KOGOD SCHOOL of BUSINESS
AMERICAN UNIVERSITY • WASHINGTON, DC

Testimony of
Donald T. Williamson
Kogod Eminent Professor of Taxation
Howard S. Dvorkin Faculty Fellow
Executive Director, Kogod Tax Policy Center
Kogod School of Business
American University
Washington, D.C.

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Hearing on
"IRS Puts Small Businesses
Through Audit Wringer"

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Chairman Chabot, Ranking Member Velazquez and Members of the Committee, thank you for the opportunity to testify on the issues small businesses confront when they are audited by the Internal Revenue Service.

My name is Don Williamson and I am a professor of taxation at American University's Kogod School of Business where for the past thirty-two years I have been the Director of the School's Masters in Taxation degree program. The MST program at American University offers graduate courses in federal taxation to accountants and small business owners who wish to expand their knowledge of our nation's tax laws. Our course offerings include not only traditional classes in subject areas such as the taxation of corporations and partnerships, international taxation and tax policy but also more specialized areas of the tax law such as IRS practice and procedure that address the issues of this hearing regarding the IRS examination of small business tax returns.

In addition to my academic work, for the past 27 years I have had my own tax preparation and tax planning practice, LaMonaca & Williamson, CPAs, in Falls Church, Virginia which specializes in the tax issues facing small businesses and their individual owners. LaMonaca & Williamson prepares hundreds of tax returns for small businesses as well as representing such taxpayers daily before the IRS examination, appeals and collection divisions, thereby making me uniquely qualified to speak with you today.

I. Complexity of the Law Contributes to Time Consuming, Unproductive Return Examination

Over the course of my tenure as an academic and tax practitioner I have seen with dismay the Internal Revenue Code grow in complexity, becoming intrusive and pervasive in its reach and incomprehensible to all but those who devote their careers to its study.

This complexity arises, in part, from the now annual amendments to the Internal Revenue Code that have a profound, even paralyzing, effect on small businesses that impedes their efficient operation and obstructs their ability to grow and create jobs. In fact, since 2001, there have been approximately 5,000 amendments to various sections of the Internal Revenue Code—about one per day on average. Consequently, not only small business persons, but even their tax advisers are overwhelmed by the complexity resulting in steady increases in fees advisers charge to their small business clients.

The National Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours preparing tax returns or otherwise responding to IRS inquiries about the preparation of their returns, the equivalent of 1.25 million full-time jobs. In meeting these requirements 70% of small businesses employ tax professionals to prepare their returns and represent their interests before the IRS at a cost of more than $16 billion for the services of attorneys, accountants and other professionals.

In addition to wasted time and resources, there is the practical reality that it is impossible today to be knowledgeable in the entirety of our tax law. Professionals must specialize in areas (e.g., corporations, partnership, employee benefits, etc.). As a result, small businesses find that they must employ a team of tax advisers to prepare their returns and ultimately represent their interests if the returns are audited. Our own Kogod study of more than 40,000 self-employed small business owners, which we conducted earlier this year together with our research on the sharing economy, found that more than 44% of our respondents paid more than $200 for assistance in preparing their annual taxes. While generating a lucrative “cottage industry” for tax professionals, small businesses—who comprise more than 99% of all businesses—suffer from burdensome tax compliance requirements that require professional advice and divert time and resources away from activities encourages business growth and create jobs.

In fact, a survey conducted by the National Federation of Independent Business found that CPAs, attorneys, enrolled agents and other tax specialists not only prepared, at least in part, over 90% of all tax returns filed by small businesses but were also retained to represent small businesses when they were selected for IRS audit. When small business owners believe they are unable to file their own tax returns, represent their own interests before the IRS or simply contact the IRS by telephone without being subject to a "courtesy disconnect" after remaining on hold for 30 minutes, resentment towards the "system" arises, creating a cynicism and disrespect toward our tax law that will only foster non-compliance and ultimately fraud.

II. <u>Why Target Small Businesses for IRS Examination?</u>

As part of the tussle over tax rates and appropriate deductions that create an overly complex statute, tax collection and enforcement accomplished by IRS audits of tax returns remain a necessary and appropriate tool needed to enforce our tax laws. But in deciding what taxpayers to select for audit, the IRS needs to recognize that on an hourly basis of IRS auditor time, the agency collects far more revenue from large corporations with higher taxable incomes than from small and medium size businesses with lower incomes. But, nevertheless, the highest number of audits for 2014 of individual tax returns with business income was in the lowest range of business returns, i.e. $200,000 to $400,000, amounting to 50% of all audits of upper income individual returns. Indeed, the chances of a Schedule C being audited are almost twice as great as a small corporation being audited. This evidence seemingly indicates that small proprietorships are in the audit crosshairs.

One reason the IRS appears to disproportionately target small business taxpayers is the view that small businesses receive most of their income in cash, which can be particularly difficult to identify and easily misreported. The IRS has done multiple studies on the tax gap, i.e., the difference in the amount of taxes imposed and the amount of taxes paid every year, and concluded that where information reporting or tax withholding is not imposed, there is a 63% net misreporting rate of income. As a result, the IRS uses audits of small businesses and their owners to find unreported income. But, both the IRS and taxpayers agree such exercises are time-consuming and imperfect with the IRS collecting just $7.3 billion from audits last year—its lowest in 13 years.

Most audits are not random, i.e. the IRS has a secret algorithm for determining how likely each taxpayer is to have unreported income. Employing this calculus, the IRS has concluded that small businesses are less likely to be paying their fair share of taxes relative to much larger enterprises, a surprising conclusion in light of frequent press reports of multi-national corporations allocating billions of dollars of profits to no or low tax jurisdictions to avoid U.S. income taxation.

