

**WRITTEN STATEMENT OF**

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**HEARING ON**

**HOW TAX COMPLEXITY HINDERS SMALL BUSINESSES:  
THE IMPACT ON JOB CREATION AND ECONOMIC GROWTH**

**BEFORE THE**

**COMMITTEE ON SMALL BUSINESS  
UNITED STATES HOUSE OF REPRESENTATIVES**

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Chairman Graves, Ranking Member Velazquez, and distinguished Members of the Committee:

Thank you for inviting me to testify today on how the burden of tax complexity prevents small businesses from growing, hiring more workers, and investing back into their business and our economy. I would like to begin by saying bluntly that, in my view, the current state of the tax code is a mess. Since the last major reform 25 years ago, the code has become an ever-expanding patchwork of discrete provisions, often with little logical connection, and has become unreasonably difficult for taxpayers to understand. In the National Taxpayer Advocate's 2010 Annual Report to Congress, I identified the complexity of the tax code and the confusion and distrust it engenders as the number one most serious problem facing taxpayers – and the IRS. I titled that section of the report “The Time for Tax Reform Is Now,” because while there has been a lot of talk about tax reform in recent years, experience has shown that it will require a sustained, bipartisan effort – with the support of an engaged public – to make tax reform a reality.

This complexity has a direct impact on small business viability and job growth. The more time and resources a small business spends on tax compliance, the less time it will have to grow and hire employees. A 2008 study conducted by the University of Maryland and the Center for Economic Studies of the U.S. Census Bureau found that all net job growth essentially comes from business formation (*i.e.*, start-ups).<sup>1</sup> In addition, a report issued by the Small Business Administration Office of Advocacy states that small businesses are generally the creators of most new jobs as well as the employers of about half of the private-sector workforce. While small businesses are responsible for substantial job growth, they also experience greater losses when the economy is shedding jobs.<sup>2</sup> Considering that over half of new start-ups fail within four years,<sup>3</sup> it is essential that the tax system does not present an unnecessary hurdle to the success of these already fragile operations. In addition, because a substantial portion of businesses are pass-through entities, a real reduction in complexity will not occur unless individual *and* corporate tax reform occurs at the same time.

In my testimony, I first discuss how the complexity of the tax code impacts taxpayers by (1) imposing undue compliance burdens on both taxpayers and the IRS, (2) creating unfair advantages for the more sophisticated taxpayers, and (3) encouraging inadvertent as well as intentional noncompliance. I also provide suggestions on how to

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<sup>1</sup> John Haltiwanger, Ron Jarmin and Javier Miranda, *Business Formation and Dynamics by Business Age: Results from the New Business Dynamics Statistics*, Center for Economic Studies, U.S. Census Bureau 13 (May 2008).

<sup>2</sup> Office of Advocacy, Small Business Administration, *The Small Business Economy: A Report to the President* 1-2 (2010).

<sup>3</sup> Bureau of Labor Statistics, Monthly Labor Review, Vol. 128, No. 5, *Survival and Longevity in the Business Employment Dynamics Data*, 51 (May 2005).

strategically undertake a comprehensive structural tax reform initiative.<sup>4</sup> After discussing the general principles for tax reform, I discuss several current tax provisions that are burdensome to small businesses and require simplification to promote growth in hiring and investment in the economy. Finally, I will discuss the collection issues specific to small business taxpayers.

Before I delve into these issues, I wish to make two points clear. First, my statutory mandate is to address tax administration issues – not tax policy issues. While the line that separates tax administration and tax policy is sometimes fuzzy, I will try to describe the burdens that tax complexity imposes, identify challenges to enacting tax reform, and suggest some ways to approach it. However, my office does not take a position on tax rates, revenue levels, or the specifics of which tax breaks should be retained and which should be eliminated. Second, my statutory mandate is to present an independent taxpayer perspective. Therefore, although I am an IRS employee, my comments do not necessarily reflect the position of the IRS or the Administration.<sup>5</sup>

## **I. Tax Reform Principles Generally**

### **A. The Current Tax Code Imposes Significant Compliance Burdens on Businesses.**

Consider the following:

- Unincorporated business taxpayers find return preparation so overwhelming that about 71 percent now pay preparers to do it for them.<sup>6</sup>
- According to a TAS analysis of IRS data, small business taxpayers spend about 2.5 billion hours a year complying with the income tax filing requirements of the Internal Revenue Code (IRC).<sup>7</sup> This estimate does not include time spent on

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<sup>4</sup> For a more detailed discussion of tax reform applicable to both individual and business taxpayers, see Hearing on Tax Reform before the Committee on Ways and Means, U.S. House of Representatives (Jan. 20, 2011) (Written Statement of Nina E. Olson, National Taxpayer Advocate).

<sup>5</sup> The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

<sup>6</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008).

<sup>7</sup> The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for calendar year 2010 by the average amount of time the IRS estimated it took to complete the form. To isolate small businesses, the forms include: Form 1040 Schedules C, C-EZ, E, and F (excluding Form 2160 and 2106-EZ); Forms 1065, 1065B, 1120S. This estimate does not include information returns and employment tax returns, because we were unable to accurately isolate the small business portion of the total burden associated with these returns. The burden associated with these returns is significant. For

employment tax and information returns, because accurate estimates could not be developed based on the information available. In total, TAS estimates that both businesses and individuals spend approximately 6.1 billion hours on tax compliance.<sup>8</sup> That figure includes information returns, but does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.

- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the “tax industry” requires the equivalent of more than three million full-time workers.<sup>9</sup>
- A 2005 report by the Government Accountability Office (GAO) reviewed various studies attempting to quantify costs of tax compliance for businesses, and estimated that it costs businesses between \$40 billion and \$85 billion.<sup>10</sup>

**B. The Tax Code Is Rife with Complexity and Special Tax Breaks, Helping Taxpayers Who Can Afford Expensive Tax Advice and Discriminating Against Those Who Cannot.**

The tax code contains a multitude of tax breaks that benefit narrow groups of taxpayers or industries. These tax breaks are enacted to encourage certain types of behavior or provide benefits in certain circumstances, but the average small business taxpayer does not qualify for the benefits.<sup>11</sup>

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example, the estimated average taxpayer burden for businesses (filing Form 1065 or 1120S) for completing and filing Schedule K-1 are approximately 765 million hours. Report 44591, Copies of Returns Posted in 2010, Cycle 52 (Dec. 2010). While the IRS estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and, as noted in the text, it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation.

<sup>8</sup> The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2008 by the average amount of time the IRS estimated it took to complete the form.

<sup>9</sup> This calculation assumes each employee works 2,000 hours per year (*i.e.*, 50 weeks, with two weeks off for vacation, at 40 hours per week).

<sup>10</sup> For an overview of previous studies by the IRS and several outside analysts trying to quantify compliance costs, see Government Accountability Office, GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System* 13-14 (Aug. 2005). The estimates do not include the costs of collecting and remitting income and payroll taxes for employees.

<sup>11</sup> Examples of such tax benefits include the Electric Vehicle Qualified Plug-In Electric Drive Motor Vehicles Credit in IRC § 30D; The Film and Television Productions Deduction in IRC § 181; the Forestry Conservations Bonds Credit in IRC §§ 54A(d)(1)(A) & 54B; and the Railroad Track Maintenance Credit in IRC § 45G.

