Statement of

Pete Sepp
President
National Taxpayers Union

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Tax Reform: Ensuring that Main Street Isn't Left Behind

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Contact Information:
Pete Sepp
President
National Taxpayers Union
108 N. Alfred St.
Alexandria, VA 22314
703-683-5700
president@ntu.org

Introduction

Chairman Chabot, Ranking Member Velázquez, and Members of the Committee, I am honored to have been invited to present comments today for your hearing, "Tax Reform: Ensuring that Main Street Isn't Left Behind."

My name is Pete Sepp and I am President of National Taxpayers Union (NTU), a non-partisan citizen group founded in 1969 to work for less burdensome taxes, more efficient, accountable government, and stronger rights for all taxpayers. One of NTU's greatest honors was having its then-Executive Vice President David Keating named to the National Commission on Restructuring the Internal Revenue Service (IRS) in 1997, a federal panel whose recommendations later became the basis for the most extensive IRS overhaul in a generation. More about our work as a non-profit grassroots organization, and the thousands of members we represent across the nation, is available at www.ntu.org.*

Throughout our 46-year history NTU has held a special concern for small business and self-employed taxpayers, who make up a somewhat larger proportion of our membership than would be represented in the general working population of the United States. Although we advocate for many structural changes to the tax system, from the comprehensive to the incremental, one common aspect on which NTU often specifically focuses is the *administrability* of such proposals. As policymakers define the rates, bases, deductions, credits, and other features of a tax system, what will the practical impact be on taxpayers' lives and their rights?

As NTU has discovered firsthand, few sectors can be more deeply affected by the answer to this question than small business. In the 1970s and 1980s, many of the first Americans to approach NTU's advocacy staff and share "horror stories" of harsh treatment by the Internal Revenue Service were small business owners. In the 1980s and 1990s, the surge of start-ups and independent contractors began changing the nature of the workforce, and once again NTU participated in attempts to adapt the tax system to new times. In the 2000s and 2010s, the increasingly interconnected global economy, along with relatively short-lived tax policies, has presented new complexity challenges to NTU's members.

Accordingly, the following testimony will include recommendations not only for redesigning technical elements of the tax law, but also creating a framework for implementation and enforcement that is efficient for the economy and respectful toward the citizens it serves.

Before exploring these recommendations, it is helpful to put some of the biggest challenges facing small business taxpayers into historical and statistical perspective.

Members of the Committee are well aware of many figures and anecdotes that detail the complexity, uncertainty, and fear of harsh enforcement that can characterize the taxpaying experience of the small business community. A few bear repeating here.

The Challenge of Complexity

It is no secret that the act of *filing* taxes can be a significant and distinct burden from the act of *remitting* taxes. This is true for many segments of the population, particularly businesses of all sizes. According to an annual study, "A Complex Problem: The Compliance Burdens of the Tax Code"

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published by our research affiliate National Taxpayers Union Foundation, the federal personal and corporate tax system extracted 6.1 billion hours and $233.8 billion out of the economy this past year (a trend that has been worsening). Other analyses suggest that two-thirds or more of these sums would be attributable to the business sector, including corporations, partnerships, and sole proprietorships. Such statistics should, on their own, be cause for alarm among policymakers, but there are more specific examples that deserve attention.

Perhaps the most extreme individualized illustration of the complexity load that businesses bear is General Electric's 2006 tax return, which would have amounted to over 24,000 pages had it been printed on paper. GE's tax return may be even longer today. When NTU's researchers contacted GE's media relations staff in 2010, they were told that the firm's tax department had stopped counting after the filing documents routinely exceeded the 24,000-page mark every year.

Companies such as GE, with hundreds or even thousands of employees laboring to fulfill tax requirements, are forced to pass along their costs in the form of higher prices, lower shareholder returns, or fewer employment opportunities. Small businesses must do the same. Yet, it is clear that even in tax compliance, economies of scale can sometimes occur, making the chore of meeting tax obligations disproportionately more difficult for small businesses and self-employed individuals. At the same time, their ability to exercise "pass along" options is more limited.

How can the impact of tax compliance and complexity on small businesses in particular be expressed? There are numerous possibilities, but the following are, in my opinion, most instructive:

- A September 2014 report for the National Association of Manufacturers calculated that the regulatory cost *per worker* for all tax compliance activities in firms of any size was a whopping $960 (using 2012 data and expressing in 2014 dollars). For companies with fewer than 50 employees, the tab was much worse – over 50 percent more, at $1,518 per worker.
- According to the National Society of Accountants, the average fee for an itemized 1040 long form return with Schedule A and a state return this year will be $273. A Schedule C filer will pay an extra $174, plus (if applicable) $126 for Schedule E (rental income) and $115 for Schedule D (gains and losses). Woe to the S Corporation founder, who will shell out an average of $778 for completion of Form 1120S.
- A September 2011 analysis by Quantria Strategies for the Small Business Administration's Office of Advocacy determined that for sole proprietorships – the most common form of small business – the average monetized 1040 filing burden for firms with receipts of under $25,000 was $474, compared to $909 for those with receipts of $5,000,000 to under $10,000,000. This suggests there is an inescapable compliance expense that functions in a near-regressive manner.
- Business owners themselves are not oblivious to this expense, and they apparently believe the price tag is mounting. The National Federation of Independent Business has long conducted a survey of small firms' outlook on the economy. One question asks business owners to identify the single most important problem facing their operation, such as poor sales, insurance, interest rates, taxes, the cost of labor, government requirements, etc. During the past four years the problem of taxes has risen sharply as the top concern, from 19 percent in December of 2010 to 27 percent in December of 2014. Government requirements comprised the greatest worry among just 13 percent of respondents in 2010, but had jumped to 22 percent in 2014. Throughout that time the problem of poor sales was tumbling from the top spot.
- Some of this apprehension is likely due to the implementation of the Affordable Care Act (ACA) of 2010. Earlier this month National Taxpayers Union Foundation's researchers visited the IRS's special website section devoted to ACA, and determined that the online destination offered 3,322 pages of regulations, Treasury decisions, revenue procedures, and other guidance. While this

