Statement of

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Regarding the Subcommittee's Hearing on

"Audits and Attitudes: Is the IRS Helping or Hurting Small Businesses?"

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Introduction

Chairman Huelskamp, Ranking Member Chu, and Members of the Subcommittee, it is a great honor for me to provide comments today for your hearing, "Audits and Attitudes: Is the IRS Helping or Hurting Small Businesses?"

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. In 1997, NTU's then-Executive Vice President David Keating was named to the National Commission on Restructuring the Internal Revenue Service (IRS), 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 47-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?

It is particularly fitting that your Subcommittee preside over this discussion of small business tax audits, because the conduct and outcomes of IRS examinations directly impact not only the rights of business owners, but also their ability to contribute toward economic growth, to comply with tax laws in the future, and to obtain the capital needed to expand.

I. Small Businesses and IRS Enforcement: A Troubled History

In our experience, IRS treatment of the small business community has historically served as a barometer for systemic reforms of the tax laws as well as tax administration. 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.

A 1987 Senate Finance Committee hearing, for example, focused in part on the plight of Thomas Treadway of Pipersville, Pennsylvania, who lost his trash-management business after an IRS audit resulted in a $247,000 assessment (including penalties and interest) against him. The assessment was later thrown out in its entirety, but Treadway's livelihood was severely impacted due to overly aggressive IRS collection tactics (including a $22,000 seizure of his girlfriend's bank account). In a 1990 Finance Committee proceeding, Kay Council (an NTU member) described how her husband, Alex, was driven to suicide after an IRS audit of the Councils' real estate development business disallowed a tax shelter. The tax agency never contacted the Councils or their accountant about the deficiency until four years after the fact, at which point the tax bill had soared to nearly $300,000. The IRS's destroyed their business, and Kay Council only prevailed after spending some $70,000 on legal fees drawn partially from the life

**As a matter of organizational policy National Taxpayers Union neither seeks nor accepts any kind of grant, contract, or other funding from any level of government.*

insurance policy of her deceased husband. Tragically, this suicide over a mishandled tax audit was not the only incident of its kind. Subsequent hearings and media accounts in the mid-1990s uncovered harsh tactics against small business owners. Armed raids of IRS agents on establishments such as the Jewish Mother restaurants in Virginia and the Kids Avenue clothing stores in Colorado highlighted how tax enforcers could effectively ruin a small business's reputation with its customers … and, in turn, its viability.

Ultimately stories such as these led Congress to enact comprehensive taxpayer rights safeguards in 1988, 1996, and 1998. Those laws have all worked to curb some of the agency's worst excesses, provide limited remedies for wronged taxpayers, and introduce new layers of accountability through the IRS Oversight Board and the National Taxpayer Advocate.

Yet, further challenges have arisen. In 2013, for example, *The Wall Street Journal* revealed that the IRS was targeting small businesses for heightened scrutiny over their cash transactions. The article described how the agency's initiative, which included sending owners "Notification[s] of Possible Income Underreporting," left many small business people feeling intimidated.

Hearings held in April of last year and May of 2016 by your colleagues on the Ways and Means Committee have uncovered another wrinkle to the government's apparent suspicion of cash-intensive businesses that deal in cash. Despite some embarrassing revelations several years prior in *The New York Times*, the IRS has been teaming up with the Department of Justice in pressing asset forfeitures among small business owners dealing in cash. The Committee revealed more than 600 cases involving over $40 million of seized funds from "individuals and families who have been forced to forfeit their assets even though they have not been proven guilty of any crimes."

Although Congress took the commendable step last year of codifying the "Taxpayer Bill of Rights" principles promulgated by the National Taxpayer Advocate, the job of protecting taxpayer rights will never be finished. As the Tax Code, the economy, and technology are all constantly evolving in new directions, so must the laws designed to prevent abuse of authority and provide appropriate remedies when such abuse occurs.

The following testimony is intended only to provide highlights surrounding tax administration issues for small businesses, especially in the areas of tax examinations. Its recommendations should be considered as part of a broader effort that is needed to update protections and procedures for all taxpayers. In April of 2015 I was asked to testify before the full Committee on Small Business at a hearing entitled, "Tax Reform: Ensuring that Main Street Isn't Left Behind." Several sections of my testimony for that hearing continue to have relevance, and have been updated or modified for inclusion in various portions of this document.

II. The "Fear Factors" of Audits

In late November 2001, a McKenna Research poll of 500 respondents reported that by a 50 percent – 32 percent margin, more Americans worried about "receiving an audit notice from the IRS in the mail" than "receiving anthrax in the mail." These results reflect a degree of gallows humor. However, McKenna's findings – at the height of the nation's concern over terrorism – also reflect how deeply-seated Americans' fears of the tax agency were, even three years after adoption of the IRS Restructuring and Reform Act of 1998.

Fast forward to 2013, when a Gallup Poll found that 62 percent of those surveyed felt the IRS had "more power than it needs to do its job," and it is clear that the public has remained anxious over the tax man's ability to pry into Americans' daily lives.

IRS examinations, whether in the form of field or correspondence audits, must be viewed with other interrelated pieces of the tax administration puzzle to gain a full appreciation of problems and solutions. Document matching and math error correction are among the other tools the IRS employs to oversee and ensure compliance in the tax filing process.

Yet the fact remains that some of the most contentious issues surrounding tax administration center upon, or are a consequence of, audits. These matters range from the clarity and content of the laws themselves, to appeals of audit results, to IRS employee conduct, and to remedies in the courts.