Beyond these narrow provisions, the tax code contains many general provisions that well-advised taxpayers may exploit. Indeed, many large accounting firms, law firms, and investment banking firms have regularly mined the code for ambiguities to develop tax-reduction “products” they can sell to paying clients. While taxpayers who can afford pricey legal advice are benefiting disproportionately from tax breaks, unsophisticated taxpayers sometimes fail to claim tax breaks because they do not know they exist. An example of this lack of awareness is illustrated in the HIRE Act provision, discussed below.

Overall, the complexity of the tax code leads to perverse results. Taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. Yet, at the same time, sophisticated taxpayers often find arcane provisions that enable them to reduce or eliminate their tax liabilities.

**C. Complexity Obscures Understanding and Creates a Sense of Distance Between Taxpayers and the Government, Resulting in Lower Rates of Voluntary Tax Compliance.**

IRS data show that when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. Workers who are classified as employees have little opportunity to underreport their earned income because it is subject to tax withholding. Employees thus report about 99 percent of their earned income. But among workers whose income is not subject to withholding, compliance rates plummet. IRS studies show that nonfarm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.<sup>12</sup>

Noncompliance cheats honest taxpayers, who must pay more to make up the difference. To me, this raises an important question: Why is it that few Americans would steal from a local charity, yet a high percentage of taxpayers who have a choice about paying taxes appear to have no compunctions about cheating their fellow citizens?

The Taxpayer Advocate Service has conducted research into the causes of noncompliance and plans to conduct additional studies. While we do not have definitive answers, we can suggest at least two hypotheses. First, no one wants to feel like a “tax chump” – paying more while suspecting that others are taking advantage of loopholes to pay less. Taxpayers who believe they are unfairly paying more than others inevitably will feel more justified in “fudging” to right the perceived wrong. Transparency is a critical feature of a successful tax system. It is essential if the system is to build taxpayer confidence and maintain high rates of compliance. Simplifying the code to make computations more transparent would go a long way toward reassuring taxpayers that the system is not rigged against them.

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<sup>12</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>).

Second, most people feel a sense of affinity and unity with local organizations, while in relative terms, they feel disconnected from the federal government. This may be because members of a community generally understand the services that local organizations provide and the benefits they personally derive, while many Americans do not understand how their tax dollars are spent or how they benefit. Or it may be because people know the leaders of local community groups personally, while the government seems faceless. Either way, I suspect that stealing from a local charity feels to many like stealing from family and friends, while cheating on one's taxes feels to some like a victimless offense.<sup>13</sup>

For these reasons, I think it is important to increase taxpayer awareness of the connection between taxes paid and benefits received. I have recommended that Congress direct the IRS to provide all taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent. This "taxpayer receipt" could be a more detailed version of the pie chart currently published by the IRS but would be provided directly to each taxpayer annually.<sup>14</sup> I believe better public awareness of the connection between taxes and government spending may improve civic morale, increase tax compliance, and make more productive the national dialogue over looming fiscal policy choices as well.

#### **D. The Dirty Little Secret: Tax Breaks Generally Benefit the Masses.**

There is a widespread belief that the influence of "special interests" is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers, including several described above. But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from tax breaks that are technically called "tax expenditures." A tax expenditure is generally defined as any reduction in tax revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.<sup>15</sup>

In the following example, we present a tax computation that illustrates the role of tax expenditures with a small business owner. The scenario is fictitious, but it illustrates the extent to which various tax benefits may apply to a small business owner.

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<sup>13</sup> See generally National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 147-150 (Research Study: *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (discussing the effect of social norms on tax compliance).

<sup>14</sup> See IRS Form 1040 Instructions (2009), at 100.

<sup>15</sup> Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 § 3(3) (July 12, 1974). When Congress wishes to spend money, it may do so in either of two ways. It can make expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. For a detailed discussion of tax expenditures, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

### Example: SMALL BUSINESS OWNER

Taxpayer B, as a sole proprietor, operates his own contracting business that grosses almost half a million dollars yearly, but after the costs of equipment and supplies yields income of \$200,000, out of which B pays \$25,000 in expenses such as wages, licenses, insurance, fees, and advertising. Late in 2010, B buys a new SUV of over 6,000 pounds that he drove solely for business that year. Under a provision for “bonus” depreciation, the full \$60,000 price is deductible. Because B’s contracting business is considered a domestic production activity, he also can deduct about \$5,000 of “qualified production activities income.” Through the business, B obtains health insurance for \$10,000 and puts away another \$10,000 for retirement (in a simplified employee pension plan known as a SEP). As a self-employed proprietor, B must pay about \$14,850 in self-employment (SE) tax, but half of this is deductible.

B’s spouse earns \$25,000 as a kindergarten teacher, buying classroom supplies out of pocket, of which she can deduct \$250. The Bs pay \$10,000 in state, local, and property tax, \$10,000 in home mortgage interest, and \$5,000 in charitable contributions.

Although the Bs have income of \$200,000, the deduction of numerous tax expenditures brings them down into the 25-percent marginal bracket (and the Alternative Minimum Tax does not apply to this situation). For income tax purposes, after an \$800 Making Work Pay credit, B pays about \$10,300, or an effective tax rate of five percent of the \$200,000. In addition, B pays about \$14,850 of SE tax (the counterpart to certain payroll tax on employees).

Table 1. Tax Treatment

Category	Item	Amount (\$)	Net (\$)
Income	Business income after expenses	175,000	200,000
	Salary	25,000	
Deductions	Bonus depreciation	60,000	(124,950)
	Domestic production	5,000	
	Health insurance (SE)	10,000	
	Retirement (SEP)	10,000	
	½ SE tax (rounded)	7,400	
	Schoolteacher expenses	250	
	State, local, and property taxes	10,000	
	Mortgage interest	10,000	
	Charitable contributions	5,000	
	Exemptions	7,300	
Taxable income (25% marginal bracket)			75,050
Income tax	(rounded)		11,100
Credit	Making Work Pay		(800)
Net tax	(5% result)		10,300

This scenario illustrates that tax reform is not an easy issue. In theory, most of us agree that the tax code is too complex and that broadening the tax base by eliminating



existing tax breaks in exchange for lower rates would improve the system.<sup>16</sup> In practice, the prospect of lower rates may seem speculative and distant, while the threatened loss of existing breaks raises immediate concerns.

Despite these concerns, I personally believe that fundamental tax reform is essential and urgent. More importantly, I believe that taxpayers will support tax reform by wide margins if they gain a better understanding of the trade-offs involved and are engaged in an informed dialogue. If tax reform is enacted on a revenue-neutral basis, the average taxpayer's bill will not go up, and taxpayers will be much happier to have a more transparent system. They will understand how much tax they are paying, they will understand how their tax is computed, and many will save time and money by no longer needing to pay a preparer to do the job for them.

Both to gauge and build public support, I encourage you to discuss with your constituents both the complexity of the existing tax code and the trade-offs between tax rates and tax breaks that reform will require. An uninformed taxpayer who hears he may lose a tax break will instinctively seek to retain it to prevent his tax bill from rising. An informed taxpayer who understands she will be losing a tax break, but probably will not pay more tax because rates will be substantially lowered, will have a very different reaction. The Tax Reform Act of 1986 was the last major revision of the tax code, and despite considerable initial concerns, taxpayers came around. On the final votes, the Act was supported by significant bipartisan majorities in the House and the Senate.<sup>17</sup> I expect that a similar dynamic will play out again in the near future.