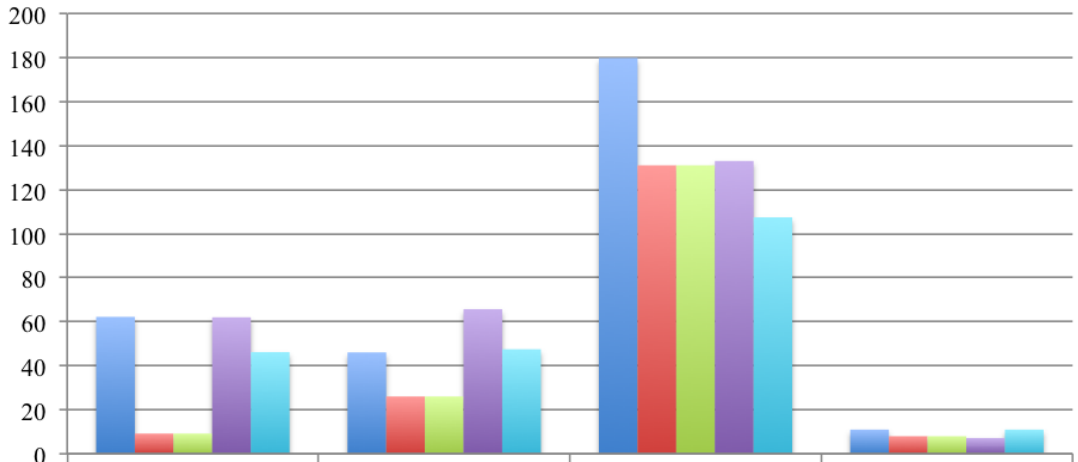
information was designed for numerous constituencies, small businesspeople are likely left as confused as anyone over the direction that ACA will take in the future.

One important question surrounding these statistics is, how do they compare with the experience of firms in other countries who are considered our competitors? The answer is not cause for celebration.

For 10 years, the annual "Paying Taxes" analysis has served as a respected benchmark for measuring the administrative aspects of income and employment taxes at all levels of government among all the nations of the world. Currently published by PricewaterhouseCoopers in consultation with the World Bank, "Paying Taxes" creates a compliance scenario based on a hypothetical company formed as the most common limited liability entity under local laws, with a total of 60 employees engaged in "general industrial or commercial activities."

PwC bases its rankings on hours per year spent complying with the country's tax filing procedures, the number of payments in connection with such procedures, and the overall tax rate the business would face, constructing an "ease of payment" index that weights those metrics. NTU's research arm selected PwC's five most recent reports (2011-2015), and compared the average results for the U.S. and four other Organization for Economic Cooperation and Development (OECD) countries often regarded as close competitors. The figure below, reproduced directly from "A Complex Problem," depicts the findings.

Figure 2. PwC "Paying Taxes" Report Metrics, 2011-2015 Average



	Rank	Tax Rate (Percent)	Time to Comply (Hours/Year)	Payments
United States	62.2	46.06	179.8	11
Canada	9.2	26.04	131	8
United Kingdom	9.2	26.04	131	8
France	62	65.7	133	7.2
Australia	46.2	47.48	107.4	11

PwC's data indicate that the U.S. ranks worst among the five OECD countries compared in terms of the total time a business spends complying with the Tax Code and overall ease of payment. Such findings underscore how U.S. small businesses can be trapped within a tax administration structure that is more obtuse than those found in many other developed countries.

The Challenge of Fair Enforcement

Some six thousand years ago, an inscription found in the ancient city of Lagash (in modern-day Iraq) lamented that "you can have a lord, you can have a king, but the man to fear is the tax collector." This alone is a testament to the trepidation that taxpayers have felt throughout the history of civilization over the power of tax enforcers. During its own institutional history, NTU has been involved in an ongoing effort to rein in the worst abuses of the tax agency and establish oversight procedures. This has taken place largely through three pieces of legislation enacted in 1988, 1996, and 1998; the latter, the IRS Restructuring and Reform Act, implemented the most sweeping changes. Through it all, and years following, NTU has encountered IRS "horror stories" too numerous to repeat here.

Prior to reforms enacted in the 1988-98 period, taxpayers had only a few options in disputing an IRS assessment that did not involve considerable expense and time. Even if they decided to go to U.S. Tax Court or a Federal District Court, the most citizens could recover if they were victorious was $75 an hour in attorney fees. The 1988 law allowed taxpayers to sue for damages if they could prove an IRS employee "recklessly or intentionally" disregarded the law. The cap on attorney fees was raised to $125 per hour. Yet, these provisions were still paltry to a taxpayer, especially a business owner, contemplating months or years of lost time, a large up-front out-of-pocket expense, and a tax bill that kept accruing interest and penalties.

