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U.S. House of Representatives

Committee on Small Business

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To: Members, Subcommittee on Economic Growth, Tax, and Capital Access, Committee on Small Business
From: Committee Staff
Date: June 20, 2016
Re: Hearing: "Audits and Attitudes: Is the IRS Helping or Hurting Small Businesses?"

On Wednesday, June 22, 2016, at 10:30 a.m., in Room 2360 of the Rayburn House Office Building, the Subcommittee on Economic Growth, Tax and Capital Access of the Committee on Small Business will meet to explore how the Internal Revenue Service (IRS) is interacting with the small business community.

One of the most important relationships any taxpayer has is the one with the IRS. While most would prefer to have as limited of a relationship as possible with the agency, the fact is that everyone is responsible for paying taxes and has to communicate with the IRS in some manner. In some cases, more robust and frequent communication is desirable to head off larger problems later. The question here is, what is the IRS' relationship with the small business community? The Subcommittee will meet to examine the IRS' attitude toward small business, how small businesses are treated during the audit process, and whether the IRS is pursuing an agenda to maintain effective communication and relationships with small business taxpayers.

I. Introduction

The income tax and the IRS, then called the Bureau of Internal Revenue, both trace their roots back to the Civil War.[1] The income tax was created to help fund the war effort and was repealed 10 years later, in 1872.[2] Congress tried to revive it in 1894, but the Supreme Court ruled it unconstitutional.[3] While a variety of other types of taxes were collected in the interim, the income tax did not make a reappearance until February of 1913 when the Sixteenth Amendment to the Constitution was ratified.[4] The Amendment granted Congress the ability to levy taxes on personal income and to do so at its source, i.e., withholding.[5] The first income tax form, the 1040, made an appearance soon thereafter.[6]

In the 1950s, the IRS was reorganized and the patronage system was replaced with career, professional employees. Only the IRS commissioner and chief counsel remain subject to

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[1] https://www.irs.gov/uac/brief-history-of-irs (Oct. 8, 2015).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*
[6] *Id.*

Presidential appointment and Senate confirmation.[7] The name was also changed from the Bureau of Internal Revenue to the Internal Revenue Service.[8]

In administering the tax code, the IRS performs two distinct functions: 1) collection of revenue and 2) enforcement of the tax laws. The agency has evolved from administering a tax code that levied 1 percent tax on incomes above $3,000 and a 6 percent surtax on incomes over $500,000 in 1913[9] to administering statutes, regulations, and case law totaling around 70,000 pages.[10]

At the same time, the face of business has also changed, especially small business. For example, the number of pass-through businesses has nearly tripled since 1980, while the number of C corporations has declined.[11] The environment in which the IRS has to perform is also constantly evolving.[12] Unfortunately, while the tax code is slow to change, the IRS is even slower. This hearing will explore a few related questions: What is the current state of the relationship between the IRS and small businesses? How has the IRS' inability to evolve in real time affected that relationship? What changes does the IRS need to make going forward in order to more effectively serve the small business community?

II. Background

Small business owners have raised several issues of concern. First of all, the IRS, by its own admission, is failing to provide adequate support for taxpayers trying to comply with the law. For example, phone lines are open only during "tax season," and "tax season" does not include "extension season." Also, many taxpayers' questions are deemed "out of scope," and the IRS won't answer them by phone at all. Second, the Committee has heard anecdotal evidence that the IRS is becoming much more aggressive in its audit techniques. The question here is whether small business taxpayers are being treated fairly and whether IRS internal procedures are being followed. Third, the IRS promulgates numerous regulations. Unfortunately, sometimes those regulations disproportionately impact small businesses. Safeguards, like the Regulatory Flexibility Act, are in place to try to ensure this doesn't happen, but are they being implemented and implemented correctly?