**E. A Zero-Based Budgeting Approach Could Assist Congress in Deciding Which Tax Breaks and IRS-Administered Social and Economic Programs to Retain and Which to Eliminate.**

My suggestion is to approach tax reform in a manner similar to zero-based budgeting. Under that approach, the starting point would be a tax code without any exclusions or reductions in income or tax. As discussions proceed, tax breaks and IRS-administered social and economic programs would be added only if lawmakers decide that, on balance, the public policy benefits of running the provision or program through the tax code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS. Factors to consider in this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is

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<sup>16</sup> The bipartisan fiscal commission appointed by the President recently made recommendations along these lines. See National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 15, 28-34 (Dec. 2010) at <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>.

<sup>17</sup> The vote to approve the conference report was 292-136 in the House and 74-23 in the Senate. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 4 (1987).

provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure for achieving that purpose.<sup>18</sup>

The immediate elimination of certain tax benefits could cause hardships for businesses where established pricing or conduct is based on those provisions. Thus, if Congress decides to eliminate tax incentives in situations like this, it should consider transitional relief.

In our 2010 Annual Report to Congress, I recommended adoption of a process to evaluate whether a tax expenditure presents an administrative challenge to the IRS or taxpayers and the extent to which it achieves its intended purpose.<sup>19</sup> In addition, in our 2009 report I proposed an analytic framework for evaluating whether specific social and economic benefit programs – including benefits targeting businesses – should be run through the tax system.<sup>20</sup> If we apply this rigorous analytical framework to all proposed tax expenditures, we will adopt solely those provisions that fulfill a compelling public policy purpose, that the IRS can effectively administer without undue burden to taxpayers, and that are designed to capture information to evaluate whether the benefit achieves its intended public policy outcome.

#### **F. The Odds of Achieving Tax Reform Are Higher if the Issue Is Addressed Separately from Decisions About Adjustments to Revenue Levels.**

I am concerned that if comprehensive structural tax reform and revenue levels are considered together as part of a package, the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, my suggestion is that Congress consider addressing these issues separately. First, Congress could enact comprehensive structural tax reform on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust rates accordingly. Conversely, Congress can address these two items on parallel tracks and marry them up at the end.

#### **II. Recommendations to Simplify Several Specific Provisions that Create Unnecessary Compliance Burdens for Small Business Taxpayers.**

Even without fundamental tax reform, there is much we can do to ease the compliance burdens of small businesses. In the following discussion, I will point out several tax provisions that create unnecessary compliance burdens on small businesses and require simplification, or at the very least, more guidance.

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<sup>18</sup> See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

<sup>19</sup> See *id.*

<sup>20</sup> National Taxpayer Advocate 2009 Annual Report to Congress, Vol. 2, at 75-104 (*Running Social Programs Through the Tax System*).

**A. A Study Similar to the Taxpayer Assistance Blueprint (TAB) for Small Business and Self-Employed Taxpayers is Necessary to Understand the Particular Needs of this Taxpayer Population.**

In its fiscal year 2006 appropriations report, Congress directed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to develop a five-year strategic plan for taxpayer service.<sup>21</sup> In September 2005, the IRS formed the Taxpayer Assistance Blueprint (TAB) team, with employees from several IRS functions, including the Taxpayer Advocate Service (TAS), in response to this directive. In support of the TAB, the IRS, TAS, and the IRS Oversight Board conducted in-depth studies, including surveys, to enhance understanding of the needs and preferences of individual taxpayers. The TAB originated an approach to planning and structuring IRS research efforts on taxpayer service, forming a methodology for the IRS to follow to ensure a cohesive research structure that would complement and build on previous findings. Because of the TAB studies and additional research by TAS, the IRS now knows more than ever about individual taxpayer needs and preferences, including the willingness of individual taxpayers to try new methods of receiving IRS services.<sup>22</sup>

I am, however, concerned that the focus of the TAB has remained on Wage & Investment (W&I) division taxpayers. In directing the creation of a five-year taxpayer service strategic plan, the House and Senate Appropriations Committees were focusing on taxpayer service issues generally. W&I deals with individual taxpayers who are not engaged in a trade or business, and it is of course important that they be served. But small business taxpayers who fall under the jurisdiction of the Small Business/Self-Employed (SB/SE) division and tax-exempt organizations that fall under the Tax Exempt/Governmental Entities (TE/GE) division also require service from the IRS. Because of the complexity of the laws, they may, in fact, need more service. The TAB should be expanded to cover the taxpayers those divisions serve. I have made this recommendation in prior reports to Congress<sup>23</sup> and continue to urge the IRS to expand the TAB to a broader range of taxpayers. Although both SB/SE and TE/GE have conducted some research into aspects of their taxpayer populations, neither operating division has undertaken the comprehensive and rigorous approach that distinguished the TAB. Absent that disciplined approach, neither unit will adequately understand or meet the service needs of its respective taxpayers.

The following two items illustrate the importance of creating a taxpayer blueprint for small businesses:

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<sup>21</sup> H. R. Conf. Rep. No. 109-307, at 209 (2005). See also S. Rep. No. 109-10, at 134 (2005).

<sup>22</sup> See National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (Research Study: Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

<sup>23</sup> See, e.g., National Taxpayer Advocate 2008 Annual Report to Congress 97, 105; IRS, Report to Congress Progress on the Implementation of The Taxpayer Assistance Blueprint April 2007 to February 2008, 46; and National Taxpayer Advocate 2007 Annual Report to Congress viii, 37-38, 209.

**Truck Drivers: A Case Study in Making Decisions Without Understanding the Particular Needs of a Specialized Taxpayer Segment.** In an effort to cut costs and based on a recommendation made by the IRS's Printing and Postage Budget Reduction (PPBR) Task Force, the IRS eliminated direct mailings of tax packages to individuals and small businesses for the 2010 tax year. The IRS communicated this decision by mailing postcards to impacted taxpayers. However, after the postcards were sent, the IRS decided to also cut the package for Form 2290, which includes the Heavy Highway Vehicle Use Tax Return filed by truck drivers. No postcards went to this specialized segment of small business taxpayers, truck drivers who may spend much of their time away on the road and arrive home to find they have no forms to file a return. I am concerned that the failure to communicate this change will lead many of these taxpayers into unintentional noncompliance. A TAB study would have been helpful to understand the needs of this specialized segment of small businesses.<sup>24</sup>

**Attempts to Cut Costs May be Futile Without Understanding Small Business Taxpayer Needs.** In connection with the above-referenced PPBR decision to eliminate direct mailings of tax packages, a recent Treasury Inspector General for Tax Administration (TIGTA) report raised concerns about the IRS's tracking of its savings and the lack of documentation detailing how the IRS calculated or validated its savings estimates.<sup>25</sup> For example, over 11 million taxpayers received postcards explaining the direct mailing elimination. Yet through mid-March, order requests processed through the toll-free 1-800-TAX-FORM line experienced about a ten percent *increase* (over 266,000 orders) when it has previously experienced a six to eight percent *decrease* per year. When the IRS mails forms through this program, it costs significantly more resources to manually supply the forms rather than mail in bulk. Thus, the additional costs associated with the manual mailing could negate the estimated cost savings in the printing and postage budget. In addition, the cost estimates only considered printing and postage savings and failed to factor in the downstream consequences of noncompliance caused by the decision to stop direct mailings. Therefore, upon factoring in all the associated additional costs, the IRS may find it achieved no savings at all, while it significantly reduced taxpayer services. Such decisions would have been more well-informed if the IRS understood the needs of all of the affected taxpayer populations before implementation.<sup>26</sup>

**B. Complexity and Lack of Awareness of the HIRE Act Diminishes the Effect of Important Hiring Incentives.**

The Hiring Incentives to Restore Employment (HIRE) Act was designed to create new jobs in the private sector by helping small businesses invest, expand, and hire more

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<sup>24</sup> Information Provided from PPBR Implementation Team to TAS (March 30, 2011).

