

**Congress of the United States**  
**U.S. House of Representatives**  
**Committee on Small Business**  
2361 Rayburn House Office Building  
Washington, DC 20515-6315

**Memorandum**

To: Members, Committee on Small Business  
From: Committee staff  
Date: July 15, 2013  
Re: Hearing: "The Internal Revenue Service and Small Businesses: Ensuring Fair Treatment"

---

On July 17, 2013, the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of receiving testimony from Internal Revenue Service (IRS) Principal Deputy Commissioner Daniel Werfel (Acting Commissioner) on the methods the IRS employs to review, classify, select and audit the tax returns of small businesses.

**I. Background**

On May 14, 2013, the Department of the Treasury's Inspector General for Tax Administration (TIGTA) issued a report which found that the IRS used inappropriate criteria that identified for review conservative organizations that had applied for tax-exempt status based on their names or policy positions.<sup>1</sup> The TIGTA report said that as a result of ineffective management, the IRS allowed inappropriate criteria to be developed and remain in place for more than 18 months, which resulted in substantial delays in processing certain applications and unnecessary information requests to be issued.<sup>2</sup> The then-Acting IRS Commissioner, Steven Miller, resigned, and several Congressional committees have held hearings on these issues.<sup>3</sup>

In 2011, the Small Business Committee held a joint hearing with the Committee on Oversight and Government Reform on a draft Presidential Executive Order that would have required small

---

<sup>1</sup> TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW (May 14, 2013) (2013-10-053), *available at* <http://www.treasury.gov/tigta/auditreports/2013reports/201310053fr.pdf>.

<sup>2</sup> *Id.* On June 24, 2013 and June 16, 2013, Committee on Ways and Means Ranking Member Sander Levin sent two letters to TIGTA J. Russell George asking whether the TIGTA report narrowly focused only on conservative organizations or also included progressive organizations. Mr. George responded that stated that his report "reviewed all cases the IRS identified as potential political cases and did not limit our audit to allegations related to the Tea Party." Letter from J. Russell George, Treasury Inspector General for Tax Administration, to Rep. Sander Levin, Ranking Member, Committee on Ways and Means 1 (June 26, 2013), *available at* [http://waysandmeans.house.gov/uploadedfiles/tigta\\_final\\_response\\_to\\_rep.\\_levin\\_6.26.13.pdf](http://waysandmeans.house.gov/uploadedfiles/tigta_final_response_to_rep._levin_6.26.13.pdf).

<sup>3</sup> The Committee on Ways and Means held a hearing on May 17, 2013, the House Committee on Appropriations held a hearing on June 3, 2013 and the Committee on Oversight and Government Reform held a hearing on May 22, 2013.

businesses pursuing government contracts to disclose their political contributions.<sup>4</sup> At the time, Chairman Graves sent a letter to President Obama saying that he was disturbed by the proposed Executive Order, as its enactment would have politicized the contracting process and infringed on the free speech rights of Americans.<sup>5</sup> No final Executive Order was issued, but some small business owners felt the proposal was an attempt by the Administration to target them for political reasons.

Over the past several years, the IRS has increased the number of small businesses it audits. The Committee is interested in knowing how the IRS selects the firms it targets for increased scrutiny, those it audits, the number of firms it audits, and the duration of the audits and the yield they produce.

## II. Small Businesses and the Tax Code

Small businesses face a tax code that is a confusing patchwork of provisions, including equipment depreciation, net operating loss carryover, home office deduction, employment taxes, classification of workers and the earned income tax credit. For small businesses, tax compliance is tedious and expensive if they consult a professional to assist them. Some small business owners are fearful that their difficulty in deciphering the tax code may result in a tax return that is selected for an IRS audit.

For many years, the IRS has attempted to reduce the tax gap – the difference between what the IRS collects and what it believes taxpayers owe.<sup>6</sup> In 2011, the Government Accountability Office (GAO) recommended that the IRS increase its audits to raise additional revenue and reduce the tax gap.<sup>7</sup> In Fiscal Year (FY) 2012, the IRS increased audits across all categories of business returns by more than 12%.<sup>8</sup> The largest increases were in the audits of flow-through entities, including partnerships and S corporations, which pay business taxes at the owner's individual tax rates.<sup>9</sup> According to recent data, 75% of small businesses are flow-through entities.<sup>10</sup> For partnerships, the IRS audited 16,000 returns in FY 2012 or .47% of all partnership returns, up from 13,000 in FY 2011.<sup>11</sup> For Chapter S companies, the IRS audited 21,000 returns in FY 2012 or .48% of all Chapter S company returns, up from 18,000 in FY 2011.<sup>12</sup>

---

<sup>4</sup> *Politicizing Procurement: Will President Obama's Proposal Curb Free Speech and Hurt Small Businesses? Joint Hearing Before the Committees on Oversight and Government Reform and Small Business*, 112<sup>th</sup> Cong. (2011), available at <http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg70516/pdf/CHRG-112hhrg70516.pdf>.