III. IRS "Future State" and the ETAAC Recommendations

The IRS has recently adopted a "Future State Initiative," which is simply a term for "preparing the IRS to adapt to the changing needs of taxpayers."[13] To its credit, the IRS clearly understands that the needs of taxpayers are rapidly evolving and that it needs to comprehensively

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[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] Joseph Henchman, *How Many Words are in the Tax Code?*, THE TAX POLICY BLOG (Apr. 15, 2014), *available at* http://taxfoundation.org/blog/how-many-words-are-tax-code.
[11] Kyle Pomerleau, *An Overview of Pass-through Businesses in the United States*, TAX FOUNDATION SPECIAL REPORT NO. 227 (Jan. 21, 2015), *available at* http://taxfoundation.org/article/overview-pass-through-businesses-united-states.
[12] ELECTRONIC TAX ADMINISTRATION ADVISORY COMMITTEE, ANNUAL REPORT TO CONGRESS 11 (June 2015) [hereinafter ETAAC].
[13] https://www.irs.gov/uac/newsroom/future-state-initiative.

review how it interacts with taxpayers and administers the tax code.[14] The goal of Future State is to "take advantage of the latest technology to enhance the entire taxpayer experience . . . in a way that meets the needs of taxpayers and the tax community in an efficient and effective manner."[15] The effort is continuing to evolve, partly in response to feedback from a number of sources.[16]

One of those sources is the Electronic Tax Administration Advisory Committee (ETAAC). The ETAAC was created by the Internal Revenue Service Restructuring and Reform Act of 1998.[17] There are currently six members of the ETAAC, reflecting "broad experience and stakeholder perspectives."[18] Its primary charter is to provide input to the IRS "on the development and implementation of the IRS strategic plan for electronic tax administration." The ETAAC is required by law to report to Congress annually on e-filing (goal to receive 80% of tax and information returns electronically), the IRS' progress toward electronic tax administration, and how e-filing affects small businesses and the self-employed.[19] While the ETAAC had traditionally primarily focused on increasing e-file rates, e-file rates are fairly consistently meeting or exceeding the 80% goal.[20] So, in 2015, the ETAAC modified and expanded its scope of focus to other strategic emerging issues in electronic tax administration.

One of the ETAAC's most notable 2015 recommendations was the creation of a comprehensive, secure online account for taxpayers and their preparers.[21] The ETAAC further recommended that the implementation timeline be accelerated for businesses.[22] Clearly, if implemented correctly, this could be tremendously helpful to small businesses. The IRS recognizes the benefits of individual accounts and has included them in the Future State Initiative: "The idea is that taxpayers would have an account at the IRS where they, or those they authorize, can log in securely, get the information about their account and interact with the IRS as needed."[23] Such accounts would both improve service and reduce cost to the IRS. Cost reductions would occur throughout the process. At the front end, this process would free up limited in-person resources because the taxpayer could look directly at their account online rather than having to call the IRS.[24] At the back end, it would save money on the enforcement side by allowing problems to be identified in real time rather than years later, particularly if an in-person audit is then required.[25]

While there seems to be widespread agreement that online accounts would be helpful to small businesses, a number of questions remain, including: How feasible is the idea in the face of current and growing cybersecurity threats? Is the IRS making timely progress toward their implementation? What other considerations have not yet been taken into account?

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[14] *Id*.
[15] *Id*.
[16] *Id*.
[17] ETAAC, *supra* note 12 at iii. P.L. 105-206.
[18] *Id*.
[19] *Id*.
[20] *Id*. at 1.
[21] *Id*. at 14, *Recommendation 3*.
[22] *Id*. at 15, *Recommendation 7*.
[23] https://www.irs.gov/uac/newsroom/future-state-initiative.
[24] *Id*.
[25] *Id*.

IV. Evolutions in Auditing

The Committee is concerned about anecdotal reports of the IRS' increasing use of aggressive litigation tactics during audit. While the IRS certainly has broad authority to examine returns to ascertain their accuracy, it is governed in those activities by administrative materials such as the Statement of Procedural Rules,[26] the Internal Revenue Manual,[27] and other IRS internal guidance. The purpose of an audit is to determine the appropriate amount of tax, but some small business taxpayers have recently reported audits that feel more like trial preparation instead. Two current, high-profile cases demonstrate some of the perceived problems.

