

**WRITTEN STATEMENT OF NINA E. OLSON
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BEFORE THE

**COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES**

ON

TAX BURDENS FACING SMALL BUSINESSES

SEPTEMBER 21, 2005

Mr. Chairman and distinguished Members of the Committee:

Thank you for inviting me to testify today about tax burdens facing small businesses and proposals to reduce these burdens through changes to the Internal Revenue Code. I commend Chairman Manzullo for introducing The Small Employer Tax Relief Act of 2005, which contains a number of proposals that I have long advocated and believe would benefit small businesses considerably. (I discuss these proposals in more detail below). All businesses bear heavy burdens in complying with the tax code. Large corporations, however, can hire sophisticated law and accounting firms to handle the complex provisions affecting business taxpayers. Small business owners, on the other hand, generally must comply with both individual and business tax provisions, often with little or no professional assistance.

For many small business owners, tax issues are the single most significant set of regulatory burdens.¹ While some of these rules and regulations are unavoidable, Congress should periodically review the tax rules applicable to small businesses to ensure that they are narrowly tailored to accomplish their objectives and do not require small business owners to jump through unnecessary hoops. Moreover, the IRS should periodically review its compliance strategies to ensure that small business initiatives are appropriately designed for the problem they seek to address. Thus, to increase voluntary compliance in the small business sector, the IRS must make it easier for these taxpayers to comply. It must use education, assistance, and innovation, as well as traditional audit and collection techniques.

Before addressing the specifics of the bill, I will briefly describe the functions of my office, the problems we see that most affect small businesses, and how we can assist small businesses.

¹ See National Taxpayer Advocate 2004 Annual Report to Congress at 386-87.

The Office of the Taxpayer Advocate

Congress greatly expanded the authority of the Office of the Taxpayer Advocate and the National Taxpayer Advocate in the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).² By statute, the Office of the Taxpayer Advocate assists taxpayers in resolving their problems with the IRS and identifies both administrative and legislative proposals that might mitigate those problems.³ The mission of the Taxpayer Advocate Service (TAS) states this clearly: “As an independent organization within the IRS, we help taxpayers resolve problems with the IRS and recommend changes that will prevent problems.”

This dual mission is supported by two organizational components within TAS. The first component is Case Advocacy, which deals with problems faced by specific individual and business taxpayers. Congress has mandated that there be at least one Local Taxpayer Advocate (LTA) in each state.⁴ LTAs and the Case Advocates on their staffs assist in resolving specific taxpayer problems, ranging from simple IRS processing errors or delays to complex examinations and appeals. Any individual or business taxpayer having difficulty resolving a problem through normal IRS channels may, subject to certain criteria, obtain assistance from the Taxpayer Advocate Service. Taxpayers may contact their local taxpayer advocate (telephone numbers are listed in the Blue Pages of the phone book and in IRS Publication 1546, How to Get Help With Unresolved Tax Problems) or call 1-877-777-4778.

The other component of TAS is Systemic Advocacy. The goal of our Systemic Advocacy function is to identify issues that unduly burden groups or segments of individual and/or business taxpayers, and develop solutions to those problems. We receive hundreds of suggestions every year from inside and outside the IRS. Taxpayers may submit systemic issues to us through our website, <http://www.irs.gov/advocate>.

The National Taxpayer Advocate is required by statute to provide two annual reports directly to Congress, without any prior review by the Commissioner, the Department of the Treasury, the Office of Management and Budget, or the IRS Oversight Board.⁵ Through these reports, we generally address the proposals to which we assign the highest priority. The December 31st report comprises three major sections that:

- Identify at least 20 of the most serious problems facing individual and business taxpayers.

² Pub. L. No. 105-206 (1998).

³ IRC § 7803(c)(2)(A).

⁴ IRC § 7803(c)(2)(D)(i)(1).

⁵ IRC § 7803(c)(2)(B).

- Recommend legislative proposals to resolve significant taxpayer problems, address inequities in the law, or simplify the administration of the tax laws.
- Discuss the ten most litigated tax issues, analyze trends, and identify approaches that might prevent the need for litigation.

