

**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 20, 2015  
Re: Hearing: "How Tax Compliance Obligations Hinder Small Business Growth"

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On July 22, 2015 at 11:00 am, the Committee on Small Business will meet in room 2360 of the Rayburn House Office Building for the purpose of receiving testimony on the tax compliance burden on small firms and examine the effectiveness of actions taken by the Internal Revenue Service (IRS) intended to reduce small firms' tax compliance burden. The United States Government Accountability Office (GAO) will release a report at the hearing examining the efficacy of some IRS efforts to ensure tax compliance and the potential burdens those efforts caused small businesses. A second panel will focus on ways to reduce the burden for small firms and stress the need for comprehensive tax reform in order to lower the compliance burden and make paying taxes a simpler proposition for small businesses.

**I. Background**

Over time, our tax code has become more complex and truly temporary, with significant tax relief being extended for one year, for months at a time or even retroactively. Taxpayers, and particularly small business owners, complain that this uncertainty, coupled with new taxes and regulations, have made it difficult to comply with their tax obligations.

Changes in the tax code can be particularly problematic for small firms, not only because of the economic impact, but also the time and expense needed to comply with the law, recordkeeping, and filing requirements, staying current with the law, the paperwork and recordkeeping. While tax administration policy is an important matter, its impact on small businesses, as the generators of most new jobs, is especially significant.

A continuously changing tax code has ramifications on tax compliance as well. According to testimony by former Comptroller General David Walker,<sup>1</sup> the design of the

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<sup>1</sup>*Simplification and Increased Uniformity of Taxation Would Yield Benefits: Hearing before the United States Senate Committee on Finance, 110<sup>th</sup> Cong. (September 30, 2006) (testimony of David M. Walker), available at <http://www.gao.gov/new.items/d061113t.pdf>.*

current system of business taxation is widely viewed as flawed. Complexity can promote the use of tax shelters and reduces the perception of fairness and public confidence that other taxpayers are paying their fair share.<sup>2</sup> Additionally, individuals who do not understand the law have more difficulty complying with it, and the result is less revenue in the Treasury. The Taxpayer Advocate's 2011 Report to Congress states the code is so complex that even the IRS has difficulty administering it.<sup>3</sup> Simplification and increased uniformity could encourage greater compliance, and a more accurate representation of tax revenue collected versus what is owed.

## II. Tax Compliance Complexity and the Tax Gap

The degree to which taxpayers comply with tax rules, regulations, and statutes is essential for a government to ensure its funding.<sup>4</sup> Not surprisingly, with the importance of the collection of taxes to a government, the efficiency of tax collection and the requirements placed on its citizens is not new. Spun another way, the degree of "efficiency" achieved or not achieved by a government can be (and often is) characterized as "burden" by its citizens.

Tax compliance burden is defined as the time and money that taxpayers expend each year to comply with tax rules and regulations.<sup>5</sup> This would include federal, state, and local obligations. Time spent on tax activities can include working with a paid professional, tax planning, keeping records, completing forms, submitting forms, learning tax laws, and working with the IRS on tax issues.<sup>6</sup> Monetary burden can include expenses for hiring a paid professional to file taxes, investing in a tax software system, paying for payroll services, and legal fees.<sup>7</sup>

Tax compliance has an effect on the tax gap, identified by the IRS as the difference between the taxes owed and taxes paid on time.<sup>8</sup> Much of the small business contribution to the tax gap may be inadvertent errors because of tax complexity. Simplification and increased uniformity of the tax code and its regulations could encourage greater compliance, and a more accurate representation of tax revenue collected versus what is owed. In January 2012, the IRS estimated that the gross tax gap to be \$450 billion for 2006.<sup>9</sup>

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<sup>2</sup> IRS, NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 18 (2012), *available at* <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report>.

<sup>3</sup> IRS, NATIONAL TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS, EXECUTIVE SUMMARY 2 (2011), *available at* <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

<sup>4</sup> M. HARTNER, ET. AL., PROCEDURAL FAIRNESS AND TAX COMPLIANCE 1(2008), *available at* <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC3079897/pdf/ukmss-30410.pdf>.

<sup>5</sup> D. DELUCA, ET. AL., MEASURING THE TAX COMPLIANCE BURDEN OF SMALL BUSINESS, IBM BUSINESS CONSULTING SERVICES 1(2005), *available at* <http://www.irs.gov/pub/irs-soi/05deluca.pdf>.

<sup>6</sup> GAO, IRS CONSIDERS TAXPAYER BURDEN IN TAX ADMINISTRATION, BUT NEEDS A PLAN TO EVALUATE THE USE OF PAYMENT CARD INFORMATION FOR COMPLIANCE EFFORTS (GAO-15-513) 5 (June 2015), *available at* [http://watchdog.gao.gov/distribution/files/N8KG\\_d15513restricted.pdf](http://watchdog.gao.gov/distribution/files/N8KG_d15513restricted.pdf) [hereinafter GAO 2015 Report].