From the view of the small business person immersed in an audit, such matters of policy seem academic. What, therefore, are the more palpable "fear factors" foremost in business owners' minds when undergoing this process? Based on NTU's review of research literature, statistical analysis, oversight reports, and hundreds of anecdotes over the past several decades, we believe the following are most pertinent.

Uncertainty. Audits can be a direct consequence of complexity in the tax laws themselves. Some examinations involve straightforward questions such as whether a taxpayer can provide support for claiming deductions. In other situations, however, the questions revolve around a taxpayer's application of often-confusing laws to his or her unique situation … an application that clashes with the IRS's own interpretation.

Ranking Member Velázquez of the full Committee eloquently summed up the problem in an opening statement from 2013, when she observed that, "In the past, small businesses have told us that complexity and uncertainty create difficulty when filing tax returns. Many business owners worry that one simple mistake can lead to a costly and timely audit. And, at a time when many businesses are striving to expand, every hour and dollar counts."

For businesses, those dollars and hours add up quickly. An annual study published by our research affiliate, National Taxpayers Union Foundation (NTUF), calculated that for this year the federal personal and corporate tax system extracted 6.1 billion hours and $234.4 billion out of the economy in 2016 (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.

The complexity load that businesses bear has been a longstanding malady. NTUF reported that General Electric's 2006 tax return, would have amounted to over 24,000 pages had it been printed on paper. GE's tax return may be even longer today. When NTUF'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.

A small firm may not face as daunting a tax filing scenario as GE, but it could quite conceivably contend with a return involving dozens of forms, schedules, and worksheets backed up by the equivalent of hundreds or thousands of recordkeeping transactions.

Companies such as GE, with entire departments 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. 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.

This disparity is measurable. 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.

Unfortunately, these considerable outlays and resources do not buy peace of mind for small business owners who, as Ranking Member Velázquez stated, often operate in fear of vague laws being used against them.

Uncertainty has also crept its way into the audit selection process itself. A Government Accountability Office (GAO) report issued in January of this year on the Small Business/Self Employed (SB/SE) division of the IRS concluded that the "lack of strong internal control procedures" in the agency's 33 workstreams for identifying and reviewing returns for possible audit "increases the risk that the audit program's mission of fair and equitable application of the tax laws will not be achieved." The term of "fairness" in selecting returns was unclear or even contradictory in how it was defined among IRS staff, while "documentation and monitoring procedures were inconsistent" for ensuring that selection procedures met internal controls. Flawed inputs like these could have real-world consequences in terms of the effectiveness of audits for the government and equitable treatment for taxpayers.

Intimidation tactics. Previous taxpayer rights laws have certainly improved audits and auditor behavior. Those under examination have prerogatives due to those laws, such as recording audit proceedings and having some flexibility to determine the location where an audit will take place. Furthermore, thanks to the IRS Restructuring and Reform Act, auditors (like other IRS employees) are managerially evaluated on providing fair and equitable treatment of taxpayers. The Internal Revenue Manual has been updated to describe the sorts of behaviors that represent such treatment.

Still, members of the tax representation community have observed that the conduct and attitudes of audit personnel have not been subjected to the same level of regulation as personnel involved in collection. A passage from a 2012 article appearing on AOL News by Ross Kenneth Urken, personal finance editor for TheStreet.com, is particularly illuminating:

> In response to the 'storm trooper' reputation, the IRS publicly tried to clean up its act during the Clinton administration. Yet most of the changes it made had to do with collections, according to Anthony Parent, the founding partner of IRS Medic, a law firm oriented toward those with tax troubles. There was a lot of congressional testimony about revenue officers' abuses, but there was no censuring of abusive auditors, nor were any concrete limitations placed on their powers.
>
> IRS veterans refer to this period as 'Rah Rah '98,' Parent said – a mocking cheer that represents the emptiness in the push for audit reform. …
>
> Given that the typical auditor today was just a kid during the Clinton administration, Parent says, the public now can still expect 'skittish' auditors who 'if pushed into a defensive position, will lash out at a taxpayer.'

To this day, taxpayers and advisers continue to report on troublesome developments in IRS audits that range from isolated cases to broader policies. Here I am indebted to Daniel J. Pilla (an author and tax litigation expert), Leonard Steinberg, E.A. (a New York area tax representative), NTU's members, and

others for providing me with background information on their challenges:

- Some auditors continue to ignore or deny protocols in the Internal Revenue Manual, including "audit reconsideration" procedures when, for instance, an individual files an amended return that could obviate the need for continuing an examination.
- IRS delays in resolving some cases allow the statutory clock to keep ticking on interest that is almost never abated, even though the agency's own lack of follow-up may be to blame.
- In other areas, however, "Speed Up Audits," brought on by what some say is a reduction in IRS enforcement resources, may be leading taxpayers to a financial dead end. Writing in *The New York Times* last year, Dave Du Val of TaxAudit.com explained that, "Examiners for the I.R.S. are giving taxpayers and their accountants much less time to respond to certain audit letters. … An initial request for an appointment is followed quickly – in some instances, on the same day – with a follow-up letter that states that the requested information has not been received." That second letter contains a threat that failure to respond to the first notice could result in loss of appeal rights. A taxpayer in this situation has little, if any, time to consider even a basic response, much less an appeal.
- The IRS "rounds up" in making its case against taxpayers. Restaurants, for example, become targets through no fault of their own because of the IRS's fixation on credit-card transactions as part of the audit determination process. These transactions include taxes and tips, generating an artificially larger cash-flow than records which would reflect only actual sales of menu items.
- Innocent "chit chat" between auditors and taxpayers can become the basis for wider investigations. An auditor might innocently raise the topic of where the citizen might have last gone for vacation, or ask for advice on buying a car based on what the taxpayer owned.