Tax Problems of Small Business

Through June of 2005, small business cases accounted for 39.6 percent (or 55,143) of TAS' total case closures for fiscal year 2005. Of these cases, 80.2 percent came into TAS because of systemic problems, most notably delays, rather than because the taxpayer experienced economic hardships. Table 1 shows the top ten issues identified in TAS cases encountered by small business and self-employed (SB/SE) taxpayers for fiscal year 2005 through June 2005, and the percentage of those cases in which TAS was able to provide either full or partial relief.

TABLE 1, SMALL BUSINESS / SELF-EMPLOYED TAXPAYER ISSUES IN TAS FOR FISCAL YEAR 2005 THROUGH JUNE 2005

Core Issue Description	Volume	% of Total SB/SE Cases	% Where Relief Provided
Criminal Investigation	4,711	8.5%	48.4%
Processing amended returns	3,477	6.3%	75.3%
Levy	3,075	5.6%	60.8%
Processing original returns	2,477	4.5%	83.2%
Audit Reconsideration/Substitute for Return (SFR)	2,395	4.3%	66.8%
Open audit	2,219	3.9%	64.1%
Failure to File (FTF) / Failure to Pay (FTP) penalties	1,790	3.2%	77.0%
Revenue protection strategy (Earned Income Tax Credit (EITC) claims)	1,713	3.1%	52.0%
Missing/incorrect payments	1,555	2.8%	79.4%
Combined Annual Wage Reconciliation (CAWR)/ Federal Unemployment Tax Act (FUTA)	1,514	2.7%	82.6%

Since I became the National Taxpayer Advocate four years ago, I have identified a number of issues affecting small businesses in my reports to Congress. Many of these issues are reflected in TAS' case inventory. Some of the problems I have addressed include:

- The Confounding Complexity of the Tax Code⁶ – In my most recent Annual Report to Congress, I identified Internal Revenue Code complexity as the

⁶ National Taxpayer Advocate 2004 Annual Report to Congress at 2-7.

most serious problem facing taxpayers (and the IRS). For example, business taxpayers must grapple with a patchwork of rules that cover such items as the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and vague factors that govern the classification of workers as either employees or independent contractors.

- Education and Outreach Efforts⁷ – Tax law and administrative complexity can baffle all taxpayers and lead to compliance problems. Small Business taxpayers cannot always afford sophisticated professional tax advice. These taxpayers need IRS help and assistance in understanding and complying with their tax obligations. I am concerned that inadequate IRS taxpayer education efforts may significantly affect compliance in this complex environment. It is unclear whether changes in the IRS Small Business/Self-Employed Division's Taxpayer Education and Communication (TEC) program will lead to the right kind of outreach and education.
- IRS Customer Service and Access⁸ – As the IRS has increased enforcement efforts, my office has observed a corresponding decrease in certain taxpayer services. Examples include the elimination of telefile, which was the only free method for electronically filing employment tax returns (Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return); the elimination of Electronic Tax Law Assistance (ETLA), which could be developed into a self-help tool accessible to small business owners; the reduction in questions answered in walk-in sites, many of which are small business oriented; and the potential closing of Taxpayer Assistance Centers (TACs).
- IRS Examination and Collection Strategies⁹ – As the IRS increases its enforcement activities, I am concerned that the IRS does not have sufficient information and research to determine how best to allocate its resources between examination, collection, and taxpayer service. Nor do we know the right approach, including taxpayer service, for the particular type of taxpayer. Because business taxpayers have frequent dealings with the IRS, IRS' focus will significantly impact these taxpayers.
- Navigating the IRS¹⁰ – In fulfilling their tax obligations, small business owners have multiple contacts with the IRS. Business taxpayers file employment and excise tax returns in addition to income tax returns. They also are required to make employment tax deposits and file information returns such as Forms W-2 and 1099. Finding the right IRS employee to address a particular

⁷ National Taxpayer Advocate 2004 Annual Report to Congress at 51-66.

⁸ National Taxpayer Advocate 2004 Annual Report to Congress at 8-42.

⁹ National Taxpayer Advocate 2004 Annual Report to Congress at 211-245.

¹⁰ National Taxpayer Advocate 2003 Annual Report to Congress at 122-134; 2002 Annual Report to Congress at 7-14.

problem, or finding the program “owner” to point out program failure and discuss improvements, is often a difficult task.