<sup>5</sup> Letter from Sam Graves, Chairman, Committee on Small Business, to Barack Obama, President of the United States (April 21, 2011), available at [http://smallbusiness.house.gov/uploadedfiles/april\\_21\\_to\\_potus\\_-\\_campaign\\_disclosure\\_for\\_businesses.pdf](http://smallbusiness.house.gov/uploadedfiles/april_21_to_potus_-_campaign_disclosure_for_businesses.pdf).

<sup>6</sup> INTERNAL REVENUE SERVICE, *THE TAX GAP* (2013), available at <http://www.irs.gov/uac/The-Tax-Gap>. In 2006, the tax gap stood at \$345 billion annually; by 2012 it had risen to \$385 billion annually. Interview with James White, Director, Tax Division, Government Accountability Office, May 29, 2013 (notes on file with Committee staff).

<sup>7</sup> GOVERNMENT ACCOUNTABILITY OFFICE, *IRS COULD SIGNIFICANTLY INCREASE REVENUES BY BETTER TARGETING ENFORCEMENT RESOURCES*, GAO-13-151, (Dec. 2011), available at <http://www.gao.gov/assets/660/650521.pdf>.

<sup>8</sup> INTERNAL REVENUE SERVICE, *IRS AUDITS*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/IRS-Audits>.

<sup>9</sup> INTERNAL REVENUE SERVICE, *FISCAL YEAR 2012 ENFORCEMENT AND SERVICE RESULTS 4*, available at <http://www.irs.gov/pub/irs-news/FY%202012%20enforcement%20and%20service%20results-%20Media.pdf>.

<sup>10</sup> NFIB RESEARCH FOUNDATION, *TAX COMPLEXITY AND THE IRS POLL*, (2006), available at [http://www.411sbfacts.com/sbpoll-tables-res.php?POLLID=0055&QID=00000001702&KT\\_back=1](http://www.411sbfacts.com/sbpoll-tables-res.php?POLLID=0055&QID=00000001702&KT_back=1).

<sup>11</sup> INTERNAL REVENUE SERVICE, *FISCAL YEAR 2012 ENFORCEMENT AND SERVICE RESULTS 4*, available at <http://www.irs.gov/pub/irs-news/FY%202012%20enforcement%20and%20service%20results-%20Media.pdf>.

<sup>12</sup> *Id.*

Similarly, a 2008 Syracuse University study found that the IRS significantly increased audits of small businesses, while reducing them on large firms. At a 2009 Small Business Committee hearing considering whether tax compliance costs were slowing the economic recovery, one small business owner testified that he was audited by the IRS beginning in 1989 – over ten years – and various IRS employee investigations found that he owed \$2300 and was owed an overpayment of \$1800.<sup>13</sup> Nevertheless, Mr. Smith testified that he paid the tax the IRS said he owed three times. He calculated the burden of the audit on his business to be over 150 hours of his personal time, and over 100 hours of his employees' time, and an inestimable amount of lost business.<sup>14</sup>

During the 1998 debate on the IRS Restructuring and Reform Act,<sup>15</sup> legislation which resulted in a major restructuring of the IRS and the addition of new taxpayer "rights,"<sup>16</sup> Congress publicly criticized the IRS' information systems, aggressive auditing tactics and poor customer service.<sup>17</sup> After the bill's enactment, overall audit rates markedly declined.<sup>18</sup> Since at least FY 2002, however, audit rates for S corporations and partnerships have increased.

### III. IRS Examinations or "Audits"

An IRS audit is a review or examination of an organization or individual's accounts and financial information to ensure information is being reported correctly and according to tax laws and verify that the amount of tax reported is accurate.<sup>19</sup>

The IRS now audits about 1% of tax returns each year.<sup>20</sup> The audited returns are suspected to have a high probability of unreported or underreported income and, therefore, likely yield additional revenue.<sup>21</sup> Yet detecting unreported or underreported income is not easy.

---

<sup>13</sup> *IRS Oversight: Are Tax Compliance Costs Slowing the Economic Recovery? Hearing Before the House Comm. on Small Business*, 111<sup>th</sup> Cong. (2009) (statement of Christopher (Kit) Smith) (on file with Committee staff).

<sup>14</sup> *Id.* at 1.