It was no wonder that many businesspeople told lawmakers in hearings during the 1980s and 1990s that they believed the cost of disputing an IRS tax bill – even if they knew the agency was wrong – simply became too prohibitive. To be sure, there were appeal and abatement processes for audits that have improved over time in terms of accessibility and affordability for taxpayers without extraordinary means. Unfortunately, even into the mid-1990s, many Americans facing IRS demands felt helpless. According to a 1995 study by tax litigation expert Daniel J. Pilla:

> The average individual face-to-face tax audit led to the assessment of $4,780 in additional tax and penalties, not including interest. However, just 5 percent of those found to owe more money appealed. The 5 percent number is significant in this way: the GAO has proven that the IRS's computer notices are wrong 48 percent of the time. Still, 95 percent of the public is persuaded that IRS audit results are correct or not worth fighting. That testifies to the degree to which the IRS has the public convinced that it cannot win when challenging an audit.

In short, all too many Americans thought it was cheaper to pay what the IRS said they owed rather than fight.

A review of more recent tax enforcement statistics from the IRS Data Book (Publication 55) still paints a daunting picture for small businesses:

- Over the past ten Fiscal Years, the IRS Chief Counsel's Office has typically closed over 70,000 "tax enforcement and litigation" cases per year. Roughly ¾ of those cases fell under the category of "Small Business and Self-Employed." No other area of practice – large businesses, criminal issues, or even general legal services – comes close.
- While it is true that "small corporations" filing the 1120 form are less likely to have their returns scrutinized than larger firms, the majority of business entities declare their profits and pay their

taxes using 1040 forms. Thus, it is more relevant to analyze the experiences of businesses in the latter situation. A comparison of 1999, 2004, 2009, and 2014 data (every fifth year of available statistics online) shows that the examination coverage rate for *all* taxable individual income tax returns ranged from 0.8-1.0 percent. However, over that same period the rate for business tax returns within this category reporting gross receipts of under $200,000 was between 1.0 and 4.2 percent.

Some might argue that statistics such as these – and many others – merely show that small businesses are likelier to be cheating on taxes, and so they have invited more attention from authorities. I would assert that this characterization is oversimplified. In NTU's near-four-decade experience of detailed work on taxpayer rights legislation, one common theme we have encountered is "the fear factor" that taxpayers experience when encountering the IRS. Small business owners, especially, are able to tally the costs of contesting an IRS bill they know to be wrong versus simply "settling up" and carrying on. In too many instances, small businesses facing long odds of prevailing choose the latter option.

Consider, for example, the average additional recommended tax in 2014 resulting from field audits of business 1040 tax returns with receipts between $25,000 and $100,000 – a total bill of $8,756 per return. Imagine the decisions this audited business owner – the very definition of "the little guy" – would face. If he or she hires a tax professional for representation at an audit, the average fee, according to the National Society of Accountants would be $144 per hour. It would not be unusual for the accountant to spend 10 hours on this stage of the audit. Should the initial examination go against the owner, he or she could choose to retain the accountant for the administrative appeals process, perhaps involving an additional 10 hours of time. Meanwhile, the owner could have easily spent 10-20 hours of time gathering records, reviewing paperwork, etc., at an average compensation amount (according to the National Association of Manufacturers study mentioned previously) of $48.80 per hour.

To get this far into the audit process, the owner could have already spent close to $3,900, nearly half the contested bill. Should the administrative route fail, the owner then has broad options to file a Tax Court petition or try to litigate in federal court. While many Tax Court petitions never advance, and often lead to settlements, this process could easily consume another 10 hours of a legal professional's time (at likely a higher rate of compensation). Should litigation actually take place, a qualified tax attorney might demand $300 per hour or more. If the owner prevails, his or her ability to recover the entirety of fees like these remains doubtful. The maximum hourly amount that can be awarded is barely $200 per hour, and only if the court determines the IRS's position was not "substantially justified." In a 2013 *Wall Street Journal* article, respected tax lawyer Robert Wood estimated that over the past decade, he identified at least 22 taxpayers involved in IRS disputes who received some kind of attorney compensation or litigation costs from courts, "although some rewards may later have been reduced."

All along this difficult road, the owner must also take account for the damage that eventual liens or levies could have on his or her business reputation, not to mention lost productivity diverted from keeping the company profitable.

Confronted with this type of calculus, it is little wonder that many business owners who are innocent (or in many cases just made an honest mistake) are intimidated into capitulating completely to the IRS's position or making a compromise that substantially weakens their balance sheets. The latter course can actually backfire on the government, should the business become so infirm that it no longer is able to deliver receipts to the Treasury.

Granted, IRS reforms have expanded both the number and the usability of appeals avenues to taxpayers, the availability of Taxpayer Assistance Orders, as well as safeguards against hasty or capricious liens and seizures. Nonetheless, the IRS came under new scrutiny last fall regarding its collection policies, amid revelations from *The New York Times* that the agency had made hundreds of tax-

related seizures in 2012 by creatively employing civil asset forfeiture laws. As the *Times* observed (with historical relevance in my opinion), "The government can take the money without ever filing a criminal complaint, and the owners are left to prove they are innocent. **Many give up** [emphasis added]. … The median amount seized by the I.R.S. was $34,000, according to [an] Institute for Justice analysis, while legal costs can easily mount to $20,000 or more."

The IRS has pulled back from this controversial strategy, but the National Taxpayer Advocate's report to Congress from last year suggests that the "fear factor" alluded to earlier has consisted of more than a collection of sensational stories. She noted that:

- "Collection Due Process" hearings still place too much emphasis on "collection" and not enough on "due process" for taxpayers;
- The IRS's automated case selection system too often fails to arrive at satisfactory resolutions of cases at reasonable collection yields; and
- The agency does not give sufficient consideration to installment agreements or offers in compromise to resolve business tax deficiencies in the way it does for individual tax liabilities.