<sup>25</sup> TIGTA, Ref. No. 2011-40-025, *Publishing and Mail Costs Need to Be More Effectively Managed to Reduce Future Costs* (Feb. 28, 2011).

<sup>26</sup> Information Provided from PPBR Implementation Team to TAS (March 30, 2011).

workers.<sup>27</sup> Under the HIRE Act, a qualified employer is relieved from paying the employer's share (6.2 percent) of the Old-Age, Survivors and Disability Insurance Benefits tax (commonly referred to as Social Security) on all wages paid to formerly unemployed qualified employees from March 19, 2010, through December 31, 2010.<sup>28</sup> The employer may also receive a tax credit of up to \$1,000 for each new employee retained on the payroll for at least one year.<sup>29</sup>

The complexity and general lack of awareness of the HIRE Act diminishes the impact of the tax incentives intended to encourage hiring. The enactment of the law was immediately eclipsed by interest in the enactment of the Patient Protection and Affordable Care Act.<sup>30</sup> Thus, many businesses were potentially unaware of the beneficial hiring incentives in the HIRE Act - especially those that only meet with their accountants at the end of the year.<sup>31</sup>

Even for businesses that were aware of the incentives, the poor timing and circumstances surrounding the enactment of this Act created a complex and confusing reporting situation. The relief from the employer's share of payroll taxes began on March 19, 2010, a Friday in the middle of a pay period, and less than two weeks from the end of a payroll tax quarter. Even though the relief from payroll matching was available for wages paid on a small portion of the *first* quarter of 2010 (between March 19 and March 31), businesses were directed to claim this credit during the *second* quarter payroll period and prepare their first quarter 2010 Form 941, *Employer's Quarterly Federal Tax Return*, as if the law had not taken effect.<sup>32</sup> Only time will tell if this unusual quarterly reporting results in increased and possibly incorrect wage reporting discrepancy inquiries in 2011.

Further, the requirements of the statute create compliance and administrative burdens. Because the purpose of the credit is to increase the number of employees on-roll, a business cannot simply replace an employee and qualify for the credit. There are exceptions if an employee is replaced because he or she separated from employment

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<sup>27</sup> Pub. L. No. 111-147, 124 Stat. 71 (March 18, 2010); see also <http://www.dems.gov/topics/hiring-incentives-to-restore-employment-act-hire> (last viewed March 29, 2011).

<sup>28</sup> IRC § 3111(d).

<sup>29</sup> To encourage businesses to retain the new hires for at least 52 consecutive weeks, the HIRE Act provides a credit up to the lesser of \$1,000 or 6.2 percent of the first \$16,129.03 of wages paid to each retained worker. The credit will be claimed on the employer's 2011 income tax return (except a fiscal year taxpayer may be eligible to claim the credit on a 2010 tax return). There is no minimum weekly number of hours of work required to qualify for the credit. See Pub. L. No. 111-147, § 102, 124 Stat. 71, 75 (March 18, 2010).

<sup>30</sup> Pub. L. No. 111-148, 124 Stat. 119 (March 23, 2010).

<sup>31</sup> See Russell Marketing Research, *Findings from Task 149: The Taxpayer Advocate Service Research Program with a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3*, 8 (July 2002).

<sup>32</sup> IRS, *FAQs About Claiming the Payroll Exemption*, available at <http://www.irs.gov/businesses/small/article/0,,id=220750,00.html> (last viewed April 8, 2011).

voluntarily or for cause. This provision creates a burden for small businesses to document something they did not do (replace an employee), and if questioned, prove a negative. For the IRS, this provision creates the burden of a nearly unenforceable statute.

The application of these provisions is further complicated by an unusual definition of “unemployed” and the requirement to have the formerly unemployed, once properly identified, complete an affidavit attesting to his or her jobless status. Under the Act, the definition of “unemployed” is not based on a worker seeking employment, but rather an individual not having worked for more than 40 hours during the 60-day period ending on the date the individual begins employment.<sup>33</sup> For example, a student who is neither working nor seeking employment during the school year, but is hired for the summer is considered unemployed for purposes of the HIRE Act and could qualify an employer for payroll tax relief. Reliance on a common understanding of the term “unemployed” could cause an employer to miss out on substantial tax relief – up to \$6,622 per employee.<sup>34</sup>

### **C. The Creation of an Optional Standard Home Office Business Deduction Would Reduce Small Business Burden.**

The tax laws regarding the home office deduction are considered by many to be too complex while the associated recordkeeping responsibilities are considered too time-consuming. Specifically, the complexity associated with the current requirements to calculate the portion of the home expenses attributable to the home office, and to calculate the depreciation for that area, may discourage eligible taxpayers from taking the deduction. In addition, the process of reporting the deduction differs based on the type of business conducted and whether the taxpayer is an employee or self-employed.<sup>35</sup>

One way to encourage eligible taxpayers to take the deduction is to simplify the provision. Accordingly, in my 2007 Annual Report, I recommended that Congress amend IRC § 280A to create an optional standard home office deduction. The

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<sup>33</sup> Pub. L. No. 111-147, § 101, 124 Stat. 71, 73 (March 18, 2010). The new, qualified employee must sign an affidavit stating “Under penalties of perjury, I certify I have not been employed for more than 40 hours in the 60-day period ending on \_\_\_\_\_, 2010 when I began my employment.” To meet this requirement, the IRS created a new form, Form W-11, *Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit*, and added one more responsibility for small businesses already feeling “taxed” by too many requirements and forms.

<sup>34</sup> The maximum payroll tax that may be forgiven is \$6,622 per employee. This figure is calculated by multiplying the employer portion of social security taxes (6.2 percent) by the maximum taxable wages of \$106,800. There is no maximum dollar amount of relief per employer.

<sup>35</sup> For the reporting requirements associated with this deduction, see IRS Pub. 587, *Business Use of Your Home*. The home office business deduction is reported on several different schedules, depending on whether the taxpayer is an employee (Schedule A), a self-employed individual with nonfarm business income (Schedule C), or a self-employed individual with farm income (Schedule F). Employees who itemize deductions on Schedule A report the deduction on Line 21, “Unreimbursed employee expenses.” The taxpayer must also attach Form 2106, *Employee Business Expenses*.

legislative provision would direct the Secretary to draft regulations that calculate the deduction by multiplying an applicable standard rate, as determined and published by the Commissioner on a periodic basis, by the applicable square footage of the portion of the dwelling unit described in IRC § 280A(c).<sup>36</sup> Finally, to decrease the taxpayer burden associated with reporting the deduction, Congress should encourage the IRS to simplify the reporting of the optional standard deduction on Schedule A, *Itemized Deductions*; Schedule C, *Profit or Loss From Business*; and Schedule F, *Profit or Loss From Farming*.

