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Congress of the United States
U.S. House of Representatives
Committee on Small Business

2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To:	Members, House Committee on Small Business
From:	Sam Graves, Chairman
Date:	February 7, 2011
Re:	Hearing: "Buried in Paperwork: A 1099 Update"

On Wednesday, February 9, 2011 at 1:00 pm, the House Committee on Small Business will hold a hearing entitled, "Buried in Paperwork: A 1099 Update" in Room 2360 of the Rayburn House Office Building. The hearing will examine the effect of the expanded 1099 reporting provision on small businesses and the effect its cost will have on economic growth, job creation and the Internal Revenue Service (IRS) going forward.

The Committee will hear testimony from Rep. Dan Lungren (R-CA), R. Jerol Kivett, President, Kivett's Inc., Clinton, NC; John "Mark" Eagleton, Managing Member, Eagleton Ventures, LLC, The Egg & I Restaurant, Golden, CO; Seth Shipley, Shipley's Fine Jewelry, Hampstead, MD, Mike Kegley, B.O.L.D. Homes, Inc., Union, KY; about how this mandate would affect small firms.

I. Background

Historically, Section 6041(a) of the Internal Revenue Code required that persons making certain payments in the course of business totaling $600 or more in a taxable year file an information report (generally a 1099-MISC return[1]) with the IRS and the payee (vendor).

Section 6041 was amended by the Patient Protection and Affordable Care Act, P.L. 111-148 (PPACA) which was signed into law on March 23, 2010, and the Small

[1] For payments to employees, generally a Form W-2 is used.

Business Jobs Act of 2010, P.L. 111-240, which was signed into law on September 12, 2010. Both of these amendments will significantly increase the number of 1099 forms that will be required to be filed, increasing the burden on businesses, particularly small firms, and on the IRS.

At a time when we are depending on our nation's small businesses to create jobs and invest in our economy, this new reporting requirement creates an administrative burden for those very businesses. Even the IRS' National Taxpayer Advocate has noted that implementation of the new requirements may turn out to be disproportionate as compared with any improvement in tax compliance.[2] In addition, the Taxpayer Advocate believes that the requirement will present significant administrative challenges for the IRS.[3]

The reporting requirement was added to the PPACA as an effort to reduce the tax gap. The tax gap is the difference between the amount of tax that is collected and that which the IRS believes should have been reported and paid. This provision would reduce the tax gap by encouraging the reporting of income that has not already been reported. By increasing tax collections, this provision was intended to generate revenue to help cover the cost of the health care law.

II. Section 9006 of the Patient Protection and Affordable Care Act

For payments made after December 31, 2011, Section 9006 of the PPACA amends the information reporting requirements of Internal Revenue Code (IRC) section 6041. First, information reporting will be required for goods as well as services. Second, the exception for payments made to corporations will be eliminated.

All businesses have always been required to report certain types of payments. For example, under current law, if a business purchases $600 in services from an independent contractor during a calendar year, that payment was required to be reported to the contractor and to the IRS on a 1099 (payments for services are required to be reported). But if a business pays $600 to rent office space from a corporation, the payment was not required to be reported (payments to corporations are exempt). If a business pays $600 for a computer, it was not required to be reported (merchandise and equipment are exempt).

The health care law's expanded reporting requirement will impose additional requirements on all businesses, no matter how small, for purchases made after December 31, 2011. Under the new law, businesses must also report payments to corporations and for expenses such as rent, merchandise and equipment to a single vendor if they exceed the $600 per calendar year threshold.

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[2] Report of the National Taxpayer Advocate, Fiscal Year 2010 Objectives, available at: http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf.

[3] Report of the National Taxpayer Advocate, Fiscal Year 2011 Objectives, available at: http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal..pdf.

III. Corporate Payments

Under prior law, most corporate payments were exempt from the reporting requirements under IRS regulations even though they were not explicitly exempt in the IRC. PPACA added language to IRC Section 6041 providing that "for purposes of this section, 'person' includes any corporation that is not an organization exempt from tax under section 501(a)."[4] Information reporting will be required for payments to all non-tax-exempt corporations made after December 31, 2011.

