

**Written Statement of**

**Nina E. Olson  
National Taxpayer Advocate**

**Before the**

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

**Hearing on**

**The Effects of Tax Compliance Initiatives on Small Business**

**April 5, 2006**

Mr. Chairman and distinguished Members of the Committee:

Thank you for inviting me to testify today about IRS enforcement and small business. I believe that small business is an essential component of the nation's economy. At the same time, small businesses bear a large share of regulatory burdens. And for many small business owners, tax issues are the single largest contributor to these regulatory burdens.<sup>1</sup> I commend Chairman Manzullo and this committee for introducing last year's Small Employer Tax Relief Act of 2005,<sup>2</sup> and thank you for the opportunity I was afforded to offer testimony on that legislation.

That bill contained several proposals that I have long advocated and believe would benefit small businesses considerably by helping to reduce certain tax burdens. These proposals include:

1. Amending the Internal Revenue Code (the Code) to allow married couples operating businesses as co-owners to elect out of the partnership provisions of the Code;<sup>3</sup>
2. Amending the code to allow a small business corporation to elect to be treated as a subchapter S corporation under the Code in conjunction with filing its first Form 1120S (U.S. Income Tax Return for an S Corporation);<sup>4</sup>
3. Repealing section 162(l)(4) of the Code to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment;<sup>5</sup>
4. Amending the Code to reduce or eliminate the Federal Tax Deposit avoidance penalty when a taxpayer has made a timely deposit but failed only to make such deposit in the prescribed manner,<sup>6</sup> and

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<sup>1</sup> See National Taxpayer Advocate 2004 Annual Report to Congress at 386-87.

<sup>2</sup> H.R. 3841, 109<sup>th</sup> Cong. (Sept. 21, 2005).

<sup>3</sup> See National Taxpayer Advocate 2004 Annual Report to Congress at 401-402 and 2002 Annual Report to Congress at 172-184.

<sup>4</sup> See National Taxpayer Advocate 2004 Annual Report to Congress at 390-393 and 2002 Annual Report to Congress at 246.

<sup>5</sup> See National Taxpayer Advocate 2004 Annual Report to Congress at 388-389 and 2001 Annual Report to Congress at 223.

<sup>6</sup> See National Taxpayer Advocate 2004 Annual Report to Congress at 400 and 2001 Annual Report to Congress at 222.

5. Repealing the alternative minimum tax (AMT) for individuals.<sup>7</sup>

In addition to these proposals, I have also recommended that Congress alleviate small business tax burdens by (1) regulating unenrolled return preparers to help ensure that small business tax returns are prepared accurately, which would serve to prevent the burdensome IRS administrative and enforcement procedures associated with incorrect returns,<sup>8</sup> and (2) authorizing the Secretary of the Treasury to grant a one-time abatement of the failure-to-file and failure-to-pay penalties for taxpayers who have a history of compliance.<sup>9</sup>

**The Office of the Taxpayer Advocate and Small Business**

As I testified last year, the Taxpayer Advocate Service (TAS), expends significant efforts to assist small businesses with their tax burdens and IRS entanglements. Through February of fiscal year 2006, small business cases accounted for 43.7 percent of TAS' total case closures. Of these cases, 79.5 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 2006 (through February 2006), 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 2006 THROUGH February 2006**

<b>Core Issue Description</b>	<b>% of Total SB/SE Cases</b>	<b>% Where Relief Provided</b>
Criminal Investigation	10.3%	60.8%
Levies	6.1%	61.0%
Processing amended returns	6.0%	77.5%
Audit Reconsideration/Substitute for Return (SFR)	5.2%	74.6%
Processing original returns	4.3%	82.5%
Open audit	3.4%	70.9%
Expedited refund requests	3.2%	55.6%
Missing/incorrect payments	3.1%	83.2%
Combined Annual Wage Reconciliation (CAWR)/ Federal Unemployment Tax Act (FUTA)	3.0%	86.1%
Failure to File/Failure to Pay penalties	2.7%	74.4%

<sup>7</sup> See National Taxpayer Advocate 2005 Annual Report to Congress at 375, 378; 2004 Annual Report to Congress at 383-385; and 2003 Annual Report to Congress at 5-19.

