by passing the Small Business Regulatory Enforcement Fairness Act (SBREFA). The RFA amendments in SBREFA permitted judicial review of an agency's failure to comply with the RFA, established special small business advocacy review panels for Environmental Protection Agency (EPA) and Occupational Safety and Health Administration (OSHA) regulations impacting small entities, and required the IRS to comply with the RFA on some "interpretative" regulatory cases.

For the most part, the SBREFA changes have been successful. Adding judicial review has given agencies an incentive to comply with the RFA. The panel process has institutionalized outreach to small entities and has helped ensure that EPA and OSHA identify and consider less burdensome alternatives that still accomplish their rulemaking objectives. Because of the type of early small business input on agency rulemaking created by the panel process, the covered agencies have often been able to develop better rules. Unfortunately, the increase in the scope of the RFA to cover IRS interpretative rules has not always had as consistent results.

Regulatory Assistance from OIRA and Treasury

Before I address IRS' compliance with the RFA, I want to give credit for the accessibility and responsiveness of the Administration officials here today. I believe small business has a friend in both Dr. Graham and Assistant Secretary Olson. My office works with Dr. Graham and the desk officers at OIRA everyday. During my first year at Advocacy, we signed a memorandum of understanding between our offices and we are working together to implement Executive Order 13272, which underscores the President's commitment to *Proper Consideration of Small Entities in Agency Rulemaking*, as the order is titled. Over the last couple of years, Advocacy's staff have worked closely with OIRA on many draft regulations. An increasing percentage of Advocacy's work occurs during the pre-proposal stage largely because of the relationship that has developed with OIRA. It is much easier and more productive to deal with

potential RFA and other small business concerns before a rule reaches the *Federal Register*. Combining and leveraging our expertise has been beneficial for both offices and for the small business community.

Since Assistant Secretary Olson assumed her present role, she has gone out of her way to seek out and listen to the concerns of small business. In addition to her hectic schedule as the President's lead tax advisor, Assistant Secretary Olson reaches out to small business groups and maintains an open door policy for stakeholder involvement. During the consideration of the "mobile machine" proposed regulations, the Treasury granted extra time for small businesses to file comments, and to Assistant Secretary Olson's credit, scheduled a hearing where small business persons could voice their concerns. When Members of Congress and the small business community argued that the proposal was overbroad and a policy issue, Assistant Secretary Olson agreed to postpone further action to allow time for legislative consideration. We view her actions as responsive to small business concerns.

Achievements for Treasury/IRS that reflect IRS sensitivity towards the small business community.

Over the past few years, in Advocacy's annual report to Congress on agency compliance with the RFA, we note that Treasury and the IRS have come a long way since the development of a division within the IRS devoted to small business and the self-employed. This new division has worked closely with the small business community to

identify contentious issues and resolve them through consultation and negotiation. Great progress has been made in such areas as:

- cash vs. accrual accounting
- installment sales reporting
- electronic Federal taxpaying
- new comparability testing for tax treatment of pension plans

We are encouraged by the proactive efforts of Treasury and the IRS to identify problems confronting small business and work to reduce or eliminate them. The Taxpayer Advocate's Office has worked very closely with my office on recommended changes to facilitate small business tax compliance. The Small Business Division of the IRS has established an Office of Burden Reduction with the full-time mission of identifying wasteful requirements imposed on taxpaying businesses and identifying ways to reduce or eliminate them. Likewise, the industry issue resolution process and the practitioner and small business trade association meeting groups that, I am proud to say, we helped IRS establish, provide a useful sounding board for small business feedback on upcoming IRS issues. Finally, we are encouraged by Treasury's efforts to establish a burden model that should help the department assess the impact of their proposals more accurately and provide solid information on which to base good rulemaking.

These initiatives are relevant to today's hearing, because, like the pre-proposal work that Advocacy does with OIRA, we see these innovations with the IRS as tools for the benefit of small business. The agency also publishes a business plan to prioritize and

publicize upcoming regulatory efforts. When the IRS can identify a contentious issue early and reach out to the small business community to work on a solution, they can together produce satisfying results. It is an increasingly transparent system. All these initiatives are helpful and I think Treasury and the IRS can be proud of their efforts.

IRS Compliance with the Regulatory Flexibility Act

The premise of the RFA is that an agency must undertake a transparent and careful analysis of its proposed regulations—with specific attention to the small business community—to identify their impact on small businesses and develop alternatives to reduce or eliminate the small business burdens without compromising the public policy objective. In our view, the Treasury and IRS have drawn the requirements of the RFA too narrowly, thereby denying small businesses the meaningful open analysis intended by Congress in the RFA and SBREFA.