IV. Payments that Trigger Information Reporting

Historically, IRC 6041(a) required information reporting for payments of $600 or more for rental property, salaries, wages, premiums, annuities, compensations, remunerations, emoulments or other fixed or determinable gains, profits or income.[5] For payments made after December 31, 2011, PPACA expanded information reporting to include amounts in consideration of property[6] and other gross proceeds.[7]

Last year, the IRS requested public comments[8] regarding guidance on these new requirements, including the appropriate scope and interpretation of "amounts in consideration of property" and "gross proceeds." The comment period ended on September 29, 2010.

V. Section 2101 of the Small Business Jobs Act of 2010

Persons who receive income from rental properties have not been considered to be engaged in a trade or business. Section 2101 of the Small Business Jobs Act, however, amended Section 6041, and beginning with payments made in January 1, 2011, most landlords are considered to be engaged in the trade or business of real estate and required to file 1099 forms reporting those payments. Exceptions are made for persons receiving the bulk of their rental income from temporarily renting their principal residence,[9] those who receive rental income of a minimal amount,[10] and those for whom the requirements of reporting payments would cause hardship.[11]

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[4] IRC Section 6041(a).
[5] Ibid.
[6] Patient Protection and Affordable Care Act, Section 9006.
[7] Ibid.
[8] Internal Revenue Bulletin: 2010-29, Notice 2010-51, July 19, 2010, available at: http://www.irs.gov/irb/2010-29_IRB/ar09.html.

[9] IRC Section 6041(h).
[10] Ibid.
[11] Ibid.

VI. Credit Card/Third Party Network Transactions Exception

The Treasury Department and the IRS issued a proposed regulation that would exempt from Section 6041 reporting for payment credit card transactions. Some believe that this exemption will harm small businesses. Because many small businesses do not accept credit card payments due to the high transaction fees, they could lose the business of companies that plan to avoid the provision by using credit cards.

VII. IRS Response

Although efforts were made to alter or eliminate the provision during the last Congress, each failed. As a result, the IRS is moving ahead with plans for implementation. On April 14, 2010, the Committee held a hearing on tax issues and IRS Commissioner Shulman testified. Several Committee Members expressed their concerns about the implementation of the new law to the Commissioner.

Following the hearing, a group of Committee Members sent letters to Commissioner Shulman requesting information on the IRS' plans for implementation. In his response, the Commissioner said that the IRS is reviewing suggestions received during the comment period, and working to find opportunities to minimize the burden and avoid duplicative reporting.[12]

VIII. Effect on Small Businesses

The Taxpayer Advocate noted in her Fiscal Year 2011 objectives report[13] that the 1099 reporting provision would have a disproportionate effect on small businesses. Larger businesses would seem to be better able to adjust to the new provisions' administrative cost and burden than smaller ones.

Administrative Burden

The small business owner who purchases at least $600 per year on fuel for transportation, paper for a printer or copier, rent, utilities, office furniture and equipment, vehicles, postal metering and package delivery services, food and beverages, janitorial services, and any other routine or recurring expense will have to obtain Taxpayer Identification Numbers (TIN) for what could be purchases from hundreds of vendors and track those purchases by vendor.

In a survey by the National Small Business Association (NBSBA), it was estimated that under the new law, the average small business will file 95 1099 forms, instead of the 20 that they currently file. NSBA estimated that very small businesses

[12] Letter from Douglas Shulman to The Honorable Sam Graves, October 20, 2010.
[13] Report of the National Taxpayer Advocate, Fiscal Year 2011 Objectives, available at: http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal..pdf.

(those with 10 or fewer employees), which currently file an average of two1099 forms per year, will file 20 under the new law.[14]

Confusion and Complications

Small businesses have raised a number of issues regarding the implementation of the new reporting provisions. Some questions have been answered in IRS publications, and others are less certain.

For example, would purchases be totaled before or after sales tax? Some businesses use the calendar year method of recordkeeping, and some use the fiscal year method. IRS 1099 reporting is based on calendar year payments. Businesses use different types of software to maintain their accounting, and their current software may not easily track purchases. Some companies may have to purchase new software or pay for additional accounting or data processing services to track purchases. With the credit card exemption, businesses would need to segregate credit card or debit card transactions from those made with other payment methods. Retailers and wholesalers of expensive products would be forced to file 1099s solely to order and maintain inventory.

Would a firm be penalized if it makes a good faith effort to obtain a TIN but is unsuccessful? How would a firm withhold on routine purchases such as airline tickets and hotel bookings. What process would be employed to resolve discrepancies between data? What about payments that were ultimately refunded?