- Processing of Offer-in-Compromise Cases – My office has identified numerous problems with this program in past reports to Congress.¹¹ If the continuing problems with this program are resolved, the offer-in-compromise option can be helpful to small business taxpayers who fall behind on their income, payroll or self-employment tax deposits and payments and who are attempting to become compliant and get a “fresh start”.
- Collection Due Process (CDP)¹² – The CDP process is relatively new to the IRS, but a backlog of cases has nevertheless grown very quickly.¹³ Established by RRA 98, it allows taxpayers an opportunity to have a hearing before an independent Appeals Officer to explore alternatives to proposed collection levies or the filing of a notice of federal tax lien. The effective implementation of this program in accordance with the intent of RRA 98 remains a concern to me. My office will continue to monitor CDP case timeliness, processes, and procedures to ensure that taxpayers understand the available collection alternatives and have a meaningful opportunity to raise them.
- Federal Tax Deposits (FTD)¹⁴ – The IRS assesses a large number of penalties when taxpayers fail to make employment tax deposits when due or in the correct manner,¹⁵ but the rules are complicated and may change during the life of a business. For small businesses, these penalties can be very severe and potentially impact their ability to continue operations. My office is continuing to monitor this problem. Currently, the IRS assesses FTD penalties against one out of 16 employment tax returns, yet it later abates more than 60 percent of the total amount originally assessed.¹⁶

¹¹ National Taxpayer Advocate 2004 Annual Report to Congress at 311-341 and 433-450; 2003 Annual Report to Congress at 99-112; 2002 Annual Report to Congress at 15-24; 2001 Annual Report to Congress at 46-48 & 52-54

¹² National Taxpayer Advocate 2004 Annual Report to Congress at 451-470 and 2002 Annual Report to Congress at 110-115.

¹³ Appeals had 18,732 Collection Due Process cases in inventory on Sept. 30, 2004, with 25 percent in process for over 6 months. See Appeals Inventory Report (AIR) for period ending Sept. 30, 2004.

¹⁴ National Taxpayer Advocate 2003 Annual Report to Congress at 197-205.

¹⁵ In fiscal year 2004, the IRS assessed 2,313,900 Employment Tax Federal Tax Deposits Penalties involving \$3,722,213 and abated 536,873 Employment Tax Federal Deposit Penalties involving \$2,270,799. IRS Data Book 2004, Table 27 - Civil Penalties Assessed and Abated by Type of Penalty and Type of Tax, at 45.

¹⁶ TIGTA, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments*, Ref. No. 2004-30016 (Sept. 2005), at 4; IRS Data Book 2004, Table 27 (Civil Penalties Assessed and Abated by Type of Penalty and Type of Tax), at 45.

- Obtaining an Employer Identification Number (EIN)¹⁷ – Acquiring an EIN is a crucial first step for new businesses. Historically, taxpayers encountered delays in obtaining an EIN. In response, the IRS developed a method for businesses to obtain identification numbers directly from the IRS website.¹⁸ The taxpayer completes an application form online and the system issues an EIN immediately. This approach is a significant improvement that will benefit business taxpayers, and I commend the IRS for developing this long-needed automated application program.
- Missing/Incorrect Payments¹⁹ – Missing or incorrect payments impose additional burdens on business and individual taxpayers, requiring them to substantiate their payments, often repeatedly. Through June of fiscal year 2005, TAS closed 4,792 cases involving problems with missing or incorrect payment and credit issues.
- Combined Annual Wage Reporting (CAWR) Reconciliation²⁰ – The IRS and the Social Security Administration (SSA) jointly administer the CAWR program, which matches earning and withholding statements from Form 941 (Employer’s Quarterly Tax Return) and Form W-2 (Wage and Earnings Statements) for each employee and Form W-3 (Transmittal of Income Tax Statements). Ideally, all information reported on Form 941 should match the information on Forms W-2 for a given year, but this is not always the case. The IRS and SSA try to resolve discrepancies and may contact the employer. If the employer does not respond or does not file the correct forms, the IRS can assess a penalty against the employer for intentionally disregarding its filing requirements. In FY 2004, the IRS assessed 91,602 CAWR related penalties totaling about \$2.2 billion, while abating 28,347 of these penalties totaling nearly \$1.4 billion (31 percent of total assessments and 64 percent of total dollars assessed).²¹ The frequent abatement of penalties indicates a serious problem with the administration of this program that adversely and unnecessarily affects small business.