Correspondence from the IRS can intimidate as well, whether intentionally or not. In the 2013 *Wall Street Journal* article cited above that explored the IRS's crackdown on cash-intensive businesses, one owner remarked, "There's an emotional thing when you get an ominous-looking letter from the IRS." Another noted, "There are so many reasons why even if you're the most honest taxpayer, you're not going to match" a given business's credit-card record sales records with non-card transactions.

Even routine audit correspondence can have this effect. According to Daniel J. Pilla, who has decades of experience in helping thousands of clients, the Revenue Agent's Report (RAR) mailed with the post-audit "30-day letter" can be misunderstood. As he wrote in his recent book, *How to Win Your Tax Audit*, "Citizens commonly mistake the RAR for a bill, which it is not. They do not understand that it is merely a proposed change, which they can appeal."

The National Taxpayer Advocate (NTA) of the IRS has also identified subtle but important flaws in IRS correspondence audits that contribute to the intimidation effect. In her latest Annual Report to Congress "report card" (which evaluates follow-up on NTA's "Most Serious Problems" (MSPs) in tax administration), the Advocate determined that the IRS has "overlooked the Congressional mandate to assign a specific employee to correspondence examination cases, thereby harming taxpayers." The agency fails even to provide a telephone number or employee identification code on audit notices generated by individual tax examiners. Depriving audited taxpayers of this information leaves them feeling even more isolated.

Some potentially intimidating IRS actions aren't revealed until the taxpayer is placed in a nearly untenable position. Despite their questionable intersection with taxpayer protection laws, "parallel investigations" involving the criminal and civil arms of tax examination have continued apace. An August 2015 article appearing on the American Institute for Certified Public Accountants' "Tax Adviser" website describes the "gradual evolution" of this technique. Whereas traditionally a civil proceeding would be "frozen" if the tax examiner thought the case should be referred to authorities in the criminal sphere, more

and more cases "over the past decade" have been marked by "extensive interaction between criminal and civil enforcement personnel."

According to Justin J. Andreozzi, Randall P. Andreozzi, and Arlene Hibschweiler, who authored the article, the IRS cannot intentionally portray a criminal investigation as civil to the taxpayer involved. The IRS, however, "does not have an affirmative obligation to disclose the existence of a criminal investigation … IRS civil examiners are instructed not to disclose that a criminal investigation has been opened, and, if asked, only to state that any information obtained in a civil examination can be shared with criminal investigators." The resulting fallout could, they write, "range from trivial inconveniences to much more serious landmines such as a tax adviser's unwittingly waiving a client's constitutional rights." Currently parallel investigations are employed most forcefully in abusive tax shelter transactions, and the chances of an innocent business owner encountering them are low. But as the recent asset forfeiture debacle has shown, powers intended for use in one capacity can be wielded in others.

Deadweight losses. By its very nature, any IRS examination involves a considerable expenditure of time, effort, and money on the part of the business owner and the owner's professional advisors. Substantiating deductions or reconciling income often requires gathering or producing copious records. The owner's mental energy is shifted away from maintaining or growing the business and toward meeting what can seem like an endless list of IRS demands. And of course, the out-of-pocket expense for financial and legal advisors can take on enormous dimensions, sometimes out of proportion to the amount of tax at issue. With so much at stake, one would be led to believe that most small businesses would appeal adverse IRS determinations. This is not the case, and the reasons merit further analysis.

According to the most recent *IRS Data Book*, 29 percent of all field audits and 57 percent of all correspondence examinations of small corporations in Fiscal Year 2015 involved no proposed change to the taxpayer's liability. Among 1040 returns reporting business income, the percentages were generally smaller, although those with business receipts above $200,000 subject to correspondence audits had a no-change rate of above 50 percent.

It is clear that the number of small business taxpayers who actually appeal their audits is quite low. There are several ways of measuring the appeal rate, but *Data Book* presentations show that 6,291 taxable nonfarm 1040 returns with business income of under $200,000 involved "unagreed recommended additional tax" out of 191,501 returns in that category examined. Even after throwing out "no change" returns and recommended decreases in tax liabilities, from these statistics alone the rate of appeals in audit situations appears to be paltry, hovering somewhere below 5 percent.

Is this apparent low frequency of disputes simply attributable to the IRS being correct in the position it takes from the vast majority of examinations? Numerous authorities, from prominent members of the tax advisory community, to the Government Accountability Office, to the National Taxpayer Advocate, would answer, not at all.

In fact, there are many reasons why small business owners do not appeal audit determinations. As explained earlier, the very content of IRS correspondence can be unclear about a taxpayer's right to contest the tax agency's recommendation. There is also another consideration at work.

Many business people 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 are 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 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 [*Pete Sepp comment: note 2015 statistics above showing how little this figure seems to have changed*]. 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.

Consider, for example, the average additional recommended tax in 2015 resulting from field audits of business 1040 tax returns with receipts between $25,000 and $100,000 – a total bill of $9,947 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, the average fee, according to the National Society of Accountants' most current public data, 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, more than one-third of 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 amount that can be awarded is barely $200 per hour, and only if the court determines the IRS's position was not "substantially justified."

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 businesses are forced into either conceding 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.

Existential threats. Some small businesses clearly do owe major tax liabilities as a result of a civil examination or investigation, to the point of their very existence being endangered. For criminal enterprises or "shell" firms, this is no real loss to the economy or society.

