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On Behalf of
The National Small Business Association

NSBA
National Small Business Association®

House Small Business Committee

Hearing:

"Closing the Tax Gap Without Creating Burdens for Small Businesses"

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Chairwoman Velazquez, Ranking Member Chabot and members of the committee, thank you for the opportunity to testify about several of the Treasury Department's legislative proposals to reduce the “tax gap” and the implications they will have on the small-business community. My name is Paul Hense and I am the president of Hense and Associates, a CPA firm located in Grand Rapids, Michigan. I also serve as the Immediate Past Chairman of the National Small Business Association.

Before I give my thoughts on the implications of the so-called “tax gap” and how Congress and the IRS are seeking to address it, let me outline the “tax gap,” how it is being defined and interpreted, and what it may mean for small-business owners like myself.

To begin, the “tax gap” is certainly not a new issue. It has been a persistent problem over the last 20 to 30 years despite myriad congressional and IRS efforts to reduce it. The rate at which taxpayers comply with tax laws has barely changed since 1984, when approximately 87 percent were compliant. Yet, in recent years Congress has brought a new focus on closing the “tax gap.”

IRS develops its “tax gap” estimates by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely comply with their tax obligations. That rate is then used, along with numerous other assumptions, to estimate the dollar amount of taxes not timely or accurately paid. For tax year 2001, the IRS estimates nearly 17 percent of owed taxes were late or not paid at all, which translates into an estimated gross “tax gap” of $345 billion. The IRS recovered about $55 billion of this sum, leaving a net “tax gap” of $290 billion.

Thus, the “tax gap” includes both deliberate and illegal tax evasion but also non-payment that occurs for more innocent reasons; taxpayer error or simple inability to pay. Even Nina Olson, the IRSs taxpayer advocate, told Congress that IRS auditors have found that an estimated 94 percent of noncompliance is the result of honest mistakes by tax filers who simply don’t understand the 17,000-page beast of a tax code.

The millions of honest small-business taxpayers are at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few “bad apples” that do not fulfill their tax obligations.

Earlier this year, the administration’s FY 2008 budget called for a number of steps to close the “tax gap.” Of the 16 different proposals outlined, many of them would impose new regulatory, reporting and withholding burdens on small business—all in an effort to try to “catch” other businesses that might not be reporting all of their income. Given the extraordinary burden that compliance with the tax code already imposes on small businesses, it strikes me as unfair at best to ask honest small businesses to do even more in order to catch a few potential cheats.

The most burdensome proposals would expand information reporting on payments to corporations, require a certified taxpayer identification number from contractors, and mandate information reporting on merchant payment card reimbursements.

A recent nationwide poll conducted by the NSBA shows that 61 percent of small-business owners do not even know about the "tax gap." However, once informed of the IRS proposals, the majority of respondents believed the proposals would increase burdens on their businesses.

As the nation's oldest nonpartisan small-business advocacy group, NSBA has thoroughly reviewed these recommendations and found most would not effectively increase compliance and minimize the “tax gap.” Instead, they add additional and unnecessary burdens on already over-burdened small-business owners.

Information Reporting Requirements on Payments to Corporations

Under current law, corporations are exempt from our current Form 1099 information reporting system which requires all other taxpayers making payments of $600 or more for services to send a Form 1099 to the IRS. The FY2008 budget proposal recommends an expansion to the Form 1099 filing system by requiring a business to file an information return on payments to corporations aggregating to $600 or more in a calendar year.

In practicality, this means that every time a small-business owner ships a package with Federal Express or uses some other service, and the expenses total more than $600 by year-end, they would need to keep the receipts, prepare a Form 1099 and file them not only with the IRS, but with Federal Express and any other companies as well. If enacted, every small-business owner will face an increased paperwork and administrative burden for each additional 1099 Form prepared. Increased costs are incurred for mailing additional forms and for hiring outside assistance to ensure that businesses are correctly complying with the law. Furthermore, if a business previously has not been required to utilize the Form 1099 filing system, greater difficulties with compliance is likely to ensue.

NSBA is concerned what the IRS will do with this amount of data. We do not believe that the IRS even has the capacity to utilize this data.

Requiring a Business to Obtain a Certified Taxpayer Identification Number from Contractors

Another administration proposal recommends that a contractor be required to supply to the business the contractors certified Taxpayer Identification Number (TIN). The business would be required to verify the contractors TIN with the IRS, who would determine whether the certified TIN-name combination matches the IRS records. If the contractor fails to furnish an accurate TIN, the business would be required to withhold a flat-rate percentage of gross payments to that contractor.

This will result in delays in performing and paying for contractors services. A system with substantial requests for paperwork and long wait times to receive needed approvals would harm daily operations of the business and disrupt the contractor's cash flow.

Included in this proposal is the creation of a voluntary withholding system. Contractors receiving payments of $600 or more in a calendar year from a business can require a business to withhold a flat-rate percentage of their gross payments, with the flat rate of 15, 25, 30 or 35 percent being selected by the contractor.

This is especially burdensome and complex to small-businesses if each contractor requests a different rate. Then business owners may have to withhold from some contractors and report information returns on others—resulting in increased administrative nightmares for the small-business. Plus allowing the contractors the option transfers the compliance burden from the contractor to the business owner creating further disincentives to utilize contractor services.

Information Reporting Requirements on Merchant Payment Card Transactions

Currently, taxpayers are subject to some level of information reporting and withholding requirements. Employers must report wages and withhold applicable payroll taxes and federal income taxes for their employees. Businesses are required to report payments made for services in connection with their trade and business of more than $600 per year. However, the administration has proposed an increase in information reporting by annually requiring credit and debit card issuers to inform the IRS about aggregate reimbursement payments made to businesses.