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 1.

<sup>9</sup> *Id.*



The United States federal tax system is a voluntary system. As a result, uncollected revenue from noncompliance may arise from various sources. The IRS has focused most of its tax gap studies on the individual income tax return, and more specifically, on the areas of the return that are not subject to withholding or third-party information reporting. As a result, the tax gap estimates place a heavy emphasis on business income reported on individual income tax returns. Because many small businesses report their income and expenses on the individual income tax return, the IRS focus creates the general perception that the tax gap problem is predominantly one associated with individual income tax returns and the business income of small businesses.<sup>10</sup>

Small businesses are disproportionately affected by tax complexity. A study by the Small Business Administration's (SBA) Office of Advocacy disclosed that small firms pay 67% more to comply with the tax code than large firms do, with tax complexity a contributing factor.<sup>11</sup> A more recent update to that study<sup>12</sup> found that firms with less than 50 employees pay, on average, \$1,518 per employee in tax compliance burden, whereas firms with more than 100 pay \$647.

Because the assumption made by the IRS that tax gap problem is a small business problem, they have taken steps to increase voluntary compliance from that segment of the business population. This has the potential to increase the compliance burden on the affected segments.

### III. GAO Report 15-513

In June of 2013, the Small Business Committee requested a GAO report describing: the characteristics of the small business population; how characteristics of a small business affect compliance burden; and how IRS integrates small business compliance burden considerations in decision-making. The GAO has concluded this report titled, "IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts," (hereinafter "report") which officially will be released at the hearing. In addition to researching these characteristics, the report also details IRS' plan for evaluating a new payment card sale reporting pilot program.<sup>13</sup>

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<sup>10</sup> OFFICE OF ADVOCACY, SBA, AN EXAMINATION OF THE 2001 IRS TAX GAP ESTIMATES' EFFECTS ON SMALL BUSINESSES 5-6 (2011), available at [https://www.sba.gov/sites/default/files/2001%20IRS%20Tax%20Gap\\_0.pdf](https://www.sba.gov/sites/default/files/2001%20IRS%20Tax%20Gap_0.pdf).

<sup>11</sup> NICOLE V. CRAIN AND W. MARK CRAIN, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS 7-8 (2010), available at <https://www.sba.gov/sites/default/files/The%20Impact%20of%20Regulatory%20Costs%20on%20Small%20Firms%20%28Full%29.pdf>.

<sup>12</sup> W. MARK CRAIN AND NICOLE V. CRAIN, THE COST OF FEDERAL REGULATION TO THE U.S. ECONOMY, MANUFACTURING, AND SMALL BUSINESS 2 (2014), available at <http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Full-Study.pdf>.

<sup>13</sup> For a detailed description and discussion of this pilot program, please see GAO Report 15-513. For simplicity's sake, this memorandum will not delve into the specific methodology and outcomes of this program and instead focus on the findings of the GAO in regard to the characteristics of small firms and issues surrounding tax compliance complexity.

## A. The Characteristics of the Small Business Population

Using 2010 IRS taxpayer data, GAO found that small businesses (defined in this report as individuals or entities with substantive business activity but with less than \$10 million in total income and deductions) make up about 99 percent of all businesses.<sup>14</sup> Approximately 69 percent (or about 16 million) are individual taxpayers classified as sole proprietorships, landlords, or farmers.<sup>15</sup> The remaining 31 percent are partnerships, S corporations,<sup>16</sup> or C corporations.<sup>17</sup> Individual taxpayers generated only 23 percent of the total income of small businesses, whereas small business partnerships, S corporations, and C corporations accounted for the majority—77 percent—of total small business income.<sup>18</sup> In general, most small businesses are classified as individuals, but most small business income is earned by partnerships and corporations.

## B. How Characteristics of a Small Business Affect Compliance Burden.

According to GAO's report, small businesses undertake a number of tax-compliance related activities that create burden.<sup>19</sup> These activities can be grouped into general categories such as income tax activities, employer-related tax activities, and third-party information reporting tax activities.<sup>20</sup> Tax compliance activities are not limited to the annual filing of a tax return, but rather occur throughout the year. For example, sole proprietors are generally required to file income returns every April. Some small businesses need to pay estimated income taxes four times a year. Moreover, small businesses with employees are required to deposit employment taxes either monthly or semiweekly, and to report summary information of these activities on a quarterly basis. Additionally, depending on specific business operations, other tax compliance activities such as reporting excise tax, tax planning, and recordkeeping happen throughout the tax year.<sup>21</sup>

The tax compliance burden associated with these activities varies depending on the business' asset size, filing entity type (e.g., sole proprietor, partnership, etc. . .), number of employees, and industry type.<sup>22</sup> Research indicates that burdens increase with the size of the business, whether measured in terms of assets, receipts, or employment; however, burden per dollar of assets or receipts or per employee decline with size due to economies of scale.<sup>23</sup> For

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<sup>14</sup> GAO 2015 Report at Highlights page.