¹⁷ National Taxpayer Advocate 2001 Annual Report to Congress at 43-45.

¹⁸ IRS News Release IR-2003-77 (June 13, 2003).

¹⁹ National Taxpayer Advocate 2002 Annual Report to Congress at 147-149.

²⁰ National Taxpayer Advocate 2003 Annual Report to Congress at 220-226.

²¹ IRC § 6721(e) data as of Sept. 30, 2004 for Intentional Disregard Penalty (penalty reference code 549) from IRS Office of Enforcement Revenue Information System (ERIS). ERIS captures data on civil monetary penalties. The total numbers above include penalties assessed by the IRS Large and Mid-Sized Business (LMSB), Small Business/Self-Employed (SBSE) and Tax Exempt and Governmental Entities (TEGE) divisions. SBSE accounted for 83,941 of the assessed penalties and \$841.6 million of total dollars assessed; and 25,474 of the abatements and \$439.4 million of total dollars abated. Thus, the IRS SBSE division abated 30 percent of total assessments and 52 percent of total assessed dollars.

TAS Small Business Outreach

In addition to helping small business taxpayers resolve problems, TAS also reaches out to these taxpayers to improve their awareness of our services. In 2004, TAS created IRS Publication 4295, TAS Small Business Pamphlet, which specifically promotes TAS services to small business. Small business outreach is also among the primary objectives for Local Taxpayer Advocates throughout the year. During fiscal year 2005, LTAs have made approximately 400 contacts to small business markets. These contacts include small business associations, individual businesses, and participation at small business conventions reaching almost 200,000 small business stakeholders. Some examples of these local efforts include:

- A Local Taxpayer Advocate office coordinated with the local Small Business Administration office to have TAS information included in the Small Business Resource Guide on a permanent basis.
- LTAs contacted Small Business Development Centers and had TAS literature distributed to their field offices in certain states.
- LTAs attended Small Business Expos, Entrepreneurial Expos, Minority Small Business Expos, and Small Business Development Days throughout the country.

On a national level, TAS has developed and maintained a strong and positive partnership with the Small Business Administration (SBA) over the last several years. TAS provides a representative at all SBA Regulatory Fairness Hearings. These hearings provide a public forum for small business owners and trade associations to bring their concerns to top officials in Federal, state and local government agencies. In FY 2005, TAS participated in the SBA's Small Business Expo, a three-day event that brings together current and prospective small business owners, corporations, trade associations, Federal and other government employees, and community leaders to champion the development and growth of small businesses.

Small business taxpayers submit complaints regarding IRS enforcement actions to the SBA's Ombudsman in accordance with the Small Business and Agricultural Regulatory Enforcement Fairness Act of 1996.²² TAS works these cases to ensure an independent review of IRS actions is completed. TAS is able to advocate and provide assistance once the taxpayer provides proper authorization. We issue a comprehensive report and analysis of each case to the SBA Ombudsman after TAS reviews the case and takes all appropriate actions to address the taxpayer's concerns. TAS received two new Small Business Regulatory Enforcement Fairness Act (SBREFA) cases through the second quarter of FY 2005 and currently has 17 open cases.

²² Pub. L. No. 104-121 § 222 (1996).

The Small Business Administration's National Ombudsman recently gave the IRS an overall rating of A-, and an A+ in quality of response based on the advocacy and casework provided by TAS in FY 2004. The IRS is one of only two federal agencies that received A+ ratings. The SBA commended TAS for resolving small business taxpayer issues.²³

Legislative Recommendations Affecting Small Business

In the four year-end reports I have submitted to Congress since becoming National Taxpayer Advocate in 2001, I have made several legislative recommendations that would, if enacted, assist small businesses. I am pleased to note that The Small Employer Tax Relief Act of 2005 contains provisions identical or similar to five of my previous recommendations:

Married Couples as Business Co-Owners²⁴

An unincorporated business jointly owned by a married couple is classified as a partnership for federal income tax purposes.²⁵ As such, the business is subject to complex record-keeping requirements and must file a partnership income tax return (Form 1065, U.S. Return of Partnership Income).