#### **D. Simplification of the S Corp Election Process Would Alleviate Burden on Small Businesses.**

Subchapter S corporations are the most common corporate entity in the tax system. In Fiscal Year (FY) 2009, 4.5 million S corporation returns were filed, accounting for about 64 percent of all corporate returns, with 45 percent of S corporation returns reporting gross receipts under \$100,000 and 63 percent reporting gross receipts under \$250,000.<sup>37</sup> S corporation status is highly desirable because in addition to traditional corporate attributes such as limited liability and transferable ownership, these corporations “pass-through” profits or losses to shareholders who report the income and receive the tax benefit of any losses on their individual returns.<sup>38</sup>

Small business corporations may elect to be treated as flow-through entities by submitting Form 2553, *Election by a Small Business Corporation*, on or before the 15th day of the third month of the tax year,<sup>39</sup> while an S corporation tax return is not due until the 15th day of the third month after the end of the tax year.<sup>40</sup> Many taxpayers overlook this requirement, subjecting themselves to serious tax consequences that include taxation on the corporate level and the inability to deduct operating losses on shareholders’ individual tax returns.

Businesses that wait until the tax return filing date to make this election are deemed to have made the election for the succeeding year, and must seek retroactive relief upon a showing of reasonable cause under one of four revenue procedures or through a private

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<sup>36</sup> The standard rate must include a clearly identifiable depreciation component for taxpayers to be able to track depreciation. Upon the sale of a residence, taxpayers must recapture any allowed or allowable additional depreciation pursuant to IRC § 1250. For simplification, the depreciation component should be calculated based on the straight-line method of depreciation to render the recapture calculation unnecessary. Nonetheless, the taxpayer would still need to track depreciation, because upon the sale of the residence, the amount of the home sale exclusion in IRC § 121 must be reduced by any depreciation allowed or allowable after May 6, 1997.

<sup>37</sup> IRS, *Data Book 2009*, Table 2, 4; IRS, CDW, Business Returns Transaction File (Tax Year 2009).

<sup>38</sup> IRC § 1361(a)(1) defines an “S corporation” as “a small business corporation for which an election under §1362(a) is in effect for such year.”

<sup>39</sup> IRC § 1362(b)(1)(B); Treas. Reg. § 1.1362-6(a)(2).

<sup>40</sup> IRC §§ 6037 and 6072(b); Treas. Reg. § 1.6037-1(b); Instructions for Form 1120S, *U.S. Income Tax Return for an S Corporation*, at 3 (2009).

letter ruling (PLR) request.<sup>41</sup> Challenges in the S election process for taxpayers include the complexity of relief procedures for a late S corporation election; the often prohibitive cost of retroactive relief via a PLR; the IRS's inability to verify the receipt and acceptance of S corporation returns and election applications; and the downstream burdens on shareholders of the conversion of S corporation returns to regular, taxable corporate returns. In processing years 2008 and 2009, 81,431 and 97,823 S corporation returns respectively could not be processed as filed because of missing or late elections, IRS errors in recognizing or processing a valid election, and an absence of effective relief procedures.<sup>42</sup> These unprocessed returns accounted for nearly 17 and 24 percent of all new S corporation filings for those two years.<sup>43</sup>

To alleviate the burden on small businesses, I recommend that Congress simplify the S corporation election process by amending IRC § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation by checking a box on its timely filed (including extensions) Form 1120S, *U.S. Income Tax Return for an S Corporation*.<sup>44</sup> I also recommend that the IRS expedite the issuance of a consolidated revenue procedure for late election relief; immediately identify and correct accounts where tax was assessed without following deficiency procedures; expand outreach efforts to include a simple and complete guide to the late election relief process; develop an administrative appeal process for taxpayers whose elections are denied; and allow electronic filing of the S corporation election form.<sup>45</sup>

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<sup>41</sup> IRC § 1362(b)(3) and (b)(5). See Rev. Proc. 2007-62, 2007-2 C.B. 786; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 97-48, 1997-2 C.B. 521. The IRS Office of Chief Counsel issued 226 PLRs for late S corporation elections under IRC § 1362 from FY 2007 to FY 2009, for which the IRS charged a user fee ranging from \$625 to \$14,000 per request. TIGTA, Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010). For current PLR procedures and user fees, see Rev. Proc. 2011-1, 2011 I.R.B. 1.

<sup>42</sup> Business Master File (BMF) Extract from IRS Compliance Data Warehouse (CDW) for Processing Years 2007-2009 (June 2010). If there is no election on file, the return information cannot "post" to the IRS Master File, and the return becomes "unpostable."

<sup>43</sup> Prior IRS research reports revealed approximately 20 percent of these returns remain unpostable for multiple years. IRS, Small Business/Self-Employed Division (SB/SE) Research report, *Profile Taxpayers with Unpostable Initial 1120S Returns* (May 2007).

<sup>44</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 410-411 (Legislative Recommendation: *Extend the Due Date for S Corporation Elections to Reduce the High Rate of Untimely Elections*). See also National Taxpayer Advocate 2004 Annual Report to Congress 390; National Taxpayer Advocate 2002 Annual Report to Congress 246.

<sup>45</sup> National Taxpayer Advocate 2010 Annual Report to Congress 278-90 (Most Serious Problem: *S Corporation Election Process Unduly Burdens Small Businesses*).



## **E. The Worker Classification Rules are Complex and Create Uncertainty.**

Misclassification of workers can have serious consequences for the workers, the recipients of the services they provide, and tax administration in general. Whether a worker is classified as an employee or independent contractor affects the application of labor laws<sup>46</sup> as well as tax treatment for both the worker and the service recipient.<sup>47</sup> Unfortunately, the rules are complex and ambiguous, leading to intentional as well as inadvertent noncompliance in this area.

The following aspects of the classification rules lead to confusion and may even cause inadvertent misclassification of workers:

- Common Law Test Does Not Provide Clear Answers. The common law 20-factor test to determine proper classification is complex, subjective, and does not always produce clear answers. The potential for errors and abuse is high in those gray areas where not all factors yield the same result, particularly because there are no weighting rules.<sup>48</sup>
- Section 530 Safe Harbor Rule Creates Confusion. The safe harbor rule of § 530 of the Revenue Act of 1978 adds confusion to an already complicated set of classification rules.<sup>49</sup> Apparently, § 530 was enacted “to alleviate what was perceived as overly zealous pursuit and assessment of taxes and penalties against employers who had, in good faith, misclassified their employees as independent contractors.”<sup>50</sup> However, interpretation of the provision has become an additional source of disputes and confusion.<sup>51</sup>

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<sup>46</sup> Such protections include the Fair Labor Standards Act, Family Medical Leave Act, Occupational Safety and Health Act, and the National Labor Relations Act. Misclassified workers may also lose access to employer-provided benefits such as health insurance coverage and pensions. See Government Accountability Office, GAO-07-859T, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification* (May 8, 2007); Subcomm. on Income Security and Family Support, Comm. On Ways and Means, Advisory ISFS-6 (May 1, 2007).