If the 1099 forms are required to be electronically submitted to the IRS, many small firms may be required to invest in more sophisticated software or hire outside help unless the IRS develops an alternative reporting system.

IX. Methods of Filing Information Returns

The new reporting will be made by businesses to the IRS on a 1099-MISC information return.

Prior to reporting, the payer is responsible for obtaining the following information about the payee: name, address, telephone number and Taxpayer Identification Number (TIN). The 1099 return must also include the payer's name and address and the total amount paid.

If the payee does not provide a TIN, the payer is usually required to withhold 28% of the payment due as backup withholding. If the payee fails to provide a TIN after it is requested, it may be subject to a penalty.

Information returns must be filed with the IRS by February 28 of the year following the year payments were made. If the information returns are filed

[14] "In Taxes, Size Does Matter," CQ Weekly, June 14, 2010, p. 1426.

electronically, the deadline is March 31. Copies must be provided to the payee by January 31 of the year following the year the payments were made.

X. Penalties for Failure to File an Information Return

The Small Business Act increased the penalties for failure to file a return that is due beginning January 1, 2011. A small business may be fined the lesser of $100 per return or $500,000. If the return is corrected, the penalty may be lowered. If the failure to file is deemed intentional, the penalty may be $250 per return with no limit. These penalties may be updated in 2017 and every five years thereafter to adjust for inflation.[15]

Willful failure to file an information return was a misdemeanor under prior law, and punishable by a fine of up to $25,000, imprisonment of up to one year, or both. These penalties were not changed by the PPACA or the Small Business Act.

XI. Burden on the Internal Revenue Service

This provision will result in a large increase in the number of forms being filed with the IRS. Processing these forms is likely to increase the processing demand on IRS employees and strain the IRS' infrastructure. At the April 14, 2010 House Small Business Committee hearing, Commissioner Shulman said he was not yet certain what resources would be needed to implement this provision.

The National Taxpayer Advocate noted concern about the significant administrative challenges that the new reporting requirements pose for the IRS.[16] In particular, the Taxpayer Advocate is concerned about the IRS's ability to process the volume of 1099s that will be filed under the new law. She also expressed concern about the IRS' ability to determine incidents of aggregate payments of $600 or more by a small business to one vendor.[17]

XII. Legislative Proposals

Legislation to Repeal the Patient Protection and Affordable Care Act

On January 19, 2011, the House voted to repeal the Patient Protection and Affordable Care Act by a vote of 245-189. There have been several attempts to repeal or

[15] Carol A. Pettit and Edward C. Liu, 1099 Information Reporting Requirements and Penalties As Modified by the Patient Protection and Affordable Care Act and the Small Business Jobs Act of 2010, November 24, 2010, Congressional Research Service, available upon request.
[16] Report of the National Taxpayer Advocate, Fiscal Year 2011 Objectives, available at: http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal..pdf.
[17] Report of the National Taxpayer Advocate, Fiscal Year 2011 Objectives, available at: http://www.irs.gov/pub/irs-utl/nta2011objectivesfinal..pdf.

modify Section 9006 of the PPACA. These efforts failed partly because there has been disagreement on how to pay for the repeal.

Legislation to Repeal Section 9006

In the 112th Congress, Representative Dan Lungren's (R-CA) legislation, H.R. 4, would repeal Section 9006 of the PPACA H.R. 4. The bill now has over 260 bipartisan cosponsors. The bill repeals Section 9006, and does not contain a "pay for."

On February 2, 2011, the Senate passed (by a vote of 81-17) an amendment offered by Senator Debbie Stabenow (D-MI) to the Federal Aviation Administration Authorization legislation that repeals the 1099 provision. The repeal would be paid for by asking the Office of Management and Budget to identify the funding in appropriated but unspent funds.

XIII. Conclusion

The health care law's 1099 information reporting provision would create another administrative burden for small businesses and increase paperwork and compliance costs. This provision could cause a small business to postpone hiring, reduce its workforce or business investments. This provision may also require the IRS to increase its workforce, and the National Taxpayer Advocate has expressed concern about the IRS' ability to process the large volume of new 1099s.

This hearing will give Committee Members the opportunity to hear from small business owners about the impact of the provision on their companies.