Such requests for information or possible tax assessments would be burdensome and raises questions of privacy for small businesses. Also, this new level of regulatory burden on credit card issuers likely will lead to increased fees being passed on to businesses which conduct credit card transactions. These increased fees will have a negative impact on business revenue and sales, and in turn tax revenue. Further, there is no data available to distinguish between payment card transactions and cash transactions as a contributor of the “tax gap."

Inaccurately Blaming Small-Businesses for 'Tax Gap'

As defined by the IRS, the “tax gap” consists of three components: non-filing (failure to file a return), underreporting (understating income or overstating deductions), and underpayment (failure to pay reported tax owed.) Of these, IRS argues underreporting is the largest, comprising 80 percent or $166 billion of the total gap. Of the $166 billion, IRS claims that small businesses are responsible for $109 billion.

However, most of the current data on the “tax gap” is derived from extrapolations and limited information, some of which is more than 20 years old. The IRS has misinterpreted its data and has reached erroneous conclusions about where the “tax gap” lays. None of the numbers examine the effects of external factors on tax compliance. The IRS failed to consider what percentage of “tax gap” is attributed to the complexity of the tax code. It also did not study what other external factors affect taxpayers behavior. NSBA asserts that better data is needed in order to craft more targeted solutions aimed at those who are in fact non-compliant in their tax obligations.

To the extent there is underreporting of income in the small-business community, the IRS does not seem to know what types of businesses are most likely to underreport. This is crucial information for crafting a potential solution. The IRS has proposed more collection and withholding for business-to-business transactions, but what if most of the underreporting occurs in businesses that sell to individual consumers and households? We have added a new burden for little benefit.

Now that the IRS is calling for stricter filing rules, more stringent audits and penalizing smaller businesses for unintentional transgressions, they are unfairly targeting most of the businesses who report accurately on their tax returns. The IRS is hiring more auditors and is petitioning Congress for increased funding to audit more small businesses. In the last two years alone, audits of small corporations have increased 150 percent and there is every reason to believe that number will continue to increase. NSBA fully supports efforts to collect legally owed tax revenues, but not at the undue expense of the privacy and integrity of honest, hard-working entrepreneurs.

Tax Reform

The complexity of our existing tax system is a significant reason for the “tax gap.” Fundamental reform and simplification of the tax law is necessary in order to reverse this situation. Perplexed, bothered and bewildered American taxpayers spent $265 billion last year just trying to comply with the tax laws and regulations. Yet, even with this vast expenditure of money, no one—including small-business owners—is sure they successfully complied with the law. In fact, the Treasury’s own Inspector General for Tax Administration found an 84-percent error rate in spot audit visits to 26 different IRS Assistance Centers across the country in 2004.

Congress should stop trying to impose more burdens on taxpayers and replace the current tax code altogether with something that makes more economic sense, such as the Fair Tax.

NSBA Recommendations

The number one NSBA priority for the 110th Congress is working to address the root causes of these unpaid taxes and find a solution without placing excessive and intrusive burdens on honest small-business owners. We believe efforts to close the “tax gap” must focus on overall simplification, eliminating inequities within the tax code, and enhancing taxpayer education and outreach.

NSBA believes that the IRS should conduct more research to better identify noncompliant taxpayers, enhance taxpayer services to inform taxpayers of correct tax obligations and adjust its enforcement tools to target those who intentionally evade paying taxes. Adding new burdens and requirements on small business already struggling to do the right thing is simply the wrong answer.

Addressing the “tax gap” must entail balancing the desire to collect taxes that are duly owed with the importance of minimizing intrusive and complicated reporting requirements and additional audits of small businesses. Potential steps include:

1) **Improve Services**: Though the IRS has made strides in improving customer service, there needs to be a concerted effort to improve compliance assistance rather than enforcement. Additional improvements to customer service should facilitate tax paying while ensuring that unintentional errors are minimized, and not penalized.
2) **Crack down on Tax Scams**: A report by the Senate Permanent Investigations Subcommittee found that cheating on taxes now equals about four cents to seven cents on each dollar paid by honest taxpayers, or about $40 billion to $70 billion a year. NSBA supports efforts to curb tax-cheats, but the IRS and Congress must take a certain level of responsibility for creating a complex, out-of-control tax code that enables the very kind of cheating they’re trying to stop.
3) **Simplify Taxes:** Considering the legal ramifications of filing incorrect returns, much less the “tax gap,” the tax code desperately needs to be simplified. Reforms can include consolidating the number of tax breaks in the code, rationalizing and harmonizing definitions, and in general reducing the number of forms taxpayers are required to fill out each year. These changes could easily reduce the non-compliance rate and potentially raise tax revenues without an increase in tax rates.

NSBA Campaign

In order to reach these goals, NSBA has launched a campaign with three main objectives: inform small businesses about the potential threat that is posed by the “tax gap,” give small-business owners an avenue to communicate their concerns back to elected officials, and provide an information repository to answer key questions about tax compliance, in order to cut back on honest mistakes.

You can view the NSBA Web site at www.preventirsabuse.org.

The majority of small-business taxpayers want to comply with existing tax laws, thus tax simplification and education is the most effective and equitable way to improve compliance and to reduce the "tax gap."

Now is the time for Congress to support proposals that are fair and reasonable, and that do not hinder the survival, growth and innovation of our nation's entrepreneurs. Thank you for your consideration of these recommendations.