<sup>47</sup> For a detailed discussion of the tax treatment of both classifications, see Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

<sup>48</sup> In Revenue Ruling 87-41, 1987-1 C.B. 296, the IRS developed a list of 20 factors, based on cases and rulings decided over the years, to determine whether an employer-employee relationship exists.

<sup>49</sup> Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885-86 (Nov. 6, 1978) (codified as amended at 26 U.S.C. §§ 3401, 3101).

<sup>50</sup> *Boles Trucking, Inc. v. U.S.*, 77 F.3d 236, 239 (8<sup>th</sup> Cir. 1996) (citation omitted).

<sup>51</sup> The confusion stems from the following: (1) location of the provision outside the Tax Code, (2) the reliance on facts and circumstances, (3) the provision only applies to service providers and not workers, and (4) the application of the provision to employment taxes, which is statutorily defined to include income tax withholding. Pub. L. No. 95-600, § 530(c)(1), 92 Stat. 2763, 2885-86 (Nov. 6, 1978). Further, judicial

- Consequences of Reclassification by IRS. Whether misclassification is inadvertent or deliberate, significant tax consequences result if the IRS subsequently reclassifies the worker after an audit. For example, the service recipient may be liable for employment taxes for a number of years,<sup>52</sup> interest, penalties, and potential disqualification of employee benefit plans. The worker may have to pay self-employment taxes and lose the ability to take certain business-related deductions. In addition, if the worker is classified as an employee, he or she may be barred from claiming a refund of self-employment taxes because the statutory period for claiming a refund expired while the IRS was dealing with the employer's classification issue. Further, the worker has no right to petition the classification determination to the U.S. Tax Court under IRC § 7436.
- Lack of Published Guidance. Because the Revenue Act of 1978 prohibits Treasury and the IRS from publishing regulations and revenue rulings on worker classification for employment taxes, there is no current guidance. Given that general working conditions have changed significantly over the last three decades, such a prohibition is contrary to sound tax administration and likely increases the potential for both deliberate and inadvertent misclassification. Although the IRS has published training materials on this issue, they do not carry the force of law.<sup>53</sup> We also acknowledge that that private industry is rightfully concerned about any guidance issued by the government, especially if industry is not consulted beforehand.

In order to reduce the complexities and ambiguities associated with the worker classification rules, in the 2008 Annual Report to Congress I recommended the following:

1. Replace § 530 with a provision applicable to both employment and income taxes, and require the IRS to consult with the industry and report back to the tax-writing committees on the findings of such consultations, with the ultimate goal on the part of the Secretary to issue guidance based on such findings, including a specific industry focus;<sup>54</sup>

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decisions have made clear that there is no *de minimis* exception to the substantive consistency requirement of § 530. See *Institute for Resource Management, Inc. v. U.S.*, 90-2 U.S.T.C. ¶ 50,586 (Cl. Ct. 1990).

<sup>52</sup> IRC § 3509.

<sup>53</sup> See, e.g., IRS Pub. 1779, *Independent Contractor or Employee*.

<sup>54</sup> Our initial recommendation published in the 2008 Annual Report to Congress required the Secretary to issue guidance. However, based on our discussions with small business groups, we subsequently refined the recommendation to propose that Congress mandate the IRS to hold a series of consultations with the industry and report back to the tax writing committee on findings. See National Taxpayer Advocate 2008 Annual Report to Congress 375-390.

2. Direct the IRS to develop an electronic tool to determinate worker classifications that employers would be entitled to use and rely upon, absent misrepresentation;
3. Allow both employers and employees to request classification determinations and seek recourse in the Tax Court;<sup>55</sup> and
4. Direct the IRS to conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.

**F. Protection from Third-Party Payer Failures is Necessary to Protect Small Businesses from Significant Harm.**

Third-party payers provide valuable services to employers, especially small businesses, by helping them comply with federal, state, and local employment tax requirements.<sup>56</sup> A third-party payer is any person that provides the services of filing, reporting, withholding, and payment of employment taxes on behalf of the client taxpayers. In recent years, a number of these payers have gone out of business or embezzled their customers' funds.<sup>57</sup> When payers do not file the required employment tax returns or make the required deposits, employers remain liable for the underlying tax, interest, and penalties.<sup>58</sup> Usually, defunct third-party payers do not have sufficient assets to collect against upon default.

When third-party payers fail or commit fraud and abscond with their customers' funds, their clients face serious economic difficulties. Because the Code does not protect taxpayers from third-party payer failures, the IRS faces difficult decisions about how to handle these cases and often has no recourse other than to initiate collection of unpaid employment taxes from the employers and the business owners under IRC § 6672. As a result, small businesses may not only be forced to pay the amount twice – once to the payer that absconded with or dissipated the funds and a second time to the IRS – but

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<sup>55</sup> IRC § 7436 allows an employer that has been audited regarding employment taxes to petition the United States Tax Court to litigate the issue of whether a worker is an independent contractor or employee, or whether the employer is entitled to relief from any misclassification under § 530 of the Revenue Act of 1978. The collection of any underpayment of employment taxes is barred while the action is pending. This provision does not authorize the employee to petition the Tax Court.

<sup>56</sup> See Table 1.22.1, *Third Party Arrangements*, National Taxpayer Advocate 2007 Annual Report to Congress 339.

<sup>57</sup> IRS, *Examples of Employment Tax Fraud Investigations - Fiscal Year 2011*, available at <http://www.irs.gov/compliance/enforcement/article/0,,id=228085,00.html> (last viewed April 8, 2011)

<sup>58</sup> See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages); IRC §§ 3501-3511 (general provisions related to employment taxes); IRC § 6011 (general requirement of return, statement, or list); IRC § 6051 (receipt for employees); and IRC § 6302(g) (deposits of Social Security taxes).

also may be liable for interest and penalties.<sup>59</sup> Some small businesses may not be able to recover from these setbacks and be forced to cease operations.

This issue demonstrates the vital need for taxpayer protection in the payroll service industry, particularly for small business taxpayers that hire smaller third-party payers. I recommend that Congress amend the Code to define a third-party payer; make a third-party payer jointly and severally liable for the amount of tax collected from client employers but not paid over to the Treasury, plus applicable interest and penalties; authorize the IRS to require payers to register with the IRS and be sufficiently bonded; include third-party payers within the definition of a “person” subject to the trust fund recovery penalty (TFRP); and clarify that the TFRP survives bankruptcy when the debtor is not an individual.<sup>60</sup>

**G. The Willfulness Component of the Trust Fund Recovery Penalty Statute Prevents Business Owners from Continuing Operation of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act.**

IRC § 6672 provides for the assessment of a Trust Fund Recovery Penalty against any person who is responsible for withholding and paying over employment taxes and certain types of excise taxes, often referred to as the “trust fund” taxes, to the IRS and who willfully fails to do so.<sup>61</sup> As a result of the courts’ interpretation of the willfulness component of the statute, in situations where no changes in ownership occur, after finding out about an employment tax liability, the responsible person must use all available funds to pay the delinquency and cannot use any of the funds to pay operating expenses of the business, even to keep the business going.<sup>62</sup> This outcome does not change even if the delinquency resulted from a third-party bad act, such as embezzlement by a trusted employee or third-party payer.<sup>63</sup> The statute does not contain a reasonable cause exception.