In practice, most couples merely report their business income on one spouse's sole proprietorship return. As a result, that spouse alone receives credit for purposes of Social Security and Medicare. The spouse for whom no earned income is reported (the "ineligible spouse") does not receive credit for paying Social Security or Medicare tax. In the event of disability, the ineligible spouse would not qualify for Social Security disability or Medicare benefits. In the event of the death of the ineligible spouse, the surviving spouse and children would not qualify for Social Security benefits.

To address these problems, I recommend that IRC § 761(a) be amended to allow a married couple operating a business as co-owners to elect out of subchapter K²⁶ of the Internal Revenue Code. This election permits the taxpayer to file one Schedule C (Profit or Loss from Business (Sole Proprietorship)), or one Schedule F (Profit or Loss From Farming) in the case of a farming business, and two Schedules SE (Self-Employment Tax) if:

- All of the capital and profits interests in the partnership are owned by two individuals who are married to each other; and

²³ U.S. Small Business Administration 2004 National Ombudsman Report to Congress, 11-12.

²⁴ See National Taxpayer Advocate 2004 Annual Report to Congress at 401-402 and 2002 Annual Report to Congress at 172-184. See also H.R. 1528 § 308, 108th Cong. (2003).

²⁵ IRC § 761(a).

²⁶ Subchapter K is a portion of the Internal Revenue Code that contains rules and regulations governing the taxation of partnerships.

- The couple files a joint return for all taxable years that includes the items of the partnership, provided that the couple maintains adequate records to substantiate their respective interests.

I also recommend that IRC § 6017 be amended to provide that each spouse who operates an unincorporated business solely with his or her spouse as co-owner would file a separate schedule SE if the couple makes the election described above. Because more than 99 percent of all sole proprietorship and farm schedules report income below the Social Security wage cap²⁷ and because my proposal would make this provision elective, few couples would experience a tax increase as a result of this recommendation, yet many would benefit from Social Security and Medicare eligibility.²⁸

Election to be Treated as an S Corporation²⁹

Subchapter S of the Internal Revenue Code provides for the taxation of closely held incorporated businesses, including the pass-through reporting of certain items to shareholders. To be treated as an S corporation, an incorporated business otherwise meeting the eligibility criteria must make an election on the prescribed form on or before the 15th day of the 3rd month of its tax year. If this election is not made by the statutory date, it is deemed made solely for the succeeding years unless the Secretary determines that there was reasonable cause for the failure to make a timely election.³⁰

I believe that the due date for filing an S election is counterintuitive and therefore leads to taxpayer confusion and missed deadlines. It does not coincide with any other tax filing due date. Thus, when a small business corporation files a Form 1120S (U.S. Income Tax Return for an S Corporation) for its first year without having made a timely election, the IRS treats the corporation return as that of a regular corporation and assesses tax against the corporation on that basis.

After processing the return as a regular corporate tax return, the IRS provides the corporation with the opportunity to prove that it had timely filed Form 2553, Election By a Small Business Corporation. If the corporation did not file a timely election, it may submit a private letter ruling (PLR) request (or, in certain circumstances a request under Rev. Proc. 2003-43³¹) to the IRS Office of Chief Counsel seeking a reasonable cause determination for its late filing.

²⁷ See IRS Compliance Data Warehouse, Individual Returns Transaction File for Tax Year 2003, which contains the most recent filing data. The Social Security wage base limitation for 2005 is \$90,000.

²⁸ Social Security Survivors Benefits, Publication No. 05-10084, May 2004; Social Security = Understanding the Benefits, Publication No.05-10024, January 2005; Social Security Administration: What Every Woman Should Know, Publication No. 05-10127, April 2003.

²⁹ See National Taxpayer Advocate 2004 Annual Report to Congress at 390-393; 2002 Annual Report to Congress at 246.

³⁰ IRC § 1362 (b)(1)(B).

³¹ 2003-1 C.B. 998.

To address the situation described above, I recommend that Congress amend IRC § 1362(b)(1)(B) to allow a small business corporation to elect to be treated as an S corporation in conjunction with the filing of its first Form 1120S return. This recommendation would reduce taxpayer burden and controversy by aligning the act of making the election with the significant due date of filing the first corporate income tax return.