Clearly, Congress and the IRS have more work to do in this often-overlooked dimension of tax reform.

The Challenge of Uncertainty

A vague and often complex tax law, along with still-vast IRS enforcement powers, combine on their own to create a harsh, uncertain environment in which the small business owner must make plans for investments, hiring, and a host of other actions. Consider just one astounding example.

According to the 2011 "report card" on the IRS National Taxpayer Advocate's recommendations to Congress, there are a total of 43 federal tax publications adding up to 1,212 pages pertaining to "U.S. businesses involved in economic activity abroad." Incredibly, these documents in themselves "refer to other publications comprising 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions."

The IRS, at last count in 2014, sponsored over 3,700 events designed to provide "outreach for small business and self-employed taxpayers" as well as logged more than 708,000 small business electronic newsletter subscriptions to owners, payroll providers, and tax professionals. Even with this admirable effort at providing clarity for tax laws affecting both domestic and international operations (on top of thousands of private-sector services spending billions of dollars), America's small businesses will continue to suffer a competitive disadvantage until a major simplification effort provides a more readily navigable – and certain – path through the tax maze.

Yet, there is a third factor that contributes to uncertainty: the legislative process itself. Research appears capable of attempting to quantify this phenomenon:

- A March 2012 study by the Stanford Institute for Economic Policy Research developed an index to track U.S. economic policy uncertainty since 1985. The authors concluded that such uncertainty was "close to its all-time high," which was "a key factor stalling the recovery and threatening a return to recession."
- As the 2012 "fiscal cliff" approached, and with it the prospect of a return to pre-2001 tax rates, executives at a plethora of firms, from Honeywell to Northeast Wealth Management (a small business advisory company), remarked that hiring and expansion moves were being put on hold due to uncertainty over the direction Washington would take.

- A March 2015 analysis by the Institute for Policy Innovation (IPI) examined the impact on business decision-making around the up-and-down turmoil of the Section 179 small business expensing limit over the past few years. The wild fluctuations of the limit – between $25,000 and $500,000 – and its retroactive extensions were, according to IPI, particularly difficult for the agricultural sector. Citing evidence of equipment sales from the Federal Reserve Bank of Kansas City and employment news from manufacturers, IPI observed that "[i]t is reasonable to link the drop in agricultural investment and the resultant job cuts to the failure of Congress to renew the higher Section 179 allowance early enough in 2014 to have its intended incentive effect."

A few words of caution are in order at this point. It is obviously worse to make bad policy with an ironclad degree of certainty than it is to tolerate uncertainty with the prospect of a better outcome for taxpayers. The "tax cliff" compromise of 2012 was, after all, not ideal. Harsh tax rates on upper earners, which hit many thousands of pass-through businesses, amounted to one undesirable consequence of that legislation. Furthermore, Section 179, a highly important provision of tax law, has often been rolled up in "extenders" packages that contain a number of narrowly-drawn, economically distortionary items. NTU continues to commend Members of the House, both in the last Congress and the current one, for attempting to "unbundle" these parts of the Tax Code and consider each on their own merits. The recent passage by a solid bipartisan margin of H.R. 636, which would make the $500,000 expensing limit permanent, is an encouraging sign.

Meeting the Challenges: Recommendations for Reform

Although it is not the primary tax-writing body of the House of Representatives, the Committee on Small Business is uniquely equipped to provide a holistic view of the taxpaying experience in the most dynamic part of our economy. The Committee is likewise uniquely qualified to inform the debate over federal tax policy in a constructive manner. The following recommendations, both general and specific, are offered in the hope of assisting the Committee in its advice and communications with those directly involved in the reform process.

1) Maximize Economic Opportunities for Businesses.

Obviously, a wholesale replacement of the tax system could be designed to benefit all taxpayers, including small businesses. It bears mentioning that NTU has long supported two such approaches to scrapping the Tax Code: a flat-rate income tax, which for businesses would apply a single rate of tax on profits remaining after a streamlined set of deductible overhead costs is applied, or a national sales tax levied on goods and services for final retail sale. These concepts are embodied H.R. 1040, the Flat Tax Act, and H.R. 25, the Fair Tax Act, respectively.

Absent such sweeping measures, major tax reform could take the direction of reducing the corporate tax rate below the currently uncompetitive 35 percent level, reducing rates and brackets for individuals and pass-throughs, and simplifying the tax base. Here again, small businesses could, like all other taxpayers, benefit from a comprehensive exercise in tax reform.

One particular way to deliver those benefits is by reducing the cost of capital and investment; H.R. 636, mentioned above, is an example. Along with making the Section 179 limit permanent, the bill would protect S Corporations from extended periods of punitively high taxes as a result of tax status conversion or asset acquisition. In addition, making bonus depreciation permanent as well as the 15-year straight-line depreciation for certain improvements would send helpful signals to businesses considering investments in new equipment and jobs.

Allowing taxpayers to account for inflation when calculating the gain on the sale of an asset would likewise be a boon to small businesses. Such an option has received far too little attention and discussion in tax policymaking bodies up to this point.

The Ways and Means Committee's tax reform draft from the 113th Congress made several excellent strides toward reducing tax burdens on small businesses, but some elements of the plan deserve reevaluation and caution going forward. For instance, the Section 199 deduction for manufacturers would wind down from 9 percent (6 percent for oil and gas) in 2014 to 3 percent for all industries in 2016. At that point the top corporate income tax rate would still be 31 percent. By 2017, the deduction would have been eliminated, yet the rate would have been set at 29 percent. The lower, 25 percent corporate tax rate would not take effect until 2019, which means many businesses could experience substantial tax increases during the phase-in period.