Courts and legal scholars have commented that the current judicial interpretation of willfulness is “harsh,” “draconian,” and “somewhat counterintuitive,” and have advocated

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<sup>59</sup> See, e.g., IRC §§ 6656(a) and 6672(a).

<sup>60</sup> See National Taxpayer Advocate 2007 Annual Report to Congress 538-544.

<sup>61</sup> “Responsible person” is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, and pay over the withheld taxes. IRC §§ 6671(b) and 6672(a). See also *Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothlin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).

<sup>62</sup> Willfulness exists if the responsible person obtains knowledge of a withholding tax delinquency and continues to permit payments to be made to other creditors. *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970); *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987); *Wright v. U.S.*, 809 F.2d 425 (7th Cir. 1987).

<sup>63</sup> *Anuforo v. Comm’r*, 614 F.3d 799 (8th Cir. 2010); *McCloskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa 2009). See also National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; Legislative Recommendation: *Taxpayer Protection from Third Party Payer Failures*).

for change in the statute.<sup>64</sup> This interpretation appears to cause unjust results when a responsible person of a struggling business tries to resolve a past tax delinquency, which resulted from an intervening bad act, and agrees to repay the liability in installments instead of liquidating the business.<sup>65</sup> Because current judicial interpretation of the TFRP willfulness component effectively requires a business owner to stop operating a business and pay all available cash to the IRS, or to resign after obtaining knowledge about the liability, the government may be forced to make outlays in the form of unemployment benefits or food stamps to the laid-off employees. Thus, the strict application of the TFRP willfulness component can destroy the taxpayer's business, harm the taxpayer's and his employees' financial welfare, and reduce future federal revenue. In these circumstances, it is in the best interests of the government to encourage business owners to continue to operate and pay off the delinquencies in installments rather than liquidate the business and lay off employees.

I recommend that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful, if the delinquent business: (1) makes payment arrangements to satisfy the liability based upon the IRS's determination of minimal working capital needs of the business, and (2) remains current with payment and filing obligations.<sup>66</sup>

### **III. Small Businesses Facing Compliance Issues Often Face Devastating Yet Avoidable Consequences.**

The current policies and procedures of the IRS Collection operation provide inadequate attention and service to small business taxpayers with emerging collection problems, particularly those concerning employment tax obligations. The IRS needs to provide early assistance to these taxpayers and provide flexible collection tools. Moreover, the IRS must strive to understand the taxpayer's reason for noncompliance in order to apply the appropriate collection technique.

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<sup>64</sup> *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997); *Phillips v. U.S.*, 73 F.3d 939, 943 (9th Cir. 1996). See also Corrie Lynn Lyle, *The Wrath of IRC § 6672: The Renewed Call for Change – Is Anyone Listening? If You Are a Corporate Official, You Had Better Be*, 74 S. Cal. L. Rev. 1133 (May 2001).

<sup>65</sup> See, *Baimbridge v. U.S.*, 335 F. Supp. 2d 1084 (S.D. Cal. 2004) (“[S]erious injustice may result from a penalty assessment being predicated on non-IRS payments which were contemplated by the installment agreement”).

<sup>66</sup> Similar to the IRC § 7122(d)(2) requirement for allowable living expenses (ALE) analysis, the IRS should base its determination of minimal working capital needs on a thorough analysis of all facts and circumstances of each taxpayer and ensure that its determination will not leave the taxpayer without adequate funds to meet its basic operating expenses, including current and future tax obligations. The ALE standards are only applicable to individuals. IRM 5.15.1.7 (Oct. 2, 2009).

**A. By Differentiating the Types of Noncompliance, the IRS Would be Better Able to Apply Appropriate Treatments to Small Businesses.**

To apply the correct treatment for noncompliance, it is essential that the IRS understand the business's needs, vulnerabilities, and reasons for noncompliance. IRS collection practices involving small businesses make little or no distinction between "start-up" businesses, those that have been chronically delinquent, and those that have longstanding histories of successful operation and tax compliance prior to their current delinquencies. Particularly in the latter category, IRS collection policies and procedures provide little direction or flexibility to recognize that the long-term survival of these businesses represents a "win-win" outcome for both the small businesses and the U.S. government: more revenue, more jobs, and more contributions to the nation's economy. Especially in light of the recent recession, the IRS needs to adjust its collection practices to provide a potentially viable small business with a fair opportunity to resolve an outstanding tax debt in a manner that allows the business to survive.

**B. Early Intervention Is Key to Assisting Small Businesses Facing Compliance Issues.**

A study conducted by the Bureau of Labor Statistics in 2005 concluded that approximately a third of newly-established small businesses fail within two years of start-up, and over half fail within four years.<sup>67</sup> Considering this high failure rate, tax debt problems involving small business taxpayers, *e.g.*, late federal tax deposits, unfiled returns, or returns filed with balances due, are clear warning signs of high-risk collection cases. However, IRS collection practices routinely fail to recognize these "red flag" conditions, and consequently do not provide early intervention in small business tax cases at the point when IRS actions can best correct taxpayer behavior, as well as collect the delinquent revenue.

The FTD Alert is a collection tool that "alerts" the IRS to taxpayers that appear to be falling behind on their federal tax deposits (FTDs), but the IRS rarely uses this tool to proactively contact small business taxpayers before employment tax debts materialize. In fiscal year 2010, the IRS invested only 0.4 percent of the Collection resources devoted to the collection of delinquent accounts (Taxpayer Delinquent Accounts or TDAs) into the FTD Alert program.<sup>68</sup>

The collection process does not provide adequate attention to business-related (BMF) tax debts until they "pyramid" into substantial amounts.<sup>69</sup> The majority of unresolved

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<sup>67</sup> Bureau of Labor Statistics, Monthly Labor Review, Vol. 128, No. 5, *Survival and Longevity in the Business Employment Dynamics Data*, 51 (May 2005).

<sup>68</sup> IRS, Collection Activity Report, NO-5000-23, *Collection Workload Indicators* (Oct. 2010), TDA Cumulative Report No 5000-23 Mth 092010, page 0001.

<sup>69</sup> For example, in FY 2010, 24 percent of the BMF notices that the IRS considered "closed" were actually "deferred," a closing status indicating the dollar amounts of the delinquencies did not (yet) warrant the use

BMF notices that are selected for collection action as delinquent accounts are assigned initially to the Automated Collection System (ACS), which is not successful in resolving most business cases.<sup>70</sup> The time these cases spend in the ACS, and later the Queue, does not improve the collectability of these accounts, or allow the IRS to intervene when the taxpayer could most benefit from a contact.

At focus groups conducted at the 2009 IRS Nationwide Tax Forums, when tax practitioners were asked to identify actions the IRS could take to help small business taxpayers, one of the main strategies recommended was “the need for the IRS to react faster.” Participants stated, “The main problem is that many taxpayers are buried too deep by the time the IRS gets involved.”<sup>71</sup> In FY 2010, the typical BMF case assignment for the Collection Field function involved 5.6 delinquent accounts per business taxpayer.<sup>72</sup> It appears that the typical business case that the IRS believes warrants a field contact has already accumulated two years of employment tax delinquencies before a face-to-face contact is even attempted.<sup>73</sup> By this time, unfortunately, many of these small business taxpayers are “buried too deep” to effect a successful resolution of their tax debt.