<sup>8</sup> See National Taxpayer Advocate 2003 Annual Report to Congress at 270-301 and 2002 Annual Report to Congress at 216-230.

<sup>9</sup> See National Taxpayer Advocate 2001 Annual Report to Congress at 188-192.

Since I became the National Taxpayer Advocate more than five 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:

- Training of Private Debt Collection Employees.<sup>10</sup> – This year, the IRS will begin using private debt collection agencies to collect tax delinquencies under the authority granted to it by the American Jobs Creation Act of 2004.<sup>11</sup> It is unclear whether the IRS intends to expand the Private Debt Collection (PDC) initiative to Schedule C or employment tax collections. We are concerned that the private debt collection agency employees are not receiving recurring training on taxpayer rights that is equivalent to IRS employee training on this subject.
- Complexity of the Employment Tax Deposit System.<sup>12</sup> – Recent data shows that the IRS assesses failure to deposit (FTD) penalties on one out of every 16 employment tax returns, yet eventually abates more than 60 percent of the FTD penalty amounts it originally assessed. This suggests that the rules and regulations governing federal employment tax deposits are overly complex, presenting significant compliance problems for employers and administrative challenges for the IRS.
- Automated Collection System Levy Releases.<sup>13</sup> – Collection efforts through the IRS's Automated Collection System (ACS) can result in levies of bank accounts, wages or other income. Both the Code and Treasury Regulations require that the IRS promptly release levies when taxpayers enter into installment agreements with the IRS or when they demonstrate the existence of a financial hardship. Some taxpayers encounter delays, errors, or other problems when requesting a levy release.
- Limitations of the IRS Allowable Expense Standards for Collection Decisions.<sup>14</sup> – Each year, the IRS publishes schedules of national and local expense allowance standards. These standards reduce the subjectivity involved when IRS employees consider collection alternatives for taxpayers having difficulty paying the IRS. The IRS relies on the subjective judgment of its employees to allow more than the standard amounts when appropriate. Many practitioners report, however, that the IRS often fails to allow such

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<sup>10</sup> National Taxpayer Advocate 2005 Annual Report to Congress at 76-93.

<sup>11</sup> Pub. L. 108-357, Title VIII, § 881, 118 Stat. 1625 (2004).

<sup>12</sup> National Taxpayer Advocate 2005 Annual Report to Congress at 192-208; National Taxpayer Advocate 2003 Annual Report to Congress at 197-205.

<sup>13</sup> National Taxpayer Advocate 2005 Annual Report to Congress at 209-222.

<sup>14</sup> National Taxpayer Advocate 2005 Annual Report to Congress at 270-291.

additional amounts and uses the standards as an excuse to reject reasonable collection alternatives. This inflexibility adversely affects both business and individual taxpayers.

- Inadequate IRS Education and Outreach Efforts to Small Business.<sup>15</sup> – Tax law and administrative complexity can baffle all taxpayers and lead to compliance problems. Small Business taxpayers cannot always afford sophisticated tax advice. These taxpayers need IRS help and assistance in understanding and complying with their tax obligations. I believe the IRS could do more to educate small business and self-employed taxpayers about complying with their tax obligations.
- IRS Examination and Collection Strategies.<sup>16</sup> – 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. The IRS needs research to show the most effective use of its resources after taking into account the direct and indirect effects of its activities on tax revenues.<sup>17</sup> The IRS should also use more information from state and local governments to identify noncompliant taxpayers. Because business taxpayers have frequent dealings with the IRS, the IRS focus will significantly impact these taxpayers.
- Navigating the IRS.<sup>18</sup> – 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 problem, or finding the program “owner” to point out program failure and discuss improvements, is often a difficult task.
- Combined Annual Wage Reporting (CAWR) Reconciliation.<sup>19</sup> – 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

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<sup>15</sup> National Taxpayer Advocate 2004 Annual Report to Congress at 51-66.

<sup>16</sup> National Taxpayer Advocate 2004 Annual Report to Congress at 211-245.

<sup>17</sup> See generally Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 2005).