But what of legitimate business owners who are innocent of wrongdoing, or have simply made some honest mistakes? Their worries over the very survival of their companies should be our worries as well – on them depend not only the entrepreneurial spirit, but the practical benefits of economic activity and revenue generation. Jordan Markuson's experience is just one of many illustrative examples.

An entrepreneur who has been involved with half a dozen startups, Markuson co-founded a company in 2003 that bought and sold online domain names. The highly successful firm was subject to an IRS audit in 2011 and Markuson's excellent recordkeeping gave him little to fear from IRS requests to document his firm's well-flowing revenues. Unfortunately, the agency did flag him on home business expenses, eventually disallowing three years of write-offs.

In an interview accessed in 2016, Markuson told Lisa Furgison of Bplans.com that "the additional liability and accounting costs were equal to one-third of the following year's total revenue. Paying it back becomes an uphill battle because IRS back payments are not expenses, so they are coming directly for your profit." Markuson's business failed as a result of this quandary, but fortunately he was able to apply his talents to another business and maintain a positive attitude. Yet, was it truly in the government's interest to bleed a taxpaying business to death, rather than allowing the business to function as it paid its way out of a tax bill?

Other stories have a less optimistic ending. Paul Hatz, a taxpayer from Boston, had to shutter his company (and lay off more than a dozen employees) because of an auditor's error in attributing income from his corporation to him personally. Hatz had a $110,000 tax lien entered against him, and spent several years and $60,000 in representation costs clearing up the problem. The final actual tax bill was reduced to $5,000, but Hatz declared personal bankruptcy as well as losing his business. In a 2012 interview with TheStreet.com's Ross Kenneth Urken, Hatz said, "I never want to start a business again. … If you get the wrong auditor and are a small business struggling to make ends meet, you are done – out of business regardless of whether you did anything wrong or not."

Another example was brought to my personal attention from an owner of a technology consulting business, who has asked me not to reveal their identity.* After an IRS audit of the business's tax returns, a net operating loss carryback was accepted for two years of returns but denied for the third year, triggering a large tax liability. This problem was unknown to the owner until the individual discovered a tax lien had been entered on the business's assets. The owner did not agree with the IRS's position, but on the advice of an attorney entered a payment plan for the liability "to un-restrict growing my … small business." The owner was led to understand that the liens would be released after demonstrating consistent payments on the back taxes, but even after the liability was satisfied, the liens remained. This fact, still true today, has in the owner's words "resulted in me being denied a Small Business Administration backed Working Capital Line of Credit."

The owner concluded a summary of the case sent to me by writing:

> The IRS can simply say you are guilty and you either agree to make payments or they will ruin you. Of course as a taxpayer I could potentially take the IRS to court to prove my innocence but that isn't the way the system of jurisprudence is supposed to work. The taxpayer is assumed guilty even though after many years you can prove you were right … .

Will this taxpayer's business survive, to continue contributing to the economy and therefore the Treasury? Only time will tell.

Lack of remedies. 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

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**NTU can put Subcommittee staff members into contact with this business owner upon request.*

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 relative pittances 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.

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." Other award cases may exist but their prevalence remains rare.

On the other hand, the IRS's litigation resources against small businesses are formidable. Over the past ten Fiscal Years, the IRS Chief Counsel's Office has typically closed some 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.

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 recently 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. … 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."

One such individual who decided to capitulate in the face of these odds was Calvin Taylor, a business owner on Maryland's Eastern Shore. During a recent hearing before the House Ways and Means Committee, he eloquently summed up his own situation as well as that of many fellow business people:

> I had no choice but to agree to the DOJ and IRS keeping our legally earned money. I faced potential criminal charges for crimes I did not know I had committed, but that a U.S. Prosecutor had nonetheless threatened to bring against me … . The potential cost of defending myself was astronomical, and it greatly exceeded our family's resources. Settling was an obvious and sensible business decision in the circumstances, made under duress in order to avoid prosecution and potentially, a long jail term."

Rights without remedies are meaningless. Congress should address this contradiction in short order.

III. Shared Concerns with Large Businesses

Small business owners are adding another set of audit fear factors to the top of their list, and they stem, ironically, from the reorganization of the Large Business and International (LB&I) division of the IRS. The sweeping LB&I restructuring is still not sufficiently detailed for private sector experts to pinpoint the entirety of its impact. Nonetheless, overall the IRS envisions shifting its examination focus away from industry-specific clusters and toward nine practices areas, four of which are regionally oriented and the remaining five subject-oriented (e.g., enterprise activities, pass-through entities, cross-border activities, withholding and individual international compliance, and treaty and transfer pricing

operations). In February of 2016 the IRS elaborated upon the new LB&I audit approach, which is to be issue-based, outcome-driven, collaborative, and transparent.

Last year, National Taxpayers Union enthusiastically joined as a member of the Coalition for Effective and Efficient Tax Administration (CEETA), which was formed to constructively engage both the Treasury and Congress on audit process issues as the LB&I reorganization takes place. CEETA is comprised of more than a dozen trade associations and citizen groups, including: Council for Citizens Against Government Waste, Council on State Taxation, National Association of Manufacturers, Retail Industry Leaders Association, Small Business and Entrepreneurship Council, Software Finance and Tax Executives Council, and the U.S. Chamber of Commerce.

Because it is so remarkably broad, this coalition has been able to gather the experiences of numerous companies and unify them around several themes embodying opportunities to improve the way business (and in some aspects individual) tax audits should be conducted. These themes follow.