Furthermore, as Raymond Keating, Chief Economist for the Small Business and Entrepreneurship Council noted, Section 179 expensing would have reverted to parameters in place during 2008-2009 (a limit half as large as was put in place retroactively for 2014). In Keating's estimation, "depending on one's perspective, either no real headway would be made on the expensing front, or ground would actually be lost."

One definite area of "lost ground" in the draft would be the end of the so-called "last in, first out" (LIFO) method of accounting, which over one-third of companies large and small have employed. While some may view this move as simplification, in practice it would require massive restructuring of business models, especially those depending on large inventories. Owners of smaller firms rightfully expressed concern that they could be hurt as well.

Still, one of the most pressing issues with the Ways and Means draft concerns parity between "C" corporations and pass-through entities. The latter businesses, paying taxes on the individual schedule, would be subject to a top marginal rate of 35 percent, which is higher than the proposed corporate rate of 25 percent. This potential problem is ameliorated by exempting "qualified domestic manufacturing income" – a very broadly defined concept in the draft – from the 35 percent rate, but the implementation of the change could still disadvantage several classes of small businesses.

All of these matters must be carefully weighed as the 114th Congress seeks to improve upon the good work of its predecessor.

2) Keep Administrability in Mind.

The need to reduce compliance costs in the tax system is a paramount concern for small businesses. Yet, where should Congress focus its attention? An examination by Donald DeLuca, et al., published in 2005 by the IRS's Statistics of Income Division, provides some useful guidance, even though the tax laws have changed since then.

In the study, "Measuring the Tax Compliance Burden of Small Business," DeLuca and his colleagues identified "special characteristics" that increased the time and money small businesses spent in preparing income and employment tax documents. The following factors produced the most acute effects:

- Used the accrual accounting method
- Had foreign operations
- Filed returns in multiple states
- Kept records in case of Alternative Minimum Tax (AMT) liabilities
- Completed an end-of-year inventory to comply with tax rules

- Put depreciable assets into service
- Maintained a business mileage log

As far as employment taxes were concerned, these areas, though not as impactful as income taxes, still added to the compliance load relative to the entire sample of businesses:

- Filed returns in multiple states
- Managed tip income
- Declared compensation subject to special tax rules
- Had employees with the Advance Earned Income Credit
- Had special withholding situations, such as nonresident aliens

Among these, having foreign operations presented the most headaches, by boosting time burdens an average of 739 percent and costs by an average of 1,132 percent above overall baselines. Accrual accounting and AMT issues were also among the most serious obstacles for businesses seeking to minimize compliance headaches.

There is very little Congress can do to ease the pain of having to file tax returns in multiple states. Nonetheless, many opportunities for small-business-oriented tax reform present themselves as a consequence of these findings. The Quantria study mentioned previously is also instructive in showing that among industries, small businesses of various forms of incorporation working in transportation, warehousing, mining, and agriculture all cope with much higher-than-average filing burdens.

First, Congress must make progress in streamlining the reporting and recordkeeping rules for small businesses engaged in international activities, over and above any reforms that attempt to move the tax system from the current "worldwide" model to a "territorial" one. (See the previous section on uncertainty regarding the mountain of paperwork small businesses with activities abroad confront.)

Second, Congress must resist attempts to require accrual-based accounting for a greater portion of the small business community. This is an issue the Committee has explored in-depth. Last year Randy McIntyre, a partner at a Wilmington, North Carolina-based accounting firm, explained why a plan in Congress that expanded the availability of cash accounting to some businesses while denying it to personal service businesses could use retooling:

> Such a law would result in catastrophic financial and compliance burdens for those service businesses. This would force these businesses to pay taxes on accounts receivable, which has been called "phantom income," before they actually collect it. This tax on accounts receivable would be partially offset by the fact that the taxpayer should be able to deduct accounts payable – bills the business owes but hasn't yet paid. The problem is that for a profitable business, receivables are normally much higher than payables. Many businesses may have to borrow money to pay the taxes on receivables that they may not collect until sometime down the road, if ever. Any business owners who have tried to borrow money from a bank recently know how difficult this process is.

Third, Congress must make expensing, depreciation, and investment rules as simple as possible. Although steps such as bonus depreciation and higher Section 179 limits can aid small businesses, ultimately a better solution would be to allow for full expensing for firms of all sizes. Economic efficiency and non-discrimination among industries are two primary reasons for moving to such an arrangement. As the Tax Foundation's Stephen Entin has noted, the deductive value for tax purposes of a $1 investment can shrink to as little as 37 cents due to the current laws. In a 2015 paper arguing for full

expensing, Mercatus Center scholars Jason Fichtner and Adam Michel cite many persuasive sources, and point out that simplification would also be one of the biggest dividends:

> To the extent that expensing might simplify the tax code, there are also great benefits to simplifying the tax code by lessening administrative costs. … Nobel laureate and economics professor Vernon L. Smith notes in a paper titled "Tax Depreciation Policy and Investment Theory" that "perhaps the most valuable advantage of fully expensing capital outlays is that of introducing administrative and clerical simplicity where there has tended to exist great complication." In an article in *Harvard Business Review*, Allen Auerbach and Dale Jorgenson comment on the efficiency gains from removing the administrative burden of depreciation. They note that businesses could eliminate entire sections of their tax accounting staff if they were no longer required to factor tax depreciation into yearly tax liability reporting and long-run investment decisions.