<sup>18</sup> National Taxpayer Advocate 2003 Annual Report to Congress at 122-134; 2002 Annual Report to Congress at 7-14.

<sup>19</sup> National Taxpayer Advocate 2003 Annual Report to Congress at 220-226.

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. These penalties, however, are frequently abated. The frequent abatement of penalties indicates a serious problem with the administration of this program that adversely and unnecessarily affects small business.

## **The Cash Economy and the IRS**

In addition to the issues affecting small business listed above, I have also identified noncompliance in the “cash economy” as a serious problem affecting taxpayers.<sup>20</sup> Although there is no universally accepted definition of the term cash economy, I have used the term to mean payments for transactions that are not reported to the IRS by third parties.<sup>21</sup> Research indicates that there is a strong correlation between IRS information reporting and tax reporting and compliance. These findings make intuitive sense – if taxpayers think income is being reported by third parties to the IRS, they are more likely to report the income because the IRS already knows about it.

Taxpayers report 99 percent of income subject to withholding, 96 percent of income subject to third-party information reporting, and 57 percent of income not subject to withholding or information reporting.<sup>22</sup> The income reporting percentage drops to 20 percent for income earned by certain sole proprietors (called “informal suppliers”) who operate “off the books” on a cash basis in areas such as street vending, door-to-door sales, or moonlighting in a trade or profession.<sup>23</sup> Nonfiling, underreporting, and underpayment make up the tax gap – the difference between what taxpayers should have paid and what they actually paid on a timely basis.<sup>24</sup> The latest IRS estimates indicate that the gross tax gap is approximately \$345 billion. IRS enforcement activities and late payments reduce the gross tax gap by about \$55 billion, leaving a net tax gap of \$290 billion.<sup>25</sup>

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<sup>20</sup> See National Taxpayer Advocate, 2005 Annual Report to Congress at 55-75.

<sup>21</sup> *Id.*; *The Causes and Solutions to the Federal Tax Gap: Hearing Before the Senate Committee on the Budget*, 109<sup>th</sup> Cong. (2006) (written statement of Nina E. Olson, National Taxpayer Advocate at 2), available at <http://budget.senate.gov/republican/hearingarchive/testimonies/2006/NinaOlsenTestimony.pdf>.

<sup>22</sup> *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

<sup>23</sup> IRS National Headquarters Office of Research, *Interactive Tax Gap Map for Year 2001 22-23* (Feb. 24, 2004).

<sup>24</sup> *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

<sup>25</sup> *Id.*

More than a third of the tax gap may be attributable to the cash economy. The IRS has no direct estimate of the portion of the tax gap attributable to the cash economy, but according to IRS estimates:

- About 43 percent of the gross tax gap, \$148 billion per year, is attributable to underreporting of business income and self-employment taxes by individuals.<sup>26</sup>
- Over 80 percent of all individual underreporting is attributable to understated income rather than overstated deductions.<sup>27</sup>
- For tax year 2004, about 36 percent of all returns with a balance due after remittance were filed by taxpayers with Schedule C liabilities, and these returns accounted for about 50 percent of the total tax year 2004 balance due liability for all taxpayers.<sup>28</sup>
- According to IRS Research, taxpayers who owe a balance upon filing their return are more likely to understate their tax liability than other taxpayers, and more than 20 percent of taxpayers with a balance due fail to pay in full.<sup>29</sup>

This data suggests that self-employed taxpayers who file returns but underreport their income (or self-employment) taxes represent the single largest component of the gross tax gap, accounting for about a third of the gap.

### **The Role of Taxpayer Service and Education in Reducing the Tax Gap**

The tax gap requires the IRS to perform a sometimes difficult balancing act. The IRS should provide the best customer service possible in order to help taxpayers who want to comply with their tax obligations understand these obligations fully. The IRS must make complying with these obligations easy and convenient.