Lack of centralized management and accountability in audits. Under the new LB&I auditing process, more than one practice area (e.g., a regional area and an expertise area) may be assigned to a single audit. In addition, the IRS's chains of command for domestic and international audit issues are split. How will the IRS's personnel lines of reporting and most importantly, decision-making authority, be allocated in such a situation? Furthermore, the LB&I Examination Process has been established to invite open collaboration between the taxpayer and the exam team on process matters such as a timeline and how changes to the exam plan are to be communicated.

"Without centralized management or clear responsibility for an audit, it is difficult for taxpayers to seek assistance when an audit is not conducted in accordance with best practices such as the QEP [Quality Examination Process]," an extensive November 2015 CEETA memorandum to IRS officials noted. Nor does this problem facilitate the resolution of complex audit issues.

Lack of transparency. Nowhere is greater transparency more urgent than in the way official guidance over highly complex issues raised in audits is promulgated through the IRS Chief Counsel. CEETA has determined that over the past 15 years, there has been a dramatic shift toward relying upon less formal Chief Counsel Advice (CCAs), which generally have no taxpayer participation, and away from Technical Advice Memorandums (TAMs), which require agreement between the taxpayer and the IRS on the facts surrounding a given question. In the period of 2000-2004, for example, the IRS issued 928 CCAs and 393 TAMs, a ratio of less than 2-1/2 to 1. A decade later, in the 2010-2014 timeframe, 1,530 CCAs were issued, compared to just 53 TAMs – a ratio of roughly 29 to 1.

This development has serious downstream effects. CEETA noted in its November 2015 communication, "The lack of taxpayer involvement is bound to result in a less robust consideration of the facts and the issue. The use of CCAs can also hinder the resolution of cases in the Office of Appeals because Appeals officers may be disinclined to engage on an issue" after a CCA has been disseminated.

Breakdowns in the information document request (IDR) process. Through peer review, the IRS's own staff have acknowledged that IDRs are a major impediment to the workflow of audits. In 2013 LB&I clarified procedures for all IDRs going forward, requiring them to be issue-focused, discussed with the taxpayer prior to issuance, and guided by a deadline negotiated between the taxpayer and the agency. A subsequent IRS directive in early 2014 created detailed instructions on how IDRs would be issued and how they would be enforced.

Unfortunately, the execution of these otherwise sound procedures has been uneven and erratic. Problems have been reported such as IDRs with overbroad issue focuses, or "kitchen sink" IDRs for all types of irrelevant information before the initial audit conference has begun. Moreover, examiners have

issued multiple IDRs with the same deadlines, or have requested information for tax years or entities not under audit. No guidance is available to examiners on how to establish an IDR deadline or grant an extension. These problems and others can make the new process chaotic.

Delays in closing cases and honoring estimated completion dates. As noted previously, businesses have been experiencing both frustrating delays and demanding accelerations of audits at the hands of the IRS. In the case of LB&I, the prospects for resolving or appealing audits are less tenable. Increasingly, taxpayers are receiving multiple requests for extending the statutory period of examination, while estimated completion dates established in audit plans have become less meaningful.

The Catch-22 becomes evident in the Appeals division's policy requiring that 12 months always remain in the statutory examination period; this becomes a justification for the IRS to continue the audit rather than conclude the case. Taxpayers can never actually avail themselves of an appeal, and are forced into Tax Court. Some of these delays are blamed on IRS resource constraints and turnover of qualified personnel, but CEETA contends, "Issue selection and resource availability should go hand-in-hand, with issues only pursued if there are qualified and dedicated resources available."

A litigation mentality as opposed to an issue resolution mentality. In some instances CEETA members have observed that IRS exam teams seem more occupied with "preparing for litigation rather than ascertaining the correctness of a return and resolving issues." This mentality manifests itself in various ways, including IDR interviews and requests that have the effect of pre-trial discovery. Other developments are discussed below, but the end result "negatively affects the cooperative relationship, impedes transparent interaction, decreases efficiency, increases costs, and delays certainty for both taxpayers and the Service."

The coalition has made dozens of recommendations that the IRS could implement administratively in conjunction with the LB&I reorganization. However, CEETA has also identified four key matters that should be addressed through legislation in this Congress – while prudent inputs and adjustments can still be most effectively absorbed into the IRS's LB&I audit strategy. They are:

Properly limiting the designated summons. Although the IRS has the conventional power to summon testimony and documents in examinations, the designated summons is a special authority intended, according to a top IRS audit official, for situations "only after the taxpayer under examination refuses to extend the statute of limitations … and the examiner has exhausted all other means to obtain the needed information." The designated summons, unlike conventional summonses, will act to suspend the assessment period when a court proceeding is brought to enforce or quash it. As a consequence, the designated summons can, if employed improperly, compel taxpayers into nearly endless extensions of the statutory examination period. In fact, so potent is this weapon that Congress required, by statute, a report on its frequency of use (a report whose issuance we cannot verify).

Until quite recently, designated summons enforcement was quite rare. But as CEETA's memo warns, "current and former IRS officials have publicly commented that designated summonses will become a more frequent IRS management tool." Indeed, the National Taxpayers Advocate confirmed that summons enforcement (non-designated in most cases) was one of the most litigated issues in 2015, and taxpayers rarely prevail in attempting to challenge them.

It bears mentioning here that like many weapons, the designated summons can be effective when employed as a threat, not just a reality. Shrewd IRS personnel can, at an appropriate moment in the audit process, simply mention that the designated summons is available to them as a "last resort" if a taxpayer does not capitulate to their demands for yet more time to complete their examination.