<sup>15</sup> *Id.* at 6.

<sup>16</sup> S Corporations' income or losses are reported on the returns of their shareholders. A business defined as a partnership is one where the business operation between two or more individuals who share management and profits and allows for the pass-through of profits to each of the partners to declare on their individual tax returns. An LLC is essentially a hybrid entity that combines the characteristics of a corporation and a partnership or sole proprietorship. While the limited liability feature is similar to that of a corporation, it can be structured with the availability of pass-through taxation to the members of the company.

<sup>17</sup> GAO 2015 Report at 6.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at Highlights Page.

<sup>20</sup> *Id.* at 13.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at Highlights Page.

<sup>23</sup> *Id.* at 18.



example, a small business owner who figures and files his own taxes may create a spreadsheet to compute the business's taxes and keep track of the employment taxes he owes for each employee. The effort the small business owner makes to build that spreadsheet is a fixed cost, or one that does not change with an increase or decrease in the amount of goods or services that are produced. As the small business owner's sales grow and as he hires more employees, he doesn't have to repeat that effort; he just has the additional cost of adding new data on income and employees to the spreadsheet. As this business grows, its total compliance costs decline both as a proportion of sales and on a per-employee basis. For these reasons, the costs per dollar of receipts or per employee are larger for small businesses than for larger one.<sup>24</sup>

The GAO highlights 2002 IRS data which found that for S corporations, C corporations, and partnerships, the estimated tax compliance burden per employee was broken down as follows:

1 to 5 employees: \$4,308 to \$4,746;  
6 to 10 employees: \$1,307 to \$1,365;  
11 to 15 employees: \$822 to \$901;  
16 to 25 employees \$674 to &686;  
25 to 50 employees \$474 to \$488; and,  
More than 50 employees: \$182 to \$191.<sup>25</sup>

### **C. IRS Integration of Small Business Compliance Burden Considerations in decision-making.**

The GAO report details examples of how the IRS attempts to ease taxpayer burden while increasing compliance. For example, the GAO outlined the example of a burden reduction initiative at the IRS when it developed a simplified method for determining the Home Office tax deduction.<sup>26</sup>

The report also points out that IRS has said one of its strategic goals is to provide high quality and timely service to reduce taxpayer burden and encourage voluntary compliance.<sup>27</sup> As discussed earlier in this memorandum, because small firms often do not have dedicated staff to prepare their tax returns, many rely on assistance from the IRS in order to comply with their tax obligations. The IRS has fallen short in servicing small firms in this regard. There has been a documented erosion of taxpayer assistance and education activities at the IRS over the past several years. In FY 2014, 35.6 percent of phone calls went unanswered by customer service representatives; 50 percent of pieces of correspondence were not handled timely; virtually zero tax returns were prepared by personnel at IRS walk-in sites; and only about 6 percent of the outreach and education budget of the IRS Wage and Investment Division, which

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<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 20.

<sup>26</sup> *Id.* at 26.

<sup>27</sup> IRS, STRATEGIC PLAN FY 2014-2017 22 (2014), available at <http://www.irs.gov/pub/irs-pdf/p3744.pdf>.

is responsible for helping approximately 126 million individuals understand and comply with their tax obligations, is devoted to activities that involve face-to-face contact with taxpayers.<sup>28</sup>

When preparing this report, the GAO also interviewed several small business representatives who identified areas that contribute to compliance burdens. These areas include issues related to customer service, filing requirements, lack of or delayed official guidance, and compliance contacts.<sup>29</sup> While the report details instances where the IRS has sought to reduce the compliance burden, the interviews with small business representatives show that many of those efforts have yet to positively affect small entities.

#### **IV. Conclusion**

Also included in the report is an appendix of recommendations the GAO has provided the IRS in a multitude of previous reports that may lessen the impact of the tax compliance burden on small firms.<sup>30</sup> If they are ever implemented by the IRS, these 25 recommendations could go a long way to reducing compliance burdens for individuals and businesses alike.

In principle, the IRS has made note of initiatives that attempt to reduce taxpayer burden, but data shows that they are falling short of the mark. The IRS must do a better job at educating and servicing taxpayers in order to improve voluntary compliance. This hearing will provide members an opportunity to examine several of these issues in detail.

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<sup>28</sup> IRS, NATIONAL TAXPAYER ADVOCATE, 2014 ANNUAL REPORT TO CONGRESS viii (2014), *available at* <http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2014-Annual-Report/Volume-One.pdf>.

<sup>29</sup> GAO 2015 Report at 27-28.

<sup>30</sup> GAO 2015 Report at 60-65.