In this respect, the IRS has a particularly critical responsibility to small business. Small businesses carry a disproportionate share of regulatory burdens, most of which is attributable to their tax compliance obligations. A recent study by the U.S. Small Business Administration Office of Advocacy found that small firms pay 67 percent more to comply with the tax laws than do their counterparts at large firms.<sup>30</sup>

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<sup>26</sup> Taxpayers who underreport business income on individual returns account for \$109 billion of the gross tax gap and those who underreport self-employment income account for another \$39 billion. IRS National Headquarters Office of Research, *Tax Gap Map for Year 2001* (Feb. 14, 2006).

<sup>27</sup> *Id.*

<sup>28</sup> Compliance Data Warehouse Individual Returns Transaction File, Tax Year 2004.

<sup>29</sup> IRS Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters*, 7 (Jan. 16, 2004).

<sup>30</sup> See W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2005), available at <http://www.sba.gov/advo/research/rs264tot.pdf>.

Furthermore, the tax complexity small businesses face is staggering for them. Business taxpayers must grapple with a patchwork of rules that cover such items as equipment depreciation, numerous and overlapping filing and deposit requirements for employment taxes, and vague factors that govern the classification of workers as either employees or independent contractors. For these reasons, educating the small business community about their tax obligations is imperative. Overall burdens, for both small businesses and the IRS, are reduced when small business taxpayers understand their tax obligations and can keep their dealings with the IRS to a minimum. A business can use its resources to operate and grow the business, rather than to wrestle with the IRS over compliance issues.

On this front, I commend the IRS's efforts to educate small business and self-employed taxpayers through such measures as:

- Participation in small business workshops administered by the Small Business Administration Development Centers,
- The Small Business and Self-Employed Online Classroom, which provides taxpayers with a number of resources in a variety of formats, such as video, CD-ROM, and online documents, and
- Small business forums with stakeholders.

I am concerned, however, that the IRS is not doing enough to adequately educate the small business community. In fact, the IRS recently significantly downsized its small business education programs. When the IRS Small Business/Self-Employed Division's (SB/SE) Taxpayer Education and Communication (TEC) division was merged with its Communication, Liaison and Disclosure (CLD) division, education staffing was reduced from 699 in fiscal year 2003 to 184 as of October 18, 2005.<sup>31</sup> I believe reducing small business education resources is a mistake and that the IRS could do much more to educate small business taxpayers striving to understand their tax obligations and to help them voluntarily comply with the tax laws.

Many small businesses need access to face-to-face communication with the IRS. TAS focus groups show that small businesses use paid preparers for their annual returns, but try to resolve their tax issues occurring throughout the year by themselves to avoid additional expense.<sup>32</sup> Some very small businesses may be best served by meeting with IRS representatives in a face-to-face setting where they can ask questions about their specific situation and circumstances. Face-to-face contact between small businesses and the IRS also can be done in small business town hall meetings, at trade shows, or in focus groups with representatives from different industries. It is not clear whether the IRS restructuring of TEC will allow for these

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<sup>31</sup> IRS SB/SE CLD Realignment web page and fact sheet (April 13, 2005).

<sup>32</sup> See Russell Marketing Research, Inc., *Findings From Task 149 – The Taxpayer Advocate Service Research Program* (Sept. 2002) (on file with TAS).

face-to-face opportunities. It is also unclear what impact limiting services in IRS Taxpayer Assistance Centers (TACs) will have on face-to-face meetings between the IRS and small businesses.

On the other hand, the IRS is also charged with enforcing these tax laws. Some taxpayers choose not to voluntarily meet their tax obligations. Some of these taxpayers seek to skirt their responsibility by operating in the cash economy where the lack of information reporting presents ample opportunities for noncompliance. For these, the proverbial “carrot” is not enough. The IRS’s enforcement “stick” is also necessary to combat deliberate noncompliance. My concern is that the IRS use this stick only where appropriate and necessary.

### **Reasons for Focusing on the Cash Economy**

As the advocate for *all* taxpayers, the National Taxpayer Advocate must be concerned about the tax gap attributable to the cash economy for two significant reasons: fairness and burden.