Better defining circumstances for designating cases for litigation. Just as the designated summons was designed to be used only under special circumstances, the IRS has given itself the authority – when approved by high-level agency and Chief Counsel officials – to force a case or audit issue into the courts. This power has never been authorized by Congress; it is not based on legislative authority, but is an administrative power the IRS has granted to itself. It is again, intended to be wielded infrequently because doing so strips a taxpayer of the right to an administrative resolution unless the taxpayer unconditionally surrenders their position on the issue. IRS guidelines indicate that cases suitable for designation are those that "present recurring, significant legal issues affecting large numbers of taxpayers … and there is a critical need for enforcement activity with respect to such issues." Specifically, the guidelines note, the cases designated for litigation should be selected with an eye toward "judicial precedent [that] may provide guidance for the resolution of industry-wide, tax shelter or other issues."

In theory this power, carefully employed, could function effectively. But as CEETA notes, when used with less circumspection, or even threatened, designation has raised "concern [among taxpayers] regarding the predictability of their own audits and in particular the availability of Appeals."

Ending the improper use of private contractors in examinations. Last year, Senate Finance Committee Chairman Orrin Hatch made an important inquiry to Commissioner Koskinen regarding a $2.2 million contract extended to a private law firm in a large corporate audit; this contract permitted examination activities on the part of the firm best described as overbearing and harsh. Chairman Hatch stated:

> The IRS's hiring of a private contractor to conduct an examination of a taxpayer raises concerns because the action: 1) appears to violate federal law and the express will of the Congress; 2) removes taxpayer protections by allowing the performance of inherently government functions by private contractors; and 3) calls into question the IRS's use of its limited resources.

From NTU's standpoint, the IRS's action is fraught with additional risks. Allowing more entities access to confidential taxpayer information only raises the likelihood of additional data security breaches in the future, on top of several recent hacking incidents and a continuing plague of tax-related identity theft. Furthermore, if the agency is allowed to continue this practice, by issuing a "temporary regulation" without a comment period or notification, the door will be open for other grave trespasses against taxpayers' rights affecting many constituencies.

All of these factors, and more, combine to undermine taxpayer rights to appeal. The Office of Appeals is approaching its 90th year of service, while the IRS Restructuring and Reform Act of 1998 created "firewalls" between Appeals and compliance functions as well as directed the Commissioner to ensure availability of impartial appeal options. Most recently the 2015 taxpayer rights legislation affirmed that a taxpayer should be able to disagree with the Service's positions.

Yet, these assurances are becoming eroded in a number of ways, from informal threats by auditors to the actual issuance of designated summons and designating cases for litigation. Taxpayers need, and deserve, definitive statutory protections that provide, in crystal-clear detail, their right to appeal an audit without the duress of capitulating.

All of CEETA's observations and recommendations should be familiar to small businesspeople. In NTU's opinion, they are emblematic of the very same uncertainty, intimidation, deadweight losses, existential threats, and lack of remedies outlined earlier in my testimony.

Daniel J. Pilla was among the first members of the tax representation community to recognize the danger that LB&I's approaches would pose to other types of taxpayers. In his 2014 book, *How to Win*

Your Tax Audit, Pilla devoted considerable discussion to the revised IDR process and how, improperly executed, it could harm 'the little guy'. He wrote:

> At the time of issuance, the memo was pointed at only large businesses. However, it is clear that the agency will push the practices 'more deeply' into the system, exposing more taxpayers to their pitfalls. I fully expect the IRS to utilize 'strong arm' tactics more often in pressing for documents in all audits, particularly those related to business income and particularly with respect to computerized recordkeeping systems. … I fully expect [the policy] to migrate deeper into the IRS sooner rather than later.

More recently, in an April 19th 2016 endorsement letter, the Small Business and Entrepreneurship Council (SBEC, a CEETA member) expressed just how relevant CEETA's stance was to its many thousands of supporters across the country:

> Small business owners do not have the resources to endure audits without end. They certainly do not have the resources to go up against a powerful $1,000-an-hour legal team in a tax dispute, Indeed, it's not hard to see how powerful, private attorneys doing the most complex and sensitive work of the IRS could lead to abuse and harassment, not to mention expensive legal bills.

Those who believe the IRS would never hire such "big guns" to pursue smaller businesses' tax liabilities should bear in mind that decisions by auditors and Appeals officers are guided first and foremost by the facts and the law. While the agency will weigh the danger of setting an adverse precedent for the government if a case might wind up in court, the "nuisance cost" is not a formal determinant. Even so, the opening given the IRS by this questionable practice could easily permit private attorneys commanding somewhat lower rates to routinely involve themselves in cases involving smaller liabilities.

There is a larger point to be explored here. How meaningful is the distinction between small and large businesses for the purposes of audits? Of course, there are practical considerations that tend to categorize these entities. Larger businesses tend to have more globalized operations, more complex tax returns, and a somewhat greater base capacity to at least cope with compliance burdens than smaller firms. Tax laws and regulations can also define different treatment and processes for large and small businesses (e.g., expensing and depreciation rules).

Still, there are many instances where the line between "large" and "small" business becomes quite subjective, such as audit rates. For example, the *IRS Data Book* indicates that the examination rate for all "large corporation" tax returns was 11.1 percent in Fiscal Year 2015, compared to 0.9 percent for "small corporations." On the other hand, businesses declaring income through the 1040 tax return instead of a corporate form do have much higher rates than the general filing population. Depending on the income level of the business, the rate can be three times higher than that of all individual tax returns, or even eight times higher than nonbusiness returns without Schedules C, E, F, or Form 2106.