Fourth, although Congress has commendably embedded income-based protections from the AMT in permanent law, the tax will still continue to affect several million filers directly each year. Millions more will suffer even though they don't owe the AMT, because they will be forced to compile mounds of paperwork to ensure they are staying on the "right side" of the tax and its exemptions. Repealing the AMT in its entirety would be a wise decision.

Finally, lawmakers should remember that payroll tax rules, though not as big a consideration as income taxes, should still be subject to the same types of simplification efforts.

3) Make Tax Simplification Systematic … and Automatic.

NTU's Senior Counselor David Keating, who as our Executive Vice President at the time served on the National Commission on Restructuring the IRS, has on many occasions pointed out the lack of a process that would make tax simplification a habit rather than a rare activity for Congress. The IRS Restructuring and Reform Act of 1998, which was based on many Commission findings, nominally required a tax complexity analysis to at least be considered with revenue-related legislation. NTU believes that the tax-writing committees should be *required* to quantify and prominently publish the burdens of *all* proposals that add complexity or the savings from proposals that simplify the law.

But left on the proverbial cutting-room floor in 1998 was a much more powerful reform with great potential to keep the tax system in a trim condition: a quadrennial simplification process, implemented through legislation, which would evaluate all sections of the Internal Revenue Code with an eye toward simplification. The process could be extended to regulations as well. In 2014 Keating wrote in an NTU Policy Paper, "A Taxing Trend":

> The Commission [on Restructuring the IRS] found that many members of the private sector tax community were willing to volunteer substantial time to make suggestions for simplification.
>
> A quadrennial simplification commission would do a more thorough job of harnessing volunteer activity and give a broad group of people on the inside and outside of government more incentive to work for the adoption of simplification rules. This quadrennial commission would also give the JCT [Joint Committee on Taxation] and the Treasury Department more incentive to suggest simplification of the law.

It is true that since 1998, the quantity of information and input on tax complexity from agencies and volunteer has improved. In 2002 the Treasury established Taxpayer Advocacy Panels (TAPs) with volunteers from all 50 states, the District of Columbia, and Puerto Rico who "are dedicated to helping taxpayers improve IRS customer service and responsiveness to taxpayer needs." In our experience, TAPs

have provided valuable suggestions at the most granular level that could, if fully adopted by the IRS and Congress, make the taxpaying experience of all Americans (including small businesses) less troublesome. Among the 42 projects and 148 recommendations contained in TAP's most recently released annual report was detailed guidance to improve the quality of the IRS's Small Business Taxes Virtual Workshop.

The IRS National Taxpayer Advocate has also provided excellent suggestions that would better safeguard taxpayer rights and streamline administration procedures. Unfortunately, progress in getting the IRS and Congress to act on TAP and Taxpayer Advocate recommendations has been uneven.

To underscore this point, NTU reviewed the last three years of the Advocate's "report cards" on implementation of the recommendations contained in her Annual Reports to Congress. Although many of these suggestions are broad-based in that they would benefit all taxpayers, we could identify more than half a dozen key "Most Serious Problems" (MSPs) specifically pertaining to or citing small businesses, each of which contained multiple parts.

The results were not always encouraging. For instance, MSP Topic #12 from the 2013 report card noted that "IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue." This is primarily because the IRS has shunned a "proactive service-oriented approach" that would involve employees capable of quickly resolving trust fund tax delinquencies, in favor of throwing cases into the Automated Collection System. The Advocate outlined five specific steps the IRS could take to make a transition to the service-oriented approach, *none* of which the agency adopted.

The Advocate's 2012 report card examined the IRS's response to MSP Topic #20, the "Diminishing Role of the Revenue Officer," explaining that "particularly with tax debts involving small business taxpayers, the Revenue Officer's skill set should be used as critical to case resolutions that are in the best interests of the taxpayers and the United States." Once more, the Advocate made five specific suggestions involving such upgrades as allowing Revenue Officers to recommend acceptance of Offers in Compromise. Four of those suggestions had been ignored or rejected, and one had been partially adopted.

It is readily apparent that even with the introduction of a quadrennial simplification process on top of advisory tools such as TAPs and the Taxpayer Advocate reports, mechanisms need to be developed for timely consideration and implementation of reforms. The quadrennial simplification findings, for example, should require evaluation by tax-writing committees and an expedited vote process in Congress. TAP and Taxpayer Advocate guidance should be more closely monitored by Congress and, where warranted, built more fully into IRS appropriations bills as policy guidance.

4) Measure Tax Compliance Burdens More Accurately.

While attempts to assess the impact of U.S. tax compliance burdens on the private sector date back at least 70 years, the estimates of these deadweight losses have varied widely. In a 1984 review of literature for *National Tax Journal*, economists Joel Slemrod and Nikki Sorum found that most of these studies, focusing narrowly on completing individual tax returns, put the burden at the equivalent of between 1 and 3 percent of total income tax collections. Other studies based on public survey-techniques and wider definitions of compliance (including one by Slemrod and Sorum) ranged from 7 to 11.5 percent.

For its part the IRS considered the only measurable tax compliance burden to be associated with filling out the tax form, until the Paperwork Reduction Act prompted the tax agency to commission a study by Arthur D. Little in 1983. This analysis utilized advanced questionnaires of actual business and individual taxpayers in the IRS's database, and developed solid data on tax compliance, measured in hours. Subsequent models by Slemrod (with colleagues), the Tax Foundation, Donald DeLuca, and the study by Quantria Strategies for the Small Business Administration (mentioned earlier) have all improved

upon the Little approach, by refining survey techniques, monetizing the value of time spent completing returns, and aggregating data for business structure, size, and industry.