#### Cash Economy Fairness Issues

It is quite simply unfair to force compliant taxpayers to pay more than their share of the tax burden in order to supplement those who willfully do not comply. Given the size of the net tax gap, the average tax return includes a “surtax” of about \$2,200 to make up for tax revenue lost to noncompliance.<sup>33</sup>

Even more egregious from a small business perspective, however, is the resulting unlevel playing field when certain taxpayers chose to skirt their tax obligations by operating in the cash economy. As a former self-employed individual who operated my own small business for nearly 27 years and who prepared returns for and represented small business taxpayers in tax controversies during that time, I am convinced that the vast majority of small business owners are honest people who make every effort to correctly report and pay their taxes. These folks are put at a competitive disadvantage, however, when a bad apple enters their midst and begins to use cash transactions to avoid paying taxes. The honest businesses’ sales are hurt because the noncompliant competitor can use its “tax savings” to undercut the prices of goods and services. The honest businesses may also lose workers to the noncompliant competitor who promises “tax free” cash payments for services performed. Noncompliance in the cash economy causes the scofflaw to unfairly profit at the expense of the honest small business owner. This situation should be addressed both administratively and legislatively.

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<sup>33</sup> The IRS receives approximately 133 million individual income tax returns each year. IRS Pub. 1136, *Statistics of Income Bulletin, Spring 2005* (Feb. 2004) (Table 22). The net tax gap of \$290 billion divided by the number of individual income tax returns (133 million) is \$2,180 per return.

## Taxpayer Burdens and the Cash Economy

I am also concerned with the compliance burdens placed upon small businesses. As noted above, I worked for 27 years preparing tax returns and representing individual and small business clients before the IRS and Tax Court. Many of my small business clients operated, and lived, at the margins. That is, every penny that they earned went back into the business and it was very difficult for them to save and make estimated tax payments. When the IRS came calling, these folks would come to me for help. By the time I became involved in many of these cases, however, the most I could do was help with collection alternatives. In some instances, it was too late to help – the sheer weight of the tax debt caused the business to go under.

When income from a transaction is not reported to the IRS, it is much easier for a taxpayer to “fudge” his or her own tax reporting with respect to that income. This does not mean that taxpayers who receive income not reported to the IRS are “bad” people and taxpayers whose income is subject to third-party reporting or withholding are “good” people. It means simply that taxpayers whose income is subject to third-party reporting or withholding do not have the opportunity to be noncompliant because the IRS knows about their income. Participants in the cash economy, on the other hand, have a significantly greater opportunity for noncompliance. Opportunities for noncompliance can present problems for those operating at the margins. When circumstances cause taxpayers to take advantage of these opportunities for noncompliance, they risk IRS enforcement and collection actions. When the IRS can bring these taxpayers back into compliance before they have ventured too far down the wrong road, the process can be relatively painless. By the time the IRS catches up with some noncompliant taxpayers, however, it may be too late. In these cases IRS enforcement can severely cripple or destroy a small business.

I am convinced that these problems could be avoided if, among other things, there were a system that would make paying estimated tax payments as simple as making a mortgage or automobile payment. In order to be effective, however, such a system must be minimally burdensome to small businesses – particularly those businesses that are making payments to workers for services.

With these thoughts in mind, I made several legislative proposals in the National Taxpayer Advocate’s 2005 Annual Report to Congress that, if enacted, would reduce the burdens on taxpayers operating in the cash economy by helping them make easy and convenient voluntary tax payments.

One proposal is to amend Code section 6302(h) to require the IRS to promote estimated tax payments through its Electronic Funds Transfer Payment System (EFTPS) and establish a goal of collecting at least 75 percent of all estimated tax payment dollars through EFTPS by fiscal year 2012.<sup>34</sup> EFTPS is an existing system

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<sup>34</sup> See National Taxpayer Advocate 2005 Annual Report to Congress at 389-391.

that allows both individual and business taxpayers to voluntarily have tax payments debited from their bank account and transferred to the U.S. Treasury. Taxpayers may enroll in EFTPS and schedule payments on the EFTPS website.<sup>35</sup> The website is accessible 24 hours a day, seven days a week. Individual taxpayers can use EFTPS to schedule automatic payments up to 365 days in advance.

