



**Statement of Roger Harris
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Before the Subcommittee on Economic Growth, Tax
and Capital Access
U.S. House of Representatives Committee on Small
Business**

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Good morning, I am Roger Harris, President and Chief Operating Officer of Padgett Business Services. I have been a tax practitioner for over 40 years and have served on the Internal Revenue Service Advisory Council for four years and was its Chair for two of those years. I believe this experience gives me a balanced approach to small business taxation – I have had the opportunity to see what works and what doesn't work in the real world.

For nearly fifty years, Padgett Business Services has been providing accounting, income tax planning and preparation, payroll and payroll tax services to thousands of small business owners through our network of over 200 offices across the United States. Our clients generally have 20 or fewer employees and are what some people would consider “mom & pop” businesses; however, based on recent studies almost 90% of all firms that have employees operate in our target market.

Internal Revenue Service Audits of Small Businesses

Padgett's business model brings us in contact with our clients throughout the year, not just during filing season. We assist our clients in establishing good accounting, recordkeeping and tax processing. This ongoing communication allows us to understand these small business owners well beyond just knowing their numbers. Our strong belief is the best way to survive an audit is to do everything within your means to never have one. Enforcement being a prerequisite for our tax system to work, there is a real possibility for all small business owners to one-day experience the pleasure of an IRS audit. Because of that possibility the second best way to get

through the process is to have a clear, traceable record of financial transactions and of course to keep and organize receipts and invoices. A disciplined approach throughout the year generally results in less trouble with the tax man - local, state and federal.

In those occasions where audits do arise, either for established clients or individuals new to the small business world, it's important to have a broad overview of the process.

In general, there are two kinds of audits: Correspondence and Field. According to IRS data for 2014, the IRS conducted just over 291,000 Field Audits and over 950,000 Correspondence Audits. Both of these numbers have dropped considerably since their peak in 2010 of 391,000 and 1.173 million, respectively. Because Correspondence Audits tend to focus on more moderate income tax returns, and more basic issues that should not require a face to face meeting, mom-and-pop small businesses are much more likely to experience these than actually sitting across from an IRS auditor.

Correspondence Audits, known within the IRS as Campus examinations, are the most basic type of audit and are conducted – as the name implies – by mail. They are usually triggered by software that compares returns against common trends and selects those that might be considered outliers.

Field Audits typically occur when the IRS suspects major violations or they are part of an IRS research program. IRS auditors may ask that taxpayers come to their offices, but they typically visit the place of business at least once during the process.

The vast majority of small business audits are Correspondence Audits. While they are intended to cover only simple issues, because of the IRS's focus on efficiency, they can be frightening to small business taxpayers, as well as being time consuming and expensive. In some circumstances when things go wrong, they can be devastating to a business.

For a Correspondence Audit, the IRS will mail small business taxpayers either a Letter 566 or a CP 2000 notice. 566 letters advise taxpayers that their returns have been selected for examination and will list documents such as receipts needed to verify positions on returns. The CP 2000 notice will contain adjustments based on third-party documents associated with the return. A taxpayer typically must respond within 30 days.

If taxpayers agree with a notice, they simply sign the letter and return it with a check made out to the US Treasury; the problems arise usually when there is a dispute.

When responses from taxpayers arrive at the Examination center, they sit in a queue at the IRS processing center for weeks or even months depending on the backlog – causing great anxiety on the part of taxpayers. Eventually, files are assigned to auditors. If all goes well, taxpayers will receive letters thanking them for their responses and telling them nothing more is needed. Sometimes, for whatever reason, taxpayers do not receive these acknowledgements, forcing them or their representatives to hunt down their case files or to keep resending them.

As expected a good number of these responses are denied by auditors due either to the quality of the records or because of a dispute over a matter of law. While many people believe tax law is black and white the reality is most areas are gray. This graying requires the law to be applied to the facts and circumstances that exist and are specific to that small business. Sometimes it is difficult to understand all of the facts and circumstances when the discussion is by correspondence.