Health Insurance Deductions for Self-Employed Individuals³²

Internal Revenue Code § 162(l)(4) disallows a deduction for the cost of health insurance in computing the net earnings of a sole proprietor for self-employment tax purposes. Under present law, self-employed individuals do not enjoy the same tax advantages for health insurance as wage earners. While many wage earners can participate in benefit plans that allow them to pay for their health insurance with pre-tax dollars, self-employed individuals cannot. Self-employed individuals can only reduce their taxable income by the cost of their health insurance and must pay self-employment tax at the rate of 15.3 percent on this amount.³³ Wage earners who participate in pre-tax plans do not pay Social Security tax on their health insurance payments.

On consistency and equity grounds, I recommend that IRC § 162(l)(4) be repealed to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment.

Federal Tax Deposit (FTD) Avoidance Penalty³⁴

Internal Revenue Code § 6656 imposes a penalty on employers who fail to deposit employment taxes (*i.e.*, withheld income taxes, Federal Insurance Contribution Act (FICA) taxes, and Federal Unemployment Act (FUTA) taxes) within the time and in the proper manner described in IRC § 6302 and the applicable regulations, unless the taxpayer can show that the failure was due to reasonable cause and not due to willful neglect. The FTD penalty ranges from two percent to ten percent of the underpayment, depending on how late the required deposit is made. The complexity of the FTD rules and regulations can cause taxpayers to be subject to FTD penalties for failing to make deposits in the required manner even when their deposits are timely and the taxpayers are making an honest attempt to comply with the complex deposit rules.

To alleviate this overly harsh penalty burden on employers, I recommend that IRC § 6656 be amended to clarify that: (1) the reasonable cause exception to the FTD penalty shall specifically apply to instances where a taxpayer has made a timely deposit, but failed to make the deposit in the prescribed manner and such

³² See National Taxpayer Advocate 2004 Annual Report to Congress at 388-389; 2001 Annual Report to Congress at 223. See also H.R. 1873, 108th Cong. (2003).

³³ IRC § 1401.

³⁴ See National Taxpayer Advocate 2004 Annual Report to Congress at 400; 2001 Annual Report to Congress at 222. See also, H.R. 1528 § 108, 108th Cong. (2003).

failure was not due to willful neglect; and (2) in no circumstance shall the FTD penalty exceed two percent of the underpayment amount when a taxpayer has made a timely deposit, but failed only to make the deposit in the prescribed manner.

This proposal would reduce from ten percent to two percent the penalty rate for failure to make a deposit in the prescribed manner and thus reduce burdens on taxpayers who have demonstrated a reasonable attempt to comply with the complicated FTD rules.

Alternative Minimum Tax (AMT) for Individuals³⁵

The individual alternative minimum tax (AMT) is a parallel and complex tax structure imposed on top of the regular tax structure. Although the individual AMT does not affect small business directly, it can significantly impact small business owners or self-employed individuals. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through tax avoidance transactions, it now affects large groups of middle-class taxpayers with no tax avoidance motives at all. Many taxpayers are subject to the AMT simply because they have children or live in a high-tax state.

The AMT ensnares an ever-growing number of taxpayers because the amount of income exempt from the AMT is not indexed for inflation. When Congress first enacted a minimum tax in 1969, this “exemption amount” was \$30,000 for all taxpayers. Had it been indexed, this amount would equal about \$153,500 today.³⁶ Instead, the exemption amount, after a temporary increase that expires after 2005, is \$45,000 for married taxpayers and \$33,750 for most others³⁷ As a result, it is now projected that in 2010, 34.8 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the AMT.³⁸ Among the categories of taxpayers hardest hit, 89 percent of married couples with adjusted gross income (AGI) between \$75,000 and \$100,000 and with two or more children will owe AMT.³⁹

³⁵ See National Taxpayer Advocate 2004 Annual Report to Congress, at 383-385; 2003 Annual Report to Congress at 5-19. See also H.R. 1103, 109th Cong. (2005).