Making estimated tax payments is burdensome. Many self-employed individuals find it cumbersome to estimate income, keep track of the estimated tax payment dates that do not coincide with calendar quarters<sup>36</sup>, and save enough money to pay each quarter. EFTPS can alleviate some of these burdens because paying through EFTPS is more convenient than making traditional quarterly estimated payments. One key feature that many taxpayers may find attractive is the ability to schedule automatic payments to be debited from a taxpayer's bank account. A taxpayer can use this feature to voluntarily make more frequent automatic estimated payments and not worry about coming up with the required amount every quarter. Using EFTPS in this way could make estimated tax payments almost as automatic as one's automobile or mortgage payment.

Code section 6302(h) required the IRS to develop and implement an electronic fund transfer system to collect depository taxes and to collect at least 94 percent of depository taxes by fiscal year 1999.<sup>37</sup> In response, the IRS created EFTPS and now collects 95 percent of all employment tax dollars through EFTPS.<sup>38</sup> The statutorily mandated percentage gave the IRS incentive to promote the payment of depository taxes through EFTPS and to make paying these taxes through EFTPS convenient. Because EFTPS is already available for making estimated tax payments, legislation is not absolutely required, but – as with depository taxes – a legislative goal to collect a certain amount of estimated tax payments through EFTPS will encourage the IRS to promote EFTPS as a way to make these payments.

One way the IRS could promote EFTPS is by sending self-employed taxpayers a letter to remind them when estimated tax payments are due and offering the option of paying through EFTPS.<sup>39</sup> A recent IRS study found that "investors" (defined as taxpayers with a balance due of between \$100 and \$10,000 with non-wage income in excess of \$4,000 and wages of less than \$500,000) receiving reminder letters increased both estimated tax payments and withholding by a statistically significant amount.<sup>40</sup> I believe letters to self-employed taxpayers would have a similar effect.

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<sup>35</sup> [www.eftps.gov](http://www.eftps.gov).

<sup>36</sup> The four installment dates are April 15, June 15, September 15, and January 15. IRC § 6654(c).

<sup>37</sup> This percentage was phased in beginning at three percent in fiscal year 1994. IRC § 6302(h)(2).

<sup>38</sup> See National Taxpayer Advocate 2005 Annual Report to Congress at 390, note 28.

<sup>39</sup> See National Taxpayer Advocate 2005 Annual Report to Congress at 71-73.

<sup>40</sup> IRS Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters, 6-8 (Jan. 16, 2004).

A legislative goal will also encourage the IRS to make paying estimated taxes with EFTPS easier. Reports from practitioners indicate that scheduling estimated tax payments through EFTPS is cumbersome and not user-friendly. A legislative percentage goal would encourage the IRS to redesign the EFTPS interface to make scheduling estimated tax payments more user-friendly. Making e-payment of estimated taxes easy should be a high priority for the IRS because it is a way to encourage voluntary compliance. Furthermore, research indicates that a dollar spent on making it easier for taxpayers to comply with their tax obligations (and answering tax law questions) has a positive indirect effect on compliance.<sup>41</sup>

Another proposal is to amend Code section 3402(p)(3) to specifically authorize voluntary withholding agreements between independent contractors and service recipients,<sup>42</sup> and to specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow such independent contractors to deduct ordinary and necessary business expenses under Code section 162(a).<sup>43</sup> The goal of this proposal is to make it easier for independent contractors to voluntarily pay taxes when the service recipients for whom they perform work are willing to set up withholding accounts as a convenience to these independent contractors. Some taxpayers may find that a withholding agreement, entered voluntarily, is a less burdensome way to pay estimated taxes than saving and making quarterly, or even monthly, payments.

Another proposal in my Report aims to help noncompliant taxpayers return to voluntary compliance before their tax debt causes a business failure or other severe consequences. This proposal would use the current backup withholding provisions of the Code as leverage to get the attention of taxpayers that have recurring instances of noncompliance. Under this proposal, backup withholding would apply only to those taxpayers who had demonstrated a history of noncompliance. The goals of this proposal are to help these taxpayers begin to make regularly scheduled voluntary estimated tax payments through EFTPS and to help them return to voluntary compliance before their tax debts become too great to deal with.<sup>44</sup> And because this proposal would only impose backup withholding on a select group of noncompliant taxpayers, the burden on the businesses making payments to these taxpayers would be minimal.