A. Coca-Cola

On September 17, 2015, The Coca-Cola Company received a Notice of Deficiency from the IRS following a five-year audit covering tax years 2007-2009.[28] The alleged deficiency is based on the IRS' claim that Coca-Cola U.S. should have earned an additional $9.4 billion in royalty income through licensing to seven foreign affiliates located in Brazil, Chile, Costa Rica, Egypt, Ireland, Mexico, and Swaziland, resulting in an additional U.S. tax liability of $3.3 billion.[29] In addition, the agency designated the case for litigation, which precludes Coca-Cola from pursuing an administrative remedy through the IRS Office of Appeals or under the Advance Pricing and Mutual Agreement Program.[30] Coca-Cola filed a petition in U.S. Tax Court last December challenging the IRS' finding.[31]

On its face, this case is significant for two reasons. First, Coca-Cola has been using the same transfer pricing methodology for nearly 30 years.[32] More importantly, it was the subject of a 1996 closing agreement that dated back to 1987 and was subsequently approved in five successive audits through tax year 2006.[33] The agreement provided that no penalties would be assessed as long as Coca-Cola followed the prescribed method, absent any change of law to the contrary. According to Coca-Cola, the IRS did not explain its decision to depart from the long-standing agreement.[34]

Second, the IRS' decision to designate the case for litigation deprives Coca-Cola of otherwise available administrative remedies and greatly increases the cost of appealing the decision. The IRS' action in this case appears to be illustrative of a larger trend toward litigation of transfer pricing issues.[35]

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[26] 26 CFR Part 601.
[27] https://www.irs.gov/irm/.
[28] William Byrnes, *A Transfer Pricing Look into Coca-Cola and Microsoft's 10-Ks*, LINKEDIN PULSE (Sep. 28, 2015), *available at* https://www.linkedin.com/pulse/transfer-pricing-look-coca-cola-microsofts-10-ks-byrnes-esq-ll-m- [hereinafter Byrnes].
[29] Renata Ardous, *Coca-Cola Case – Is It Sweet Enough?*, MAZARS BLOG (Apr. 4, 2016), *available at* http://blogs.mazars.com/letstalktax/2016/04/04/coca-cola-case-is-it-sweet-enough/ [hereinafter Ardous].
[30] Dolores W. Gregory, *Coca-Cola Fights $9.4 Billion Transfer Pricing Adjustment*, BLOOMBERG BNA DAILY TAX REPORT (Dec. 15, 2015) [hereinafter Gregory].
[31] *Id*.
[32] *Id*.
[33] *Id*.
[34] *Id*.
[35] David Allison, *Coca-Cola Set to Battle IRS for Billions*, ATLANTA BUSINESS CHRONICLE 27A (Apr. 15-21, 2016).

B. Microsoft

Microsoft appears to be another example of this trend. However, the Microsoft case raises other issues as well.

The IRS has been investigating Microsoft's 2004, 2005, and 2006 tax returns since 2007.[36] The audit expanded, and Microsoft cooperated, turning over more than a million pages of documents, making more than 50 employees available for interviews, and extending the statute of limitations eight times.[37] Understandably, the company was eager for the IRS to complete its investigation so the case could move toward settlement.[38] Early in 2014, the IRS asked for settlement concessions that were unacceptable to Microsoft, so the company asked for a "30-day letter," basically a tax bill it could appeal.[39] Instead, without Microsoft's knowledge, the IRS signed a contract for the services of Quinn Emanuel Urquhart & Sullivan LLP on May 19, 2014.[40]

There are a number of issues that make this action both interesting and concerning. First among them is the question of whether the IRS can legally outsource its audit power. According to Microsoft's motion for an evidentiary hearing on this issue, "The Internal Revenue Code prohibits the IRS from outsourcing an audit to private lawyers, as the power to audit (like the power to take testimony pursuant to summons) is an inherently governmental function expressly reserved to IRS officers and employees."[41] The Microsoft case appears to be the first time these functions have been outsourced.[42] Clearly, the IRS had its own reservations about whether it had the authority to take such action. One month after the contract was signed, without any notice or comment period, Treasury and the IRS issued a temporary regulation permitting private contractors to participate in audit activities.[43]