Unfortunately, it is not uncommon for a small business taxpayer to fail to respond to the original correspondence from the IRS in a timely manner. If taxpayers do not respond, the IRS issues a second notice, and if there still is no response, it will issue statutory notices of deficiency, known as a “90-day letter.” At the end of that time, the IRS “assesses” the tax, including penalties and interest. Assessment establishes that taxpayers legally owe the amounts in question and then the cases are move over to collections.

The problems associated with the audit process for small businesses can range from the mundane to the Kafkaesque. First, even the simplest correspondence audits consume time and focus for business owners to find, gather and mail the requested records to the auditor. The IRS often states “but, it is up to taxpayers to keep proper records.” This is correct but it doesn’t make it any less burdensome. Even for the most organized among us, it takes time to locate and organize the correct documents. In addition to time requirements, the small business owner is usually under a great deal of stress. For many taxpayers this is their first dealing with the IRS in this way. Their minds wander to the horror stories they have all heard and they wonder how bad will this be and can I do this without help?

Second, over 70 percent of small business owners rely on enrolled agents, CPAs or attorneys when they are contacted by the IRS. Because of this, even mundane correspondence audits can have significant cost, even for small disputes the cost of representation can easily exceed the taxes in question. Many business owners do the math and decide to just pay the extra tax instead of fighting it. For those instances when small businesses respond to correspondence audit notices and auditors reject their records or legal position, outside practitioner costs can quickly add up to thousands of dollars. Longer more complex field audits can be even more cost prohibitive for taxpayers.

Another problem area for taxpayers that cost both time and money is when responses are seemingly lost or delayed in the system. The deadlines come and go and taxpayers believe that they have responded. The nature of the Correspondence Audit process is that it is almost wholly automated. If the computer at the examination campus does not know taxpayers have responded it continues to send out notices, deadlines will continue to not be met, as the IRS claim marches inevitably into assessment and collection. The IRS seems to have gotten better over the years at tracking cases but approximately a million cases go through Campus Examination centers each year. Cases can either be lost, not processed correctly, or they are not submitted in a timely manner. It is important to keep in mind that there is no one point of contact taxpayers or their representatives can call at the center to track down a particular case. This lack of a responsible human being within the bureaucracy is often the most frustrating aspect of the Correspondence Audit.

A similar problem, except on the taxpayer side, is the non-receipt of notices because taxpayers have moved, or for whatever reason are not receiving them. Taxpayers are blissfully ignorant. And on top of that the computer processing correspondence audits is blissfully ignorant as well, belching out notice after notice until cases end up in collections. Taxpayers can first learn they have a problem when their business checking accounts are frozen or another collection action has been taken. Once again unwinding these cases can be particularly time consuming and expensive.

Finally, our franchise owners have experienced inconsistent quality in personnel. It is readily apparent that older more experienced auditors have the benefits of more training, a deeper understanding of the law, and more real life experiences to guide them. Younger personnel only have a basic understanding of the law or do not have the experience that only time can provide. This lack of experience can cause delays, or even worse an incorrect determination. There has been a long term practice of allowing more complicated Correspondence Audits to be transferred to a local area office at the request of taxpayers. It has become very difficult to have these transfers approved. Similarly, requests to speak to managers and referrals to appeals can be ignored. The IRS is clearly experiencing a shortage of personnel and suffering from a lack of training.

The small business taxpayer is also at the mercy of the knowledge and experience of their tax preparer or representative. Additionally, a less qualified tax preparer may be the very reason the small business owner finds themselves in the mess they find themselves in.

At the end of the day no matter if it's the small business taxpayer, the tax practitioner, or the individual from the IRS, the cost of an extended process will be paid by the small business owner.