Yet, the need to constantly refine these methodologies remains vital. For example, however sophisticated the techniques may be for surveying taxpayers in developing time-to-completion estimates for forms, inaccuracies in self-reporting are a constant challenge. In his 1993 book, *Costly Returns: The Burdens of the U.S. Tax System*, Professor James L. Payne explains the potential "tendency to overlook many types of tax compliance activities when they take place in small, undramatic ways" with the following illustration:

> Take the case of the free-lance writer and his postage receipts. It is most unlikely that he will recall and report the time spent asking for a receipt, since it involves an almost negligible ten seconds, let us say. Nor would he recall [the] time it took to go to his filing cabinet, take out the receipt, and put it in the correct folder, which might be another ten seconds. But these small activities add up. If this writer asks for and files 100 receipts a year, he has spent over half an hour on just this activity.

Though such an analogy today would likely apply to activities such as hitting the "send" button on emails, or downloading and archiving receipts electronically, the basic point is the same.

Payne also noted how other discrepancies in the Little study (sometimes applicable to its successors) could lead to underestimated compliance burdens. Respondents were told to not report recordkeeping hours for financial profit and loss statements, though many small business owners told researchers that a primary reason for preparing such information was for tax compliance. Even the act of learning about tax-law requirements isn't always confined to studying IRS instructions prior to filing a form; numerous additional hours are spent in classrooms, or in personal discussions among professionals and laypeople alike.

Moreover, attempting to estimate the nebulous concept of "tax planning" is difficult. Accounting for an hour of time with a financial consultant seems straightforward, but what about the time stuck in traffic from the consultant's office that caused a business owner to miss his meeting with a potential client? Or the magazine article on tax tips a business read in the airport, instead of time that could have been spent on another article regarding a new product promising to double her manufacturing productivity? Given these sorts of questions, the current time-burden estimates for a 1040 "business" filer – just 3 hours for tax planning as one example – seem quite low.

In another representation of how variable the projections of tax-system losses are, Payne estimated that for every additional dollar of revenue the government attempted to raise, compliance, enforcement, avoidance, and productivity disincentive costs rose by 65 cents. But such variability should only embolden lawmakers to seek more data.

The Committee should recommend that the IRS, in cooperation with SBA and other relevant agencies and private-sector experts, routinely undertake new research initiatives to measure the true burden of the current tax system on small businesses. This basic information is key to identifying problem areas and developing fitting legislative solutions.

5) Don't Overlook Other Tax Concerns of Small Businesses.

One of the previous recommendations that mentioned payroll taxes raises a salient point about the topics that the Committee is exploring: small businesses face tax concerns of many types and at many levels.

It is worth briefly reminding ourselves, for example, that state tax systems can present small firms with all manner of compliance difficulties. The most recent example was brought to our attention through the Mackinac Center's *Michigan Capitol Confidential* newsletter. Senior Investigative Analyst Anne Schieber recounted the technical difficulties experienced by small businesses forced to use Michigan's new "Systems, Applications, and Products" (SAP) online portal for processing sales, use, and payroll taxes. Some users reported that the SAP registration process alone consumed hours, if not days, of time. Others complained of being unable to obtain timely assistance from state tax officials when they encountered payment problems.

As I noted earlier, there is a little that Congress can do to address these difficulties. However, federal lawmakers do have a role in interstate tax policy that could provide major relief and clarification for small businesses. Your colleagues on the House Judiciary Committee have recently been discussing issues surrounding taxable nexus in commerce that transcends state borders. In part due to the rise of the Internet and the integration of telecommunication technologies, states have been increasingly defining concepts of "physical presence" for tax purposes differently, leading to a confusing situation for businesses forced to contend with a patchwork of rules.

Additionally, for several years now legislation has been proposed that would permit states to require businesses to collect taxes on "remote sales" involving out-of-state buyers. In our opinion these schemes would, besides tearing down constitutional protections against predatory taxation and requiring complex reporting and remitting, subject businesses to the auditing and enforcement arms of other states on a massive scale. The so-called "small sellers" exemption built into this legislation is paltry and would provide little comfort to many catalog and online retailers that do not consider themselves to be large businesses. NTU believes Congress should not give its blessing to this concept, and should consider alternatives. One avenue to pursue would be "origin sourcing," whereby any business engaged in retail activity (online or "brick-and-mortar") would remit taxes on all sales to the jurisdiction in which the business is physically located.

Many legislative plans have been introduced in the previous and the current Congress to address other facets of taxable nexus and interstate tax matters. These include:

- The Business Activity Tax Simplification Act, which would establish a clear physical presence test to ensure that only businesses having employees or property physically present within a given jurisdiction are subject to those taxes.
- The Digital Goods and Services Tax Fairness Act, which would prevent multiple and discriminatory state and local taxes on items such as downloaded entertainment and mobile applications.
- The Multi-State Worker Tax Fairness Act and the Mobile Workforce State Income Tax Simplification Act, which would better define withholding and tax payment requirements for commuter-employees as well as workers traveling to states in which they do not permanently reside.
- The Permanent Internet Tax Freedom Act, which would forbid states and localities from imposing new discriminatory taxes on Internet access – a vital tool upon which small businesses depend.
- The Tax and Fee Collection Fairness Act, which would require that a "transactional nexus" exist between a buyer and seller before a state government could require the seller to collect taxes.

Virtually all of the items in the list above would have the salutary effect of reducing compliance and administrability problems that are becoming increasingly nettlesome.

6) Time for a New Small Business Taxpayer Bill of Rights.