Second, the contract terms are rather troubling. At a time when the IRS feels challenged by limited resources, it has committed to pay almost $2.2 million to a global law firm that boasts the second highest profits per equity partner of any law firm in the world,[44] over an approximately 2 ½ year term, with a projected contract completion date of December 31, 2016.[45]

Third, the firm is purely a litigation shop with no specialty in tax law.[46] It describes itself as "a global force in business litigation" and to this day does not list "tax" among its more than two

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[36] Alison Frenkel, *Judge in Microsoft Tax Case to Decide if IRS Improperly Hired Quinn Emanuel*, REUTERS BLOG (June 18, 2015) [hereinafter Frenkel], *available at* http://blogs.reuters.com/alison-frankel/2015/06/18/judge-in-microsoft-tax-case-to-decide-if-irs-improperly-hired-quinn-emanuel/.
[37] *Id*.
[38] *Id*.
[39] *Id*.
[40] TAX LAW EXPERTS, UNITED STATES: WHY HAS THE IRS OUTSOURCED MICROSOFT'S TRANSFER PRICING AUDIT TO A PRIVATE LAW FIRM? (Dec. 9, 2014) [hereinafter Experts], *available at* http://www.tax-lawexperts.com/news-publication/united-states-why-has-the-irs-outsourced-microsofts-transfer-pricing-audit-to-a-private-law-firm/.
[41] Frenkel, *supra* note 36.
[42] Tom Schatz, *The IRS's Abuse of Power*, THE HILL (Sept. 24, 2015).
[43] Frenkel, *supra* note 36.
[44] Experts, *supra* note 40.
[45] *Id*.
[46] Hillary Flynn and Kim Dixon, *Microsoft Doesn't Skirt Fight with IRS*, POLITICO PRO (Jan. 13, 2015) [hereinafter Flynn and Dixon], *available at* http://www.politico.com/story/2015/01/microsoft-irs-taxes-114202.

dozen practice areas.[47] This fact is particularly telling because it gives credence to the idea that the IRS is using the audit process as preparation for litigation rather than to find the right answer. It also appears that the IRS decided the Microsoft audit would go to litigation without actually telling Microsoft and continuing to go through the motions of an audit. Also notable is the fact that the IRS didn't tell Microsoft that it had retained Quinn Emanuel until August of 2014, three months after the contract was signed.[48] Other lawyers observing this development commented that it made sense to hire the firm during the audit process "because the firm can teach the IRS to litigate a trial," clearly assuming the Microsoft case was, in fact, headed for litigation rather than resolution by audit.[49]

C. Application to Small Businesses

Obviously, Coca-Cola and Microsoft are not small businesses, but that makes their examples even more concerning. If large companies with the resources to fight back are encountering increasingly confrontational strategies from auditors, then how are small businesses with limited resources being treated? It would seem to be a given that a company should be able to rely on an agreement it made with the IRS, as Coca-Cola did, without fear of future audit on that very issue. Also, administrative remedies should generally be available to taxpayers without having to bear the costs of litigation. Finally, an audit should be just that – an examination to determine a taxpayer's appropriate tax liability – not trial preparation, particularly without the knowledge of the taxpayer.

Other audit issues that have been raised with the Committee in the small business context include third party contacts. In some cases, small business taxpayers that the IRS has chosen to audit have not been approached directly by the IRS, but their customers, business partners, etc. have been approached first, prior to the company having the opportunity to respond to and potentially resolve the audit issue(s).[50] Particularly in a small town, this type of activity can be devastating to the company's reputation.

Also, the Committee was very recently made aware of at least two cases in which the IRS so aggressively audited small businesses that they went out of business.[51]

These are but a few of the questionable tactics that have been brought to the Committee's attention, and legislation is already pending in the Senate to address some of them. S. 2809 was introduced by Senator Rob Portman on April 18, 2016, and a House bill is expected to be introduced soon.