This proposal also provides that in rare instances where we have clear evidence that there is specific, demonstrated, and recurring noncompliance within a particular

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<sup>41</sup> IRS researchers estimate that every dollar the IRS spent on return preparation generated \$396 of additional tax revenue. See Alan H. Plumley, Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 41 (Oct. 1996).

<sup>42</sup> As defined in Code section 6041A(a)(1).

<sup>43</sup> See National Taxpayer Advocate 2005 Annual Report to Congress at 391-394.

<sup>44</sup> See National Taxpayer Advocate 2005 Annual Report to Congress at 383-389.

industry, we should consider using a “compliance certificate” to provide a safe harbor for businesses operating within these industries. A business would be assured that there were no backup withholding issues with respect to any taxpayer holding such a certificate. The United Kingdom has used a similar program in the construction industry for 30 years. If this part of the proposal were to be used in the construction industry in the United States, it would affect a small universe of taxpayers.<sup>45</sup>

### **Offer In Compromise Program**

The above proposals would help bring taxpayers into compliance looking forward, but what about the existing tax debts of small business taxpayers who find themselves in trouble with the IRS? These taxpayers should be able to receive help through the IRS Offer in Compromise (OIC) program. Unfortunately, however, the IRS’s administration of the OIC program is not providing these taxpayers with the assistance Congress intended when it established the program.

#### Offers Provide A Win-Win Solution

The Offer In Compromise (OIC) Program provides small businesses and other taxpayers who have fallen behind on their tax deposits or payments a way to compromise their tax debts and make a fresh start. The IRS also benefits when it accepts an OIC. The IRS collects the most it is likely to get, and simultaneously promotes future compliance by requiring, as a condition of the OIC agreement, that the taxpayer file returns and pay taxes for the following five years.<sup>46</sup> Moreover, one study found that 80 percent of the taxpayers whose offers were accepted remained in compliance with their tax obligations over the five-year period following offer acceptance.<sup>47</sup>

Neither taxpayers nor the IRS receive any comparable benefits when the IRS rejects or returns an OIC. For more than half of the offers from individual taxpayers that it rejected or returned, the IRS eventually collected less than 80 percent of what taxpayers were offering, and it collected nothing in more than 20 percent of those cases.<sup>48</sup> In addition, on average, accepted offers have been bringing in 16 cents for every dollar owed, which is higher than the 13 cents per dollar that the IRS collects on other debts that are two years old.<sup>49</sup> Thus, when the IRS accepts an OIC it

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<sup>45</sup> For the Construction Industry Schedule C Returns (based on NAICS Codes 230000 through 239999), for tax year 2004 there were 222,828 Schedule C Balance Due After Remittance Returns Filed.

<sup>46</sup> Policy Statement P-5-100, IRM 1.2.1.5.18 (Rev. 1-30-1992); Form 656, Offer in Compromise (Rev. 7-2004).

<sup>47</sup> SB/SE Payment Compliance and Office of Program Evaluation and Risk Analysis (OPERA), IRS Offers in Compromise Program, Analysis of Various Aspects of the OIC Program (September 2004).

<sup>48</sup> *Id.*

<sup>49</sup> SB/SE, Offer in Compromise Program, Executive Summary, FY 2006 - January 2006; IRS Automated Collection System Operating Model Team, Collectibility Curve (Aug. 5, 2002).

converts a noncompliant taxpayer into a compliant one, and collects taxes that would otherwise remain uncollected.

### Offer Program Expansion

In RRA 98, Congress expanded the bases for compromise to include “effective tax administration” (ETA).<sup>50</sup> The Conference Report to RRA 98 suggested that the IRS was to adopt a “liberal acceptance policy,”<sup>51</sup> and to “take into account factors such as equity, hardship, and public policy.”<sup>52</sup> However, Treasury regulations provide that the IRS will not compromise with business entities based on economic hardship.<sup>53</sup> Further, as of FY 2004, the IRS was not using its ETA authority to compromise based on equity and public policy (non-hardship).<sup>54</sup> Therefore, I recommended that Congress provide more specific guidance to the IRS to ensure that a new “equitable consideration” standard be applied in a broader array of cases.<sup>55</sup> The good news is that in late 2004, the Small Business/Self-Employed division began using factors similar to many of those that I identified in my 2004 report to evaluate ETA offers and accept more of them. Unfortunately, as of today, this guidance has not been formalized.