As this testimony has recounted, small businesses have suffered more than their share of woes from flawed administration of the federal tax system. Without constant attention to the problems small businesses encounter in defending their rights as taxpayers, other attempts at simplification and economic efficiency will be incomplete and ineffective.

Some proposed upgrades to the 1998 reforms would affect all taxpayers, but could be especially potent for small businesses. Perhaps the most ambitious of these would more fully unlock the courts as a means of preventative redress of grievances. Although the 1988 and 1998 taxpayer rights laws provided for certain exceptions, taxpayers still generally cannot enforce their rights in court until after they have been violated. Under Section 7421 of the Internal Revenue Code, no lawsuit can be brought by any person in any court for the purpose of restraining the assessment or collection of a tax, except under limited circumstances.

The case law around the Anti-Injunction Act further impedes the ability to restrain the collection of the tax. Injunctions can be granted where the failure to grant relief would result in irreparable damage to the taxpayer. But an injunction will only be allowed where it is clear that under no circumstances would the government prevail (or the taxpayer would not owe the tax). Otherwise only two remedies are available to the taxpayer: 1) Pay the tax, file a claim for refund, and sue for recovery if the claim is rejected; or 2) File a petition in Tax Court before assessment and within the short period of time allowed.

Moreover, the Declaratory Relief Act, which allows citizens to file a suit that can persuade a court to declare their rights, indicates that the law applies "except with respect to federal taxes." The Federal Tort Claims Act presents additional barriers to tax-related controversies.

NTU's David Keating has referred to these provisions as "the Berlin Wall Stopping Taxpayer Rights." The real Berlin Wall fell some 25 years ago; the one keeping taxpayers from court remains standing. Congress should give serious consideration to providing citizens with the limited ability to stop the IRS from violating their rights through litigation. Doing so will involve some level of controversy, and will no doubt prompt lengthy deliberation. Yet we remain convinced that small businesses would be especially well-served by such reforms. How could such a change be effected? A passage from NTU testimony before Congress in 1995 indicates a solid starting point, by amending the Anti-Injunction Act:

> Taxpayers should be allowed to file suit in a federal district court to enjoin the IRS from enforcement action because: the deficiency assessment was made without knowledge of the taxpayer and without benefit of the appeal procedures provided by law; there has been an improper or illegal assessment; there has been an action in violation of the law or tax laws or regulations providing for procedural safeguards for taxpayers; the IRS has made an unlawful determination that collection of the tax was in jeopardy; the value of seized property is out of proportion to the amount of the liability if other collection remedies are available; or the IRS will not release the seized property upon an offer of payment of the U.S. interest in the property.

While Congress contemplates sweeping changes in this area of law, additional progress can be made for small businesses elsewhere. Seventeen years after the IRS Restructuring and Reform Act's passage, Congress has amassed a considerable body of experience and advice on potential improvements from sources such as the National Taxpayer Advocate, professional practitioners, and small businesses themselves. Future tax administration maladies could be prevented by enacting reforms like these:

- Creating an Alternative Dispute Resolution program for audits that will permit neutral third-party mediation in a cost-effective manner. Meanwhile, small case procedures and access to installment

agreements without fees should both be expanded, thereby providing taxpayers with more low-cost options for solving tax problems.

- Strengthening safeguards against taxpayer abuses, such as a ban on ex parte communications between IRS case employees and appeals officers, and a prohibition on new issues being raised during a taxpayer's appeal process.
- Providing more avenues for redress when the IRS recklessly or intentionally disregards the law, including increases in the cap on damages and more options to recover attorney fees.
- Delivering additional opportunities for spousal relief, such as more time for filing petitions and clarifying that Tax Courts must follow applicable appellate procedures when reviewing such petitions. For over two decades NTU has sought more equitable tax treatment for "innocent spouses" (usually divorced) who are wrongfully being pursued as "responsible and willful" parties to tax controversies involving the other spouse. Divorced spouses must often reconfigure their professional as well as their personal lives, and doing so can mean becoming self-employed. Making updates to this area of law would help many people in such a situation to remain on a sound financial footing.

These types of changes are thoughtfully incorporated in legislation known as the Small Business Taxpayer Bill of Rights, slated for introduction in this Congress today by Senator Cornyn. Some sections of the bill will overlap with the taxpayer rights legislation that the House is slated to vote on today as well. It is critical for Members of Congress to follow up these votes with the legislative energy necessary to get reforms to the President's desk as quickly as possible. The Small Business Taxpayer Bill of Rights has been introduced in previous Congresses; its many valuable protections should not languish for another two years.

Conclusion: Ensuring that Main Street Isn't Left Behind Means Ensuring Taxes Don't Crush the Entrepreneurial Spirit

My singular hope in presenting this testimony is that Members of the Committee will think beyond the distributional tables, econometric analyses, JCT scores, and other dry topics that so often characterize discussions of tax policy. Rather, I urge you to consider the impact of tax laws *and their administration* on the very human quality that has animated our country since its founding: the entrepreneurial spirit of the small business owner.

That spirit, which makes our society more prosperous, offers more opportunities to disadvantaged constituencies, and delivers innovations that improve lives around the world, is a quality that can be nurtured for generations to come. But a bright future depends upon the willingness of tax administrators and Members of Congress to work together, in a bipartisan fashion, to strengthen the totality of the tax system … so that it not only allows small businesspeople to pursue their dreams but also respects their rights as they do so. Please consider NTU to be your partner in this crucial undertaking.

I thank all of you for bearing with these lengthy remarks, and NTU stands ready to answer your questions or assist in any other way with your deliberations.