Advocacy believes that it would be good for small business if the IRS performed the analysis required by the RFA. When an agency has done its homework, performing an initial regulatory flexibility analysis (IRFA) should not pose any additional burden. An IRFA provides the agency with a better understanding of the rule's impact and results in better policy because the analysis is shared with those about to be regulated. The IRS could play an especially important role in the analysis process because the agency possesses unique data and detailed statistics that are very valuable to rulemaking. Lack of information makes it hard to know what the proposal will accomplish. In our Annual

Report, we identified areas in which a different interpretation of the RFA by Treasury/IRS would have a positive impact on the rulemaking process.

A. Analyze the entire rule.

Advocacy believes that the collection of information standard was established by Congress to trigger the requirements of the RFA and not to limit the scope of the analysis to be performed. Congress sought to address the absence of analysis on IRS interpretative rules when it amended the RFA in 1996. As amended, the RFA requires IRS to comply with the RFA when promulgating an interpretative rule involving the internal revenue laws of the United States that imposes a "collection of information" requirement on small entities (defined to include "reporting *or* recordkeeping"). The Treasury/IRS has interpreted SBREFA to require an RFA analysis only on the portion of the regulation that contains a collection of information requirement. In such cases, the IRS analysis is limited by its reliance on a time burden estimate akin to an analysis under the Paperwork Reduction Act (PRA).

Advocacy interprets SBREFA to require the IRS to perform an RFA analysis of the entire rule and its impacts. Furthermore, in our view, the IRS should certify the rule under Section 605(b) of the RFA only if the rule in its entirety (and not just the collection of information element) will not have a significant economic impact on a substantial number of small entities.

The authors of this legislation were clear about their intentions. Congressman Henry Hyde, the Chairman of the committee of jurisdiction in the House said:

> *The intent of this phrase "collection of information" in the context of the RFA is to include all IRS interpretative rules of general applicability that lead to or result in small entities keeping records, filing reports or otherwise providing information to IRS or third parties… One of the primary purposes of the RFA is to reduce the compliance burdens on small entities whenever possible under the statute. To accomplish this purpose, the IRS should take an expansive approach to interpreting the phrase "collection of information" when considering whether to conduct a regulatory flexibility analysis. Congressional Record; E-573,574 April 19, 1996.*

B. Analyze the entire burden (not just reporting).

As we stated in our report to Congress in January, the IRS has often taken the view that unless a form is required, no recordkeeping requirement is imposed by the rule. We believe this was a root problem in two rulemakings last year. In the *"Excise Taxes; Definition of Highway Vehicle"* rulemaking (which we call "Mobile Machinery"), the IRS did not analyze the rulemaking because the proposals "do not impose on small entities a collection of information requirement," according to the published preamble of the proposal. When we contacted the IRS and asked about the regulation, we were told that in fact, the form that a business might normally file under the current regulations for a rebate on excise taxes would no longer apply after their exemption was repealed. We were also told that a business might still qualify for the remaining exemption of the rule but the IRS did not explain whether any paperwork was involved in that determination.

Laying aside the fact that these businesses still must file IRS form 720 to report excise taxes (even if they do not fill out the refund portion), and that the businesses would have to start filing form 2290 to pay heavy vehicle use taxes, the approach taken by the IRS did not consider the costs of getting new determinations such as legal opinions or private letter rulings, the impact of the new taxes on the small business owners, and possible alternatives that would accomplish whatever goal the IRS had in mind for this regulation. The regulators were concentrating on the "form" and not other important elements of the rulemaking. The "mobile machines" rule has been "delayed" pending action on the Highway Trust Fund legislation. Advocacy considers Treasury's suspension of the rulemaking to be a good result for small businesses. Small businesses spoke, and Treasury listened. Had Treasury complied with the Regulatory Flexibility Act as part of its rule development process (performing an initial regulatory flexibility analysis or a preliminary analysis to support a possible certification under Section 605(b)), we believe the problems with the Mobile Machinery proposal being overbroad would have been discovered earlier in the rulemaking, saving the IRS, Treasury and small business time and money.

This tendency to elevate the importance of whether there is a form to be filed over other burdens is not a new phenomenon. For instance, IRS took this approach in rulemakings on the application of self-employment taxes to limited partnerships; the uniform capitalization of farm products in nurseries; and the application of the unrelated business income tax to educational trips in the travel and tourism industry. Each of these

rulemakings ultimately had to be withdrawn and modified by the IRS to account for the recordkeeping burden.