At this stage, the IRS generally uses tax liens, levies, seizures, and the Trust Fund Recovery Penalty to collect as much of the delinquency as possible. In fact, between FY 2006 and 2010, the IRS’s use of liens and levies and the assessment of TFRPs increased substantially.<sup>74</sup> While the TFRP can be useful in certain situations, the increased emphasis on routinely making trust fund penalty determinations early in the collection process does not appear to be an efficient treatment for employment tax deficiencies. From FY 2006 to 2010, the dollar value of new TFRP delinquent accounts

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of additional Collection resources. IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

<sup>70</sup> For example, in FY 2010, while ACS collected \$557 million on business tax delinquencies, over \$23 billion was transferred to the Collection Queue, awaiting assignment to the Collection Field function (CFf) – approximately 42 times the amount collected! IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>71</sup> IRS, SB/SE Research, *Your Clients and the Economy – How Can the IRS Help*, 4 (Jan. 2010).

<sup>72</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>73</sup> Of the BMF Trust Fund notices that were not resolved in the notice stream during FY 2010, approximately 23 percent were “closed” as “deferred” accounts, *i.e.*, due to the relatively small dollar amounts of the delinquencies, the IRS systemically determined to not pursue them as TDAs. IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

<sup>74</sup> From FYs 2006 to 2010, the issuance of Notices of Federal Tax Lien (NFTLs) increased by 55 percent, while the levies issued rose 172 percent. IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010). In fiscal year 2006, the IRS CFf issued 245,757 levies and 348,888 NFTLs. These numbers have increased each year through FY 2010, when 542,045 NFTLs were filed and 667,322 levies were issued by the CFf. Additionally, TFRP assessments issued as delinquent accounts increased by 52 percent during this five-year period. IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

has increased by 30 percent, but dollars collected (including refund offsets) on these accounts have *declined by 23 percent*.<sup>75</sup> In general, the IRS collects very few of the dollars it assesses through TFRPs.<sup>76</sup>

### **C. The Use of Flexible Collection Tools Would Help Small Businesses to Come into Compliance.**

On the other hand, more flexible collection tools, such as installment agreements (IAs) and offers in compromise (OICs) are infrequently used by the IRS to resolve business-related tax delinquencies. For example, in FY 2010, the IRS approved only about 95,000 installment agreements involving tax debts for business taxpayers, even though it issued approximately 5.4 million initial collection notices during the year, and approximately 2.5 million delinquent accounts were in open status at year-end.<sup>77</sup> In addition, the IRS accepted less than 14,000 offers in FY 2010.<sup>78</sup> The process the IRS uses to consider an OIC on business tax debts makes it exceptionally difficult for a small business taxpayer to qualify for an offer without liquidating the business.<sup>79</sup>

### **D. Economic Hardship Safeguards that Currently Apply Only to Individuals Should Also Apply to Small Business Taxpayers.**

Statutory and administrative provisions that safeguard against some IRS collection actions by taking the taxpayer's economic hardship into account do not apply to business taxpayers. For example:

- IRC § 6343 requires the IRS to release a levy that is causing an economic hardship due to the financial condition of the taxpayer;<sup>80</sup>
- Pursuant to IRC § 7122, Treasury regulations permit the IRS to enter into an effective tax administration offer in compromise where the taxpayer's liability could be collected in full but collection would create an economic hardship;<sup>81</sup> and

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<sup>75</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010). Excluding refund offsets, dollars collected on TFRP TDAs have declined by 45 percent from FY 2006 to FY 2010.

<sup>76</sup> IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

<sup>77</sup> IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010); IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010); TDA Cumulative Report No 5000-6 FY 2010, page 1079 (The data cited herein relate to Business Master File Accounts).

<sup>78</sup> IRS, Collection Activity Report, NO-5000-108, *Offer in Compromise Activity Report* (Oct. 2010).

<sup>79</sup> See IRM 5.8.5, *Offer in Compromise, Financial Analysis* for more detail on this matter.

<sup>80</sup> IRC § 6343(a)(1)(D). Treas. Reg. § 301.6343-1(b)(4) provides that economic hardship is present “if satisfaction of the levy in whole or in part will cause an *individual* taxpayer to be unable to pay his or her reasonable basic living expenses.” (Emphasis added.)



- The IRS may remove taxpayers' accounts from active inventory and report them as Currently Not Collectible (CNC) where collection of the liability would create a hardship for the taxpayers by leaving them unable to meet necessary living expenses.<sup>82</sup>

Because all of these provisions define hardship with reference to a Treasury Regulation applicable only to *individual* taxpayers, none of them is available to business taxpayers.<sup>83</sup> Allowing the IRS to consider, when it commences collection activity against a small business, whether the *business* is in economic hardship would put small businesses on the same footing as individuals. We acknowledge that this is a delicate issue, but we believe, although difficult, it is possible to develop an approach that addresses these concerns fairly.

#### **IV. Conclusion: Tax Reform Can and Should Reduce the Costs of Small Business Tax Compliance.**

For all the reasons described above, I believe that fundamental tax reform must be made a priority. However, in order to be effective and far-reaching, such fundamental tax reform should include *both* corporate tax reform *and* individual tax reform. Focusing only on corporate tax reform would ignore the fact that a substantial number of businesses – both incorporated and unincorporated – are pass-through entities and therefore, a real reduction in complexity and taxpayer burden *will not occur* unless individual tax reform occurs at the same time as corporate tax reform.<sup>84</sup>

A simpler, more transparent tax code will substantially reduce the costs of tax compliance for small businesses; increase the likelihood that taxpayers will claim all tax benefits to which they are entitled; reduce the likelihood that more sophisticated taxpayers can exploit arcane provisions to avoid paying their fair share of tax; improve

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<sup>81</sup> Treas. Reg. § 301.7122-1(b)(3), providing that economic hardship is defined by Treas. Reg. § 301.6343-1(b)(4); IRM 5.8.11.2.1 (Sept. 23, 2008). Treasury considered allowing businesses to enter into an offer in compromise based on effective tax administration and economic hardship, but ultimately concluded that it did not necessarily promote effective tax administration. T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble).

<sup>82</sup> IRM 5.16.1.1 (June 29, 2010). IRM 5.15.1 (Oct. 2, 2010) refers employees to Treas. Reg. § 301.6343-1(b)(4) in analyzing a taxpayer's financial condition.

<sup>83</sup> IRM 5.8.11.2.1(2) (Sept. 23, 2008) provides: "Note: Because economic hardship is defined as the inability to meet reasonable basic living expenses, it applies only to individuals (including sole proprietorship entities). Compromise on economic hardship grounds is not available to corporations, partnerships, or other non-individual entities." (Emphasis in original.) IRM 5.16.1.1 (June 29, 2010) provides: "**Reminder:** Hardship closing codes can **only** be used for individual or joint IMF assessments, sole proprietorships, general partnerships, and LLCs where an individual owner is identified as the liable taxpayer." (Emphasis in original).

<sup>84</sup> In calendar year 2010, 3.4 million Forms 1065 and 1065B were filed and 4.5 million Forms 1120S were filed. IRS Document 6149, 2010 Update: Calendar Year Return Projections by State CY 2010 -2017 (Nov. 2010).

taxpayer morale and tax compliance; and enable the IRS to administer the tax system more effectively and better meet small business taxpayers' needs.