In short, use of IRS resources disproportionately targeting small businesses, regardless of the degree of misreported income by a few, is both an inefficient use of IRS resources and unfair to the vast majority of small businesses that properly report all their income while generating more growth and creating more jobs than any other sector of our economy.

III. Unwinding the Wringer

The excessive time and expense of auditing small businesses is, in part, due to the difficulty the IRS has in conducting examinations of tax returns when specific personnel are not assigned to a taxpayer's case. While audits are often conducted by correspondence, they can also be performed by IRS personnel who go to the taxpayer's business or ask the taxpayer to come to the local IRS office. The majority of small business audits are conducted by correspondence. If the issue involves adjustments based on third-party income reporting documents, e.g. Form 1099s, where the taxpayer failed to report income, the matter can be promptly settled by the taxpayer paying the tax on the omitted income plus paying interest on the deficiency. Penalties are often not imposed.

However, problems begin when there is a disagreement over the proposed adjustment or the IRS is seeking verification of the information on the return. In these cases, taxpayer responses to written notices often sit at IRS processing centers for weeks or even months until assigned to an auditor. Once a taxpayer's response is actually reviewed by an IRS auditor, it is often the case that the auditor will often find the taxpayer's response to be insufficient setting off a new round of correspondence consuming several more weeks or months. Rather than this exchange of letters that inevitably must be made by certified mail to ensure receipt by the IRS, a meeting, or even simply a telephone call, with someone at the IRS assigned to the case could often settle the matter in a few minutes.

Furthermore, because small business owners rely upon enrolled agents, CPAs or attorneys when they are contacted by the IRS, significant costs arise for even insignificant inquiries. In fact, many small business owners simply conclude that the cost of their time and professional fees is not worth the effort to dispute the proposed adjustment and opt simply to pay the extra tax—rather than continue to fight.

Because most correspondence audits have is no point of contact at the IRS to discuss the matter, taxpayers and their representatives simply hope they are providing the correct information. At the very least the IRS must better facilitate the tracking of correspondence audits so taxpayers may receive more prompt service. In addition, IRS should consider assigning cases to an auditor or perhaps a group of auditors if the taxpayer requests such an assignment at the time of first contact. Perhaps, if the IRS can significantly improve its online capacity, and, more importantly, its security over its online functions, taxpayers could respond to e-mail communications with specific IRS personnel.

IV. Inefficient Conduct of Audits - A Case Study

Ironically, small businesses which are more likely to be audited are less likely to have the resources to respond to inquiries and assemble evidence to support or explain their tax returns. In addition, individual taxpayers continue to have an almost illogical fear associated with being selected for an audit resulting in a strained relationship between taxpayers and an agency simply seeking to verify the information reported on a tax return. Finally, the impersonal approach by the IRS in correspondence audits, apparently due to the lack of personnel to conduct the examinations, makes for a frustrating and inefficient exercise.

These problems were illustrated most recently, in my own practice, where a small business client living in Texas was contacted by the IRS Philadelphia service center to explain the income and expenses claimed on his Schedule C. The letter did not provide the name of any person at the IRS to contact to discuss the audit and simply requested copies of all the taxpayer's books and records. With no way to understand what specific items on the return were under examination, the taxpayer, at considerably cost of time and professional fees, assembled the requested information in three large boxes which were mailed to the address requested.

After four months, the client received a one page letter with an attached one page statement of explanation declaring the taxpayer's business was a "hobby" and therefore the net operating loss claimed on the return was disallowed resulting in a substantial proposed assessment of taxes, interest and penalty. At that point, my client had already incurred fees of several thousand dollars in responding to the request for information; and I frankly advised him that taking the matter to the Appeals Division would cost even more. Nevertheless, my client insisted that I file a protest showing that his business was not a hobby.

After several more months and several letters where I was able to have the Appeals Office in Texas rather than Philadelphia hear the case, we received another letter asking again for a complete copy of all the taxpayer's travel and entertainment expenses with schedules reconciling the individual expenses incurred to the totals on the return, documentation which we had already provided. I called the Appeals Officer assigned to the case and explained that we had already supplied the examination division with this information. The Appeals Officer insisted we supply the information in even greater detail than we had the first time. Therefore, we again began to prepare new schedules cross-referencing each receipt to the totals on the returns. However, before we could complete the work, the client received a one paragraph letter dropping the case. As a result of this exercise that lasted for almost a year, the client incurred professional fees that exceeded the initial adjustment in tax proposed by the IRS had he not contested the matter.

The substantial cost of this case, not only to the taxpayer but also to the IRS itself, illustrates the limits of correspondence audits. Had an IRS employee in Philadelphia been assigned to this case, the matter would have been resolved in a few weeks rather than a year. So often audits of small businesses and individuals are resolved by simply having documentation to support the items claimed on the return. In this case the taxpayer had the documentation and I am confident the entire matter would have been closed with one face-to-face meeting.

IV. Conclusion

The burden of compliance costs, including the often unnecessary examination of small business tax returns, arises not only because of the complexity of the tax law but also because of basic inefficiencies in the selection of returns for audit and the conduct of the examinations themselves. Because of these inefficiencies, small businesses have had to turn over responsibilities for the audit of their returns to tax professionals whose fees have made it necessary for taxpayers to concede possibly incorrect IRS adjustments. By revisiting its approach to the conduct of correspondence audits, the IRS can make such examinations more efficient thereby raising additional revenue for the government and lessen the burden on the tax paying community that is the fastest growing sector of our economy.

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Thank you for the opportunity to testify today and the Kogod Tax Policy Center looks forward to working with the Committee on this critical problem of tax administration.