³⁶ Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Nov. 17, 2004). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above \$200,000 had paid no federal income tax for the 1966 tax year. See The 1969 Economic Report of the President: Hearings before the Joint Economic Comm., 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has more than quintupled since 1966, so the kinds of taxpayers who caught Congress’ attention back then would be making over \$1.16 million today. See Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Nov. 17, 2004). Yet the AMT today is not primarily affecting taxpayers with incomes over \$1.16 million. By 2010, it has been estimated that 83 percent of all taxpayers affected by the AMT will have incomes under \$200,000 – and 37 percent will have incomes under 100,000. See Leonard E. Burman et al., *The Individual Alternative Minimum Tax: A Data Update*, table 4 (Aug. 30, 2004) (accessible at 2004 TNT 175-15).

³⁷ IRC § 53(d).

³⁸ Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

³⁹ Leonard E. Burman et al., *The Expanding Reach of the Individual Alternative Minimum Tax*, *Journal of Economic Perspectives* 17 (2): 173-86 (Spring 2003) updated May 2005.

The burden that the AMT imposes is substantial. In dollar terms, the average AMT taxpayer owed an *additional* \$3,670 in tax for tax year 2003.⁴⁰ In terms of complexity and time, taxpayers often must complete a 12-line worksheet,⁴¹ read eight pages of instructions,⁴² and complete a 55-line form⁴³ simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners.⁴⁴

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. Many taxpayers are thus unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in those taxpayers being subject to penalties.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has evolved beyond its original purpose: it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is penalizing taxpayers for such non tax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

To do away with this unfair and complex parallel tax structure, I recommend that Congress repeal the AMT, or revamp it substantially to achieve its original objective.

In addition to the above proposals included in The Small Employer Tax Relief Act of 2005, I have also recommended the following proposals that, if enacted, would assist small business:

⁴⁰ Statistics of Income Spring Bulletin, 2005 Table 1.

⁴¹ 2004 Form 1040 Instructions at 35.

⁴² 2004 Form 6251 Instructions.

⁴³ 2004 Form 6251, Alternative Minimum Tax – Individuals.

⁴⁴ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2002).

Regulation of Unenrolled Return Preparers⁴⁵

Many taxpayers (including businesses) pay a third party to prepare their returns.⁴⁶ Of these paid preparers, only attorneys, certified public accountants, and enrolled agents are generally subject to regulation or oversight by the IRS or state licensing agencies.⁴⁷ Unlike the aforementioned (collectively known as “practitioners” because they are able to “practice” before the IRS⁴⁸), unenrolled return preparers are not required to demonstrate a minimum competency in the field of tax law, nor must they satisfy any continuing education requirements in order to prepare federal tax returns. Many pursue continuing education and are very competent, but some either lack or fail to maintain the required knowledge. Since the tax return represents a taxpayer’s entry point into the federal tax system, any errors on the return, however inadvertent or unintentional, can have serious consequences for taxpayers and the IRS in terms of money owed, time spent resolving the problems, and related adjustments in future years.

To illustrate the risks, let us suppose that a small business purchases \$100,000 worth of tangible personal property that qualifies for the IRC § 179 immediate-expensing deduction. If the small business engages an unenrolled return preparer who has not taken any continuing education on the new tax law, the preparer may not know how to elect the IRC § 179 deduction to which the taxpayer is entitled. The taxpayer would end up paying additional tax that could have been used instead to help grow the small business and hire additional employees.

To address this problem, I recommend that preparers who are not attorneys, certified public accountants, or enrolled agents and who prepare tax returns for a fee be required to register with the IRS and take an initial examination to demonstrate their competency to prepare either an individual or a business return. They should also be required to take either continuing professional education or testing annually and display a current certification card indicating their certified status.

Some may say such a certification requirement would be costly, and I acknowledge that there would be certain start-up and other expenses. However, our recommendation will not require a significant investment in enforcement personnel. I envision a consumer education campaign that utilizes paid advertising, outreach,

⁴⁵ See National Taxpayer Advocate 2003 Annual Report to Congress at 270-301; 2002 Annual Report to Congress, at 216-230. See also S. 832 § 4, 109th Cong. (2005).

⁴⁶ There were 130.6 million individual federal income tax returns filed in tax year 2003. Of those returns, 78.8 million (or 60 percent) were submitted by a tax return preparer. Statistics of Income Spring Bulletin, 2005.

⁴⁷ 31 C.F.R. part 10.