V. Promulgation of Regulations and Their Effect on Small Businesses

Finally, the IRS is prolific when it comes to promulgating regulations. Everyone is familiar with the idiom, "the devil is in the details," and nowhere is that more true than in the regulatory

[47] Schatz, *supra* note 42 and http://www.quinnemanuel.com/practice-areas/.
[48] Frenkel, *supra* note 36.
[49] Flynn and Dixon, *supra* note 46.
[50] Committee staff conversation with local tax professional (June 9, 2016).
[51] Committee staff conversation with Committee Member personal staff (June 20, 2016).

implementation of tax legislation. Regulations can make or break a small business. Unfortunately, the impact of regulations on small businesses isn't always considered as it should be.

A. Administrative Convenience

In some cases, the IRS seems to promulgate a regulation in a way that is convenient for the agency without consideration of the effect on small businesses. For example, Congress created the alternative simplified credit (ASC) in Section 104 of the Tax Relief and Health Act of 2006[52] to increase the number of companies eligible to take advantage of the research and experimentation (R&D) tax credit. The ASC is especially helpful to small and medium-sized companies that are unable to qualify for the regular credit. However, regulations published in 2008 specified that the ASC could not be claimed on an amended return.[53] While easier for the IRS to administer, this provision had a disproportionate impact on small businesses that would otherwise have been eligible to claim the credit. Fortunately, after much outcry over the issue, this policy was recently reversed to allow ASC claims to be taken on an amended return.[54]

B. Regulatory Flexibility Act

Additionally, the Regulatory Flexibility Act of 1980 (RFA)[55] requires agencies to analyze the economic impacts of new regulations on small businesses, and if those impacts are significant, agencies must examine alternatives that would minimize those burdens.[56] Those analyses must be published in the Federal Register with the proposed and final rules. In the analyses published with the final rule, agencies must respond to any comments by the Chief Counsel of the Small Business Administration's Office of Advocacy on the proposed rule and provide a detailed statement of any changes made to the rule in response to the Chief Counsel's comments.[57]

The RFA also requires all agencies to conduct outreach to small businesses when a rule will have a significant economic impact on a substantial number of small businesses.[58] While interpretative rules are generally exempt from the RFA,[59] the Small Business Regulatory Enforcement Fairness Act amended the RFA to apply it to some interpretative rulemakings of the IRS that fall within the scope of the RFA. It applies to those that impose a "collection of information" requirement on small entities.[60]

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[52] P.L. 109-432.
[53] 26 C.F.R. § 1.41-9(b)(2) (2014), *amended by* I.R.C. § 41(c)(5) (2015).
[54] 26 C.F.R. § 1.41-9(b)(2) (2016).
[55] Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified as amended at 5 U.S.C. §§ 601-12).
[56] The RFA uses the term "small entity," which includes small business, small organization (i.e., a not-for-profit enterprise), and small governmental jurisdiction. 5 U.S.C. § 601(6). This memorandum simply will use the term "small businesses." For a more detailed explanation of the RFA's requirements, see the Committee on Small Business's March 1, 2013 hearing memo, *available at* http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=321845.
[57] *Id.* at § 604(a).
[58] *Id.* at § 609(a).
[59] Interpretative rules generally interpret the intent expressed by Congress.
[60] SBA OFFICE OF ADVOCACY, A GUIDE FOR GOVERNMENT AGENCIES: HOW TO COMPLY WITH THE REGULATORY FLEXIBILITY ACT 10 (May 2012).

However, the IRS regularly promulgates rules that are costly and complicated for small businesses but generally contends that is has no discretion in implementing legislation.[61] The IRS frequently does not conduct an RFA analysis.

VI. Conclusion

As Congress and the Committee pursue the goal of overall tax reform, tax administration issues should also be kept at the forefront of the discussion. Often, the administration of the tax code can have just as significant of an impact on a small business taxpayer as the substantive provisions of the law. The Subcommittee will explore some of these issues in the context of this hearing.

[61] SBA OFFICE OF ADVOCACY, LEGISLATIVE PRIORITIES (2016).