So, what can the IRS improve even within the constraints of fewer resources? We believe they better facilitate the tracking of cases. If Federal Express can manage millions of packages all over the world, it seems that the IRS could come up with some sort of bar code or other tracking system that would allow both the IRS and the taxpayers to track correspondence responding to notices and the status of their cases. Most importantly, the IRS may need to be willing to assign cases earlier to an auditor or a team of auditors if the taxpayer believes such a request is in their best interest. And finally, leading to my next discussion, the IRS needs to drive a large part of the Correspondent Audit communications to the internet.

IRS Future State Vision for Small Businesses and Practitioners

The IRS vision for Future State could provide significant relief to many of the problems associated with Correspondence Audits. A taxpayer receiving one of these notices could simply activate an individual account through IRS.GOV, view their status online, scan the requested documents and email them to the examination campus, and respond to any follow ups. All of these communications would be done through a secure email system that would track all communications. If taxpayers are required to make payments, they can do so through their accounts or enter into installment agreements all online. We believe strongly that Future State accounts could provide their greatest return on investment in managing Correspondence Audits.

Unfortunately, like most things there is good news and bad news. First, IRS plans to roll out online applications for individual taxpayers over the next year or so. Similar accounts for practitioners, however, will not be available for at least a year or two beyond that. It is important to keep in mind that over 70 percent of small businesses choose to have an enrolled agent, CPA or lawyer deal with notices from the IRS. This means that most small businesses will effectively be stuck in the current snail-mail process.

Another considerable problem has to do with authentication. In order to access these accounts, taxpayers must provide information associated with their tax returns, their account numbers for a loan or credit cards, and cell phone numbers associated with their name and social security number. Unfortunately, for taxpayers who have not filed a tax return, or do not have loans or credit cards, or have cell phones provide by work or a family member, they will be effectively locked out of their own accounts. The IRS estimates that only 30 percent of taxpayers will be able to authenticate themselves and use their accounts. Currently, unlike a typical financial institution, there is no 800 line planned that taxpayers could use to authenticate themselves over the phone.

Additionally, the agency has no real plans for providing business level accounts. Luckily, most sole proprietors or LLCs filing a schedule C will be able to use the individual accounts. More complex small businesses organized as C corporations or partnerships will not have access to these accounts.

Generally, because of the real threat of online hackers, the IRS is creating a very high authentication barrier to access online accounts. The reality is, however, that most taxpayers will rarely, if ever, need access to their accounts. They will try once, with 70 percent of the time failing to gain access, and then picking up the phone or using the U.S. Mail as their primary method of contact. While practitioners and businesses, both of whom have many more interactions with the agency, will do whatever it takes to go through the authentication juggernaut in order to access the accounts.

Additionally, in the case of practitioners, they are well known to the IRS, having registered for a PTIN and a Central Authorization File number. Further, if necessary, the IRS could require a one time in-person authentication similar to the FAA's PreCheck system.

In short, as the IRS moves forward with online accounts, it must include access by practitioners – enrolled agents, CPAs, and attorneys – and businesses in order for the strategy to be successful. The agency needs to find practical methods to authenticate Circular 230 practitioners and to authorize them to solve their clients' problems. Any solution that omits practitioners fails to recognize many taxpayers benefit from representation because they (a) do not want to represent themselves, (b) recognize they are not proficient enough to represent themselves, or (c) are afraid to engage with IRS enforcement staff. Forcing a portal to face taxpayers only will place taxpayers with practitioners at a disadvantage, as a result, practitioners will continue to be parked on phone lines, and it will significantly impede taxpayers' rights to be represented before the agency.

We urge the Internal Revenue Service to consider four important policies:

1. Develop robust individual and practitioner online accounts at the same time.
2. Allow Circular 230 practitioners to execute and file authorizations electronically and immediately represent those clients.
3. Allow the use of electronic signatures for all power of attorney and disclosure authorization forms.
4. Move expeditiously to provide access to business accounts.

Thank you for this opportunity to testify today and Padgett Business Services looks forward to working with the Committee on this crucial area of tax administration.