### Continuing Challenges for the Offer Program

Another problem for the OIC program is that fewer and fewer taxpayers are actually submitting offers. As of the first four months of FY 2006, new OIC receipts declined by 28 percent, with new cases at 19,026 as compared to 26,503 for the same period during FY 2005.<sup>56</sup> This decline follows steep declines in prior years. Although the IRS’s \$150 OIC processing fee and revised OIC Form, which makes it more clear when offers will not be accepted, may have reduced the number of unrealistic OIC submissions,<sup>57</sup> the decline may also be due to an increasing number of taxpayers and practitioners reaching the conclusion that the offer process is not working as well as it should.

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<sup>50</sup> RRA 98, Pub. L. No. 105-206 (1998).

<sup>51</sup> H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998).

<sup>52</sup> H.R. Conf. Rep. 599, 105th Cong., 2d Sess. 289 (1998); H.R. Conf. Rep. 599, 105th Cong., 2d Sess., 288-289 (1998) (stating that “[t]he Senate amendment provides that the IRS will adopt a liberal acceptance policy for offers-in-compromise to provide an incentive for taxpayers to continue to file tax returns and continue to pay their taxes.... The conferees believe that the ability to compromise tax liability ... enhances taxpayer compliance.”).

<sup>53</sup> See T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (Aug. 20, 2002).

<sup>54</sup> National Taxpayer Advocate 2004 Annual Report to Congress at 311-341.

<sup>55</sup> For more detail, see National Taxpayer Advocate 2004 Annual Report to Congress 433-450.

<sup>56</sup> SB/SE, Offer in Compromise Program, Executive Summary, FY 2006 - January 2006.

<sup>57</sup> TIGTA has concluded that the OIC fee, imposed in November 2003, is responsible for reducing OIC submissions by 28%, but it is difficult to conclude that the continued reduction in OIC submissions in FY 2005 is due to the OIC fee. See Treasury Inspector General for Tax Administration, Ref. No. 2005-30-096, *The Implementation of the Offer in Compromise Application Fee Reduced the Volume of Offers Filed by Taxpayers at All Income Levels* (June 2005). The Form 656, Offer in Compromise, was revised in July 2004, and the revision was publicized in October 2004.

TAS continues to receive complaints from taxpayers and practitioners concerning the IRS process for determining an acceptable offer amount, which generally involves a comparison of income to “allowable” expenses. One common complaint is that the IRS uses allowable expense “standards” that are sometimes unreasonably low.<sup>58</sup> In January, 2006, the IRS actually lowered the national allowable expense standards for food, housekeeping supplies, apparel and services, personal care, and miscellaneous expenses, even though overall consumer prices have generally been increasing.<sup>59</sup> This decision is likely to reduce offer submissions even further by reducing the IRS’s willingness to reach reasonable compromises with small businesses and other taxpayers who are working to resolve prior year delinquencies and come back into compliance.

I appreciate this opportunity to testify before you regarding IRS enforcement and small business. I hope that my remarks prove helpful as you work on proposals to reduce small business burdens through changes to the Internal Revenue Code. We continue to look for ways to reduce opportunities for noncompliance and to make the IRS work smarter with respect to its audits.

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<sup>58</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 270-291 (MSP: Allowable Expense Standards for Collection Decisions); IRC § 7122(c)(2)(B) provides that “...officers and employees of the Internal Revenue Service shall determine, on the basis of facts and circumstances of each taxpayer, whether the use of schedules published under subparagraph (A) is appropriate....”

<sup>59</sup> IRS, *National Standards for Allowable Living Expenses*, available at <http://www.irs.gov/businesses/small/article/0,,id=104627,00.html>. For example, the national standard expense allowance for a single person making less than \$833 per month declined from \$403 in 2005 to \$367 in 2006.