⁴⁸ Circular 230 defines “practice” before the IRS as comprehending all matter connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client’s rights, privileges or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the IRS, and representing a client at conferences, hearings and meetings.

and partnering with other organizations to deliver two simple messages to tax consumers, who will enforce the program through their market behavior:

- If you pay for tax preparation, ask to see the preparer's certification.
- If you pay for tax preparation, don't pay until you see the preparer's name, address, and certification on your tax return and on your copy.

I believe this recommendation is administratively practical and efficient. Ultimately, more accurately prepared returns will benefit small businesses and other taxpayers, and reduce the resources the IRS must devote to examining incorrect returns and collecting tax.

First-time Penalty Waiver (the so-called "one time stupid act" proposal)⁴⁹

Given the complexity of the law and the tax administration system, it is easy to see how taxpayers can make mistakes – even stupid ones. Penalties are designed to deter undesirable behavior, yet, what benefit is there to the government if it penalizes a taxpayer who would amend his ways merely through education and clarification? Thus, I propose that Congress authorize the Secretary to grant a one-time abatement of the failure-to-file and failure-to-pay penalties for taxpayers who have a history of compliance.

Current Advocacy Issues

TAS welcomes suggestions and recommendations for administrative and legislative changes. Many of the proposals discussed above originated from taxpayers, practitioners or IRS employees. To enhance our ability to identify taxpayer problems, our Office of Systemic Advocacy implemented the Systemic Advocacy Management System (SAMS) in 2003. SAMS is a project identification and workload delivery mechanism that provides both internal and external stakeholders, including small businesses, with a voice in the identification of advocacy issues. SAMS is used for trend analysis and as a project management system for Systemic Advocacy analysts.

The Office of Systemic Advocacy has received 309 suggestions pertaining to small business issues since the inception of SAMS, including 71 issues during the current fiscal year.⁵⁰ From these suggestions, TAS has developed 131 small business advocacy projects that help identify the most serious problems and legislative proposals that could potentially be included in the Annual Report to Congress.⁵¹

⁴⁹ See National Taxpayer Advocate 2001 Annual Report to Congress, at 188-192. See also H.R. 1528, sec. 106, 108th Cong. (2003).

⁵⁰ Through the 3rd quarter ending June 30, 2005.

⁵¹ Through the 3rd quarter ending June 30, 2005.

TAS is also currently studying a number of small business issues, including:

- The complex rules and regulations governing employment taxes and the failure to deposit (FTD) penalties;
- Power of Attorney (POA) requirements for business who use a CPA's or attorney's address as the main business mailing address; and
- Allowing small businesses to report employment taxes on Form 1040, as is done with respect to household employees.

Taxpayer Advocacy Panel (TAP)

The Taxpayer Advocacy Panel (TAP) provides another opportunity for citizen participation, including small business participation, in improving tax administration. Established under the Federal Advisory Committee Act (FACA), the TAP serves as a two-way conduit between the IRS and taxpayers. TAP members participate in IRS focus groups and issue committees, providing input on strategic initiatives. TAP members also hold public meetings that serve as a venue for collecting and addressing issues identified by citizens.

During 2005, the TAP made a number of recommendations on issues that impact small businesses, including:

- Form 1065 Schedule D Change. Form 1065, Schedule D (Capital Gains and Losses for Partnerships), allows only four lines to record short-term capital gains and losses, and another four lines to record long-term capital gains and losses. Additional transactions resulting in capital gain or loss are required to be reported on a supplemental sheet. The TAP recommended that additional lines be added to record both short-term and long-term transactions to alleviate the need for partnerships to attach a supplemental sheet to complete their tax return.
- EFTPS System Change. Tax professionals transmit quarterly estimated tax deposits to the IRS on behalf of taxpayers via the Electronic Federal Tax Payment System (EFTPS). When such payments are made in error, there are procedures to timely cancel the payment or obtain a refund, but many tax professionals are unaware of such procedures. The TAP recommended that the IRS add instructions to EFTPS brochures outlining remedies for taxpayers who make erroneous payments after the 48-hour cutoff.

The TAP also works closely with the IRS to develop and highlight national issues that incorporate concerns identified by small business owners through public meetings, toll-free calls, and the TAP website (www.improveirs.org).

I appreciate that you invited me to testify before you regarding tax burdens facing small businesses. I hope that my remarks prove helpful as you work on proposals to reduce these burdens through changes to the Internal Revenue Code.