C. New additions to existing forms create burdens that should be analyzed

In some cases where the IRS seeks to revise or extend a currently approved form, the agency considers the additional burden on small businesses to be insignificant or mostly covered by the approval of the form.

A rulemaking at the end of last year, titled *Guidance on Reporting Deposit Interest on Non-resident Aliens* (which we call "Non-resident Alien Interest"), involved the reporting of interest paid by financial institutions to non-resident aliens. It covered 17 major industrialized nations. The IRS contact for the regulation referred us to the Treasury Department, where we were told that the regulation would affect large international banks with enough foreign advertising to attract overseas investors. We were also advised that the regulation was a smaller version of a previous proposed rule and that the revisions limited what had been worldwide coverage to only 17 nations.

Later, we heard from a couple of small business financial associations that their members had non-resident alien depositors and they would be required to file reports under the proposal. These groups considered the expense of establishing reporting and information transfer systems to be significant. W-8 forms and W-9 forms would have to be monitored and a form 1042-S issued for every foreign depositor

Although the IRS agreed to solicit comments on the costs to set up a system to track non-resident alien interest payments, a full analysis of the impact on the newly covered small financial institutions was not performed and the rule was classified as having no information collection burden on small entities. In comments filed with the IRS in response to the 2001 proposed rule, small financial institutions alerted the IRS to their concerns about the significant costs of being regulated. Once on notice, the IRS should have performed a more comprehensive analysis of small business impacts before moving forward with the revised regulation in 2002.

In our view, the IRS' emphasis on the existence of an OMB-approved form did not comply with the RFA. We believe that an important point on the Non-resident Alien Interest proposal is that a sizable new recordkeeping/reporting requirement was being imposed by the IRS on a new category of non-resident alien depositors. As stated in our comments and testimony, there was reason to believe this would have a significant economic impact on a substantial number of small entities and the IRS should have prepared an IRFA.

Had the IRS categorized the Non-resident Alien Interest rule as a "legislative" rule, involving questions of tax policy, rather than as an "interpretative" rule, which the IRS defines as "flowing directly from a statute or other legal authority," the rule would have been subject to notice and comment rulemaking under the Administrative Procedure Act, triggering the need to comply with the Regulatory Flexibility Act, whether or not

the rule involved the imposition of a collection of information on small entities. Consequently, the IRS' characterization of a rule as legislative or interpretative often determines whether or not an RFA analysis is performed.

D. Analyze the alternatives and the full impact.

In those cases where the IRS feels that they are constrained by the law to structure their regulations in a certain way and it is apparent that the structure will have a significant economic impact on a substantial number of small entities, we still believe there is value in assessing the impact of that structure on small business. We also feel considering alternatives could help them reach the same public policy goals but in a manner less burdensome to small businesses.

The Treasury generally bases analyses for interpretative rules on the Paperwork Reduction Act, but we believe the RFA requires the agency to go further; to look at alternatives, and to look at the impact of the tax the regulation imposes. In Advocacy's opinion, the IRS should seek to identify the costs and hardships potentially imposed by the regulatory approaches under consideration and look for alternate approaches to achieve the objective with less burden, prior to publishing a rule for comment. In addition, Advocacy recommends that the IRS seek to identify new categories of taxpayers brought within the scope of a new proposal. We would like to see the IRS consider these impacts in addition to the "burdens" captured by the regular PRA analysis.

Treasury/IRS compliance with Executive Order 13272.

Treasury/IRS has complied with the first requirement of E.O. 13272, which was to:

a) draft and submit to Advocacy for its comment the Treasury's written policies and procedures for considering impacts on small entities, consistent with the Regulatory Flexibility Act;
b) consider our comments in their final draft of the statement; and
c) make their statement publicly available.

The Department of the Treasury's written policies and procedures for considering small business impacts can be found at <www.treasury.gov/regs/2002-rfa-compliance.pdf?>. In Advocacy's opinion, Treasury could further improve its "Regulatory Flexibility Act Statement" by: (1) clarifying when an IRS rule is considered "interpretative" versus "legislative" (and explaining how the IRS interprets SBREFA's "collection of information" requirement to trigger the need for RFA compliance); (2) expanding the scope of "burden" that the IRS considers an impact on small entities under the RFA; and (3) committing to perform more transparent analysis, specific to small business concerns made publicly available at the proposed rule stage.

We have published our Regulatory Flexibility Act Implementation Guide on the web at www.sba.gov/advo/laws/rfaguide.pdf. We hope that if regulation writers have questions, they will feel free to use our resources.

Advocacy is currently preparing to move into the next phase under E.O. 13272, which is agency training and electronic communication.

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