<sup>15</sup> Pub. L. No. 105-206, 112 Stat. 685 (1998) (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 I.R.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

<sup>16</sup> Pub. L. No. 105-206 (1998) (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 I.R.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.). The Act, for example, created a limited privilege for taxpayers for communications between a taxpayer and their tax practitioner, and provides for civil damages in cases where an IRS office or employee negligently disregards tax statutes or regulations. *Id.*

<sup>17</sup> *Senate Panel Hears Stories of IRS Abuses*, CNN (Apr. 28, 1998), available at <http://www.cnn.com/ALLPOLITICS/1998/04/28/irs.hearings/> and Michael Hirsh, *Behind the IRS Curtain*, Newsweek (Oct. 5, 1997), available at <http://www.thedailybeast.com/newsweek/1997/10/05/behind-the-irs-curtain.html>.

<sup>18</sup> C. EUGENE STEUERLE, *CONTEMPORARY U.S. TAX POLICY* 198 (2004).

<sup>19</sup> INTERNAL REVENUE SERVICE, *IRS AUDITS*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/IRS-Audits>.

<sup>20</sup> See INTERNAL REVENUE SERVICE, *STATEMENT ON FISCAL YEAR 2012 PERFORMANCE RESULTS*, available at <http://www.irs.gov/uac/Newsroom/Statement-on-IRS-FY-2012-Performance-Results>; and INTERNAL REVENUE SERVICE, *FISCAL YEAR 2012 ENFORCEMENT AND SERVICE RESULTS*, available at <http://www.irs.gov/pub/irs-news/FY%202012%20enforcement%20and%20service%20results-%20Media.pdf>. An Associated Press story relied on former IRS employees as sources. Stephen Ohlemacher, *IRS Focuses Audits on Small-Business Owners*, ASSOCIATED PRESS, Apr. 14, 2013, available at <http://www.kansascity.com/2013/04/14/4182136/irs-focuses-audits-on-small-business.html>.

<sup>21</sup> DENNIS CYR, THOMAS ECKHARDT, LOU ANN SANDOVAL, MARVIN HALLDORSON, INTERNAL REVENUE SERVICE, *PREDICTORS OF UNREPORTED INCOME: TEST OF UNREPORTED INCOME (UI) DIF SCORES 1 (2002)*, available at <http://www.irs.gov/pub/irs-soi/puidif2.pdf>.

The IRS employs several methods for selecting returns for additional scrutiny and possible audit. These methods include automated screening, which may “flag” returns based on certain characteristics; matching third party payor information from W-2s or Form 1099s, which may reveal inconsistencies; or selecting a taxpayer’s return if a related return, such as those of the taxpayers’ business partners or investors, are being audited.<sup>22</sup>

For example, to flag certain returns, the IRS can employ the Discriminant Index Function (DIF), an automated system, which uses a mathematical formula to score tax returns based on their potential to provide additional revenue.<sup>23</sup> Small business taxpayer returns may also be selected for additional scrutiny or audit based on certain characteristics; for example, the industry or geographic location the business serves.<sup>24</sup> After returns are flagged in the automated system, experienced IRS auditors classify the returns to determine which ones should be selected for audit.<sup>25</sup>

#### A. Types of Audits – Correspondence vs. Field (Face-to-Face)

Common methods of audit are by correspondence (via mail) or in person audit.<sup>26</sup> The in person audit may be at an IRS office (office audit) or at the taxpayer’s home, place of business or accountant’s office (field audit).<sup>27</sup> For correspondence audits, the IRS typically sends a notice to taxpayer by mail and requests specific documentation or records regarding a return. The taxpayer responds to the IRS and provides the requested information by mail. The entire audit may be conducted in this manner.<sup>28</sup>

According to the IRS, the length of an audit varies, depending on the type of audit, the complexity of the items being reviewed, the availability of the information requested, and the ability of the IRS and taxpayers to schedule meetings.<sup>29</sup> An audit may or may not result in a change to the taxpayers return. The IRS may propose changes with the taxpayer agreeing, or the IRS may propose changes with the taxpayer disagreeing.<sup>30</sup>

---

<sup>22</sup> INTERNAL REVENUE SERVICE, IRS AUDITS, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/IRS-Audits>.

<sup>23</sup> Alistair M. Nevius, *Improving the Audit Selection Process*, J. ACCOUNTANCY (Jan. 2013), available at <http://www.journalofaccountancy.com/issues/2013/Jan/20126621.htm>.

<sup>24</sup> Interview with James White, Director, Tax Division, Government Accountability Office, June 17, 2013 (notes on file with Committee staff). See TAXPAYER ADVOCATE SERVICE, FACTORS INFLUENCING VOLUNTARY COMPLIANCE BY SMALL BUSINESSES: PRELIMINARY SURVEY RESULTS (2013), available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Research-Studies-Factors-Influencing-Voluntary-Compliance-by-Small-Businesses-Preliminary-Survey-Results.pdf>.