But it is also important to remember that the LB&I's jurisdiction encompasses a wide range of entities called "large corporations," including not just major multinational firms but companies with assets at a minimum level of $10 million. Granted, the latter entities can hardly be described as "mom and pop" concerns, but neither are they massive conglomerates. They could be "hometown" companies employing several dozen, rather than thousands, of individuals. The *Data Book* reports that more than one-fourth of the "large corporation" returns the agency selected for examination last year reported assets of between $10 million and $50 million.

The Transactional Records Access Clearinghouse (TRAC) has often contended that insufficient numbers of businesses, especially large ones, are being audited, thereby imperiling compliance with the law. NTU does not necessarily agree with this conclusion, because many other parts of the tax system,

such as complexity in the laws themselves, drive compliance problems. Nonetheless, in a recent data release, TRAC noted that even in the LB&I division, an increased emphasis was being placed on examining returns of Subchapter S Corporations – which are not archetypical multi-billion-dollar operations. For Fiscal Year 2016, the IRS had, according to TRAC, set a goal of increasing audits of these entities by 20 percent. It is not known if the agency will reach this goal.

Thus, the audit policies of LB&I – even if they are not immediately adapted for use in other divisions – already directly touch some companies that would not be considered massive in size. For instance, Members of this Subcommittee are well aware of the Small Business Administration's (SBA) criteria under the Code of Federal Regulations for contracting. A commonly held assumption is that a business must have fewer than 500 employees to meet SBA's standard definitions, yet this is by no means uniform. According to SBA's summary of size standards online, nearly half of all qualifying small businesses in manufacturing employ between 1,000 and 1,500 workers. A small business involved in heavy construction may have up to $36.5 million in average annual receipts, while those engaged in mining, transportation support activities, or publishing may, in certain circumstances, reach as high as $38.5 million in average annual receipts.

Furthermore, Census Bureau statistics released in February show that an establishment of any type reporting receipts of between $35 million and $39.99 million had a payroll averaging 43 employees. Even those establishments in the $10 million-$14.99 million receipt category, an amount that still seems quite large, employed an average of just 34 people.

Assets and annual receipts are two different statistical snapshots, but they are often closely related parts in the mural of a company's finances. It would not be unusual for a firm with $20 million or $30 million in yearly receipts to have $10 million or $20 million of assets on its books.

Finally, audit and enforcement actions pursued against the very largest American businesses have "ripple effects" in the small business community that works with them. Large multinationals tend to have supplier, distributor, or contractor networks numbering hundreds or even thousands of member businesses. These often-small entities suffer adverse consequences to their own bottom lines when their larger customers must alter expansion plans or reconfigure business models due to tax concerns.

The bottom line: administrative exigencies might recommend that the IRS divide itself into divisions such as SB/SE and LB&I, but ultimately the tax system must be viewed holistically. Otherwise, the rights of individual and business taxpayers become categorized, divided … and conquered by bureaucratic overreach.

IV. Overcoming the Fear Factors: Recommendations for Reform

Small businesses finding themselves in an examination or in other portions of the IRS administrative system could benefit tremendously by concerted action in the executive branch and in Congress. It cannot be overstressed that the leadership of this Subcommittee can make a genuine, salutary difference to the millions of people in the entrepreneurial community, many of whom will at some point in their businesses' evolutions will interact with the tax agency in some fashion beyond filing a return. On behalf of NTU and its members, we offer the following recommendations.

To reduce uncertainty, start small. As this testimony has indicated at length, simplifying the tax laws themselves has numerous advantages to small businesses, from reducing wasted expenditures, to increasing compliance, to making the examination process less uncertain for both the taxpayer and the IRS. Obviously, a comprehensive replacement of the entire tax system, which reduces rates, broadens the base, and streamlines filing, would be ideal.

Yet, federal officials need not remain idle while a sufficient consensus builds to move a tax reform package forward. One intriguing possibility was mentioned by the National Taxpayer Advocate: the IRS Restructuring and Reform Act of 1998 required the tax agency to report to Congress each year on "sources of and ways to reduce complexity in tax administration." Only two such documents were ever issued, none since 2002. Since Congress actually enacted legislative responses to the findings of those reports, Members of this Subcommittee should collaborate with Ways and Means and other panels to ensure that the complexity reports are regularly issued. Small business owners could see short-term improvement to some of the thorniest parts of the law (which can give rise to examination issues).

In addition, the Subcommittee can add an authoritative voice on behalf of reconstituting the Internal Revenue Service Oversight Board. Also a product of the 1998 restructuring law, the Board's purpose was to "oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction." The Board's members often brought years of experience in the private sector to bear on some of the agency's most intractable bureaucratic processes, but unfortunately a quorum does not exist for the entity to function. Congress and the Executive Branch should work together to rectify this situation.

Follow through on existing audit process flaws. The quality of information available to policymakers on taxpayers' experiences with the IRS has certainly improved over the past two decades. The National Taxpayer Advocate's Annual Report to Congress, with its Most Serious Problems facing taxpayers, has provided a wealth of actionable information to improve tax administration. In the 2015 Annual Report, many of these MSPs touched upon small business, such as:

- The Appeals Judicial Approach and Culture (AJAC) project, designed to build more firewalls between the Appeals office decision-making function and investigations conducted in the Examination and Collection arms, is backfiring. The Advocate believes AJAC, in conjunction with other policies, is "[b]eing used to intimidate taxpayers and deny their right to an administrative appeal" by encouraging curtailed appeals evaluation periods and causing cases to wind up in administrative limbo.
- The IRS may not have adequately tested information reporting data for certain parts of the Affordable Care Act (itself a major compliance challenge for small businesses). The potential result could be more extensive and expensive examination procedures.
- The IRS's "Future State" plan has been developed without significant input from the Taxpayer Advocate or public comment. A major concern is that the IRS's intent to interact with taxpayers mostly in an online setting overlooks the potential continuing demand for face-to-face service or telephone inquiries from taxpayers with complex or highly specialized issues (among them small businesses).