<sup>25</sup> Interview with James White, Director, Tax Division, Government Accountability Office, May 29, 2013 (notes on file with Committee staff).

<sup>26</sup> INTERNAL REVENUE SERVICE, 2012 DATA BOOK 21 (Sept. 30, 2012), available at <http://www.irs.gov/pub/irs-soi/12datbk.pdf>.

<sup>27</sup> INTERNAL REVENUE SERVICE, IRS AUDITS, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/IRS-Audits>.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

In 2012, TIGTA released two studies on the IRS Small Business/Self-Employed Division's audits of partnerships and S corporations.<sup>31</sup> Those studies found that DIF-selected returns had high "no change" rates; meaning the audits did not produce significant increases in revenue.<sup>32</sup> For example, in Fiscal Year 2011, TIGTA found that the IRS closed 62% of the DIF-selected S corporation returns audited in Fiscal Year 2011 with no changes, and closed 50% of DIF-selected partnership returns, or returns related to a DIF-selected audit, were closed with no changes.<sup>33</sup>

The IRS' National Taxpayer Advocate released a study in 2012 of sole proprietorships that found these small business owners may be more inclined to underreport income because their businesses deal in cash (instead of individuals whose wages are reported by third party employers to the IRS).<sup>34</sup> The tax returns of small business owners may also be targeted for other reasons.

#### IV. Possible Targeting of Small Businesses

Several Congressional committees have held hearings on the IRS's use of inappropriate criteria to evaluate organizations that requested non-profit status. This focus has led to questions about whether the IRS' inappropriate scrutiny may have extended beyond conservative groups to small businesses.

On May 31, 2013, Chairman Graves sent a letter expressing these concerns to IRS Principal Deputy Commissioner Daniel Werfel.<sup>35</sup> In the letter, Chairman Graves said he wants to ensure that all taxpayers, including small businesses, are being treated fairly. To do so, Chairman Graves requested that the Acting Commissioner provide information on the number and type of small businesses that have been selected for closer review and audit; the criteria employed to select small businesses for additional scrutiny and audit; the cost and duration of the audits; and the amount the audits recovered.<sup>36</sup> He asked that the IRS provide the information requested by June 17, 2013. On June 17, 2013, Acting Commissioner Werfel responded with an interim letter requesting an additional 15 days (July 2) to provide the information. As of July 8, Chairman Graves had not received a substantive response.

---

<sup>31</sup> See TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DESPITE SOME FAVORABLE PARTNERSHIP AUDIT TRENDS, THE NUMBER OF NO-CHANGE AUDITS IS A CONCERN (June 20, 2012) (2012-30-060), *available at* <http://www.treasury.gov/tigta/auditreports/2012reports/201230060fr.html> [hereinafter Partnership Audits], and TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, THE RECOMMENDED ADJUSTMENTS FROM S CORPORATION AUDITS ARE SUBSTANTIAL, BUT THE NUMBER OF NO-CHANGE AUDITS IS A CONCERN (JUNE 21, 2012) (2012-30-062), *available at* <http://www.treasury.gov/tigta/auditreports/2012reports/201230062fr.pdf>, [hereinafter S Corp Audits].

<sup>32</sup> S Corp Audits at 3 and Partnership Audits at 3.

<sup>33</sup> *Id.*

<sup>34</sup> TAXPAYER ADVOCATE SERVICE, FACTORS INFLUENCING VOLUNTARY COMPLIANCE BY SMALL BUSINESSES: PRELIMINARY SURVEY RESULTS (2013), *available at* <http://www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Research-Studies-Factors-Influencing-Voluntary-Compliance-by-Small-Businesses-Preliminary-Survey-Results.pdf>.

<sup>35</sup> Letter from Sam Graves, Chairman, Committee on Small Business, to Daniel Werfel, Acting Commissioner, IRS (May 31, 2013), *available at* [http://smallbusiness.house.gov/uploadedfiles/5.30.13\\_graves\\_to\\_irs\\_werfel\\_audits.pdf](http://smallbusiness.house.gov/uploadedfiles/5.30.13_graves_to_irs_werfel_audits.pdf).

<sup>36</sup> *Id.*

## **V. Conclusion**

Recent investigations by Congress have raised additional questions about the IRS's targeting of non-profit organizations, and whether the IRS may have also targeted small businesses for additional scrutiny or audits.

This hearing will be an opportunity for Members to learn more about how the IRS selects, classifies and audits the tax returns of small businesses, and will provide an opportunity for Members to ask questions of the IRS's Principal Deputy Commissioner.