The latter MSP prompts an important question about the value of online and automated service options. Clearly, small business owners accrue considerable time and expense savings by being able to conduct many tax transactions online. NTU has supported a number of the recommendations from the Electronic Tax Administration Advisory Committee (ETAAC) regarding e-filing and other issues. We have also advocated for the availability of more convenient services online; during the Senate Finance Committee's markup of taxpayer protection and security legislation in April, we urged adoption of a provision directing the IRS to create a fully-functioning online platform for filing 1099 forms by 2020.

We have cautioned, however, that sufficient consideration needs to be given to the ability of small businesses to absorb e-compliance mandates from the tax agency. Not only will the specialized issues referred to above necessitate continued access to more than "FAQs" on a website, but other

problems such as identity theft and the IRS's own porous information security will erode the "trust factor" among business filers.

State as well as federal experience in this area commends particular attention to the plight of small businesses. One 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 "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.

The matter of cost-benefit analysis behind mandates and rules brings another consideration to the fore: IRS compliance with the Regulatory Flexibility Act (RFA). Now past its 35th year of operation, RFA demands that all federal agencies "fit regulatory and informational requirements to the scale of the businesses, organizations, and governmental jurisdictions subject to regulation." Agencies must also "solicit and consider" alternatives that can meet a given regulatory requirement in a flexible manner. The Small Business Regulatory Enforcement Fairness Act of 1996 provides for judicial review of compliance with RFA and empowers the Small Business Administration (SBA) to advocate on the laws' behalf. This type of scrutiny is greatly enhanced when Congress and the Small Business Administration evaluate in detail the IRS's responses to the safeguards that are supposed to be provided by RFA.

Also, 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. TAP's most recently released annual report submitted 42 recommendations from its project committees. Many of these touched upon small business and self-employed taxpayer concerns, among them improving communication to taxpayers about the new simplified home office deduction, and expansion of free online filing options for more business tax forms, such as those involving moderate-income truck drivers.

Unfortunately, progress in getting the IRS and Congress to act on TAP and NTA recommendations has been uneven. 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 MSPs specifically pertaining to or citing small businesses, each of which contained multiple parts. MSP Topic #12 from the 2013 report card noted that "IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue," primarily because the IRS has shunned a "proactive service-oriented approach" that would involve employees capable of quickly resolving trust fund tax delinquencies. 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."

These and other MSPs remain entirely or partially unfulfilled. The recommendation made earlier in this section on IRS annual complexity assessments appeared in the Advocate's 2014 report card, and remains in stasis. The problems with IRS examination correspondence, noted in Section II, also came from the 2014 report card.

This Subcommittee could provide a vital contribution to the development of good policy in all of the areas mentioned here, from resolution of outstanding MSPs to implementation of TAP findings, to compliance with RFA in ETAAC and other matters. Even a letter of inquiry from this Subcommittee to

the IRS could be helpful in jumpstarting the complexity report process. Quarterly or semi-annual hearings about these matters, with structured review agendas, could go a long way toward ensuring follow-up.

Continue to Measure and Refine Audit Strategies. The 2015 Taxpayer Advocate's Report contains an interesting analysis on the impact of audits on Schedule C filers with incomes below $200,000. Its findings are indication of how difficult attaining the balance between tax compliance and taxpayer rights remains.

The Advocate's study, drawn from a random sample of filers who were audited after submitting Tax Year 2007 returns, found a definite tendency of noncompliant taxpayers to report more income after being "caught." Even three years after the audit, a filer whose audit resulted in recommended additional tax reported on average 120 percent more income than before they were subject to examination. However, "compliant" taxpayers whose audits resulted in no change reported, on average, 35 percent less income on their returns. The Advocate noted the need for a "better understanding of the psychological impact of audits on compliant taxpayers [which] may lead to enhanced examination approaches that mitigate the erosion of tax morale and maintain their incentives to comply."

An earlier study released by the Advocate in 2013 attempted to correlate factors involved in small business tax compliance among the ten deciles of Discriminant Index Function (DIF) scores of returns for audit selection among Schedule C filers. These taxpayers were then surveyed about their attitudes toward compliance based upon factors such as societal norms, their own "tax morale," trust of the IRS and the government, complexity and convenience of the laws, and the influence of preparers.

Although there were variations based on income, DIF scores, and other variables, the overall conclusion was that access to IRS help was key:

> The factor that explains the most statistical variance in responses to the questionnaire on voluntary compliance by small proprietors is taxpayer service, which contributes to trust in government. At the same time, factor analysis disaggregated fairness as a separate factor, related to trust as described in the literature. Similarly, tax policy appeared as a distinct factor in this analysis, suggesting that agreement or disagreement with legislative design influences compliance. Likewise, the tax policy factor may be another aspect of trust in government.

The debate will continue over how big the deterrent effect of audits and other enforcement techniques might be on taxpayers, which is why this Subcommittee should continue insisting upon quality research from the IRS, SBA, and other entities into these areas.

Embrace the audit reforms in S. 2809. One of most important recommendations NTU can make in this communication is that Members of the Subcommittee support a House companion to Senator Portman's legislation to improve taxpayer safeguards in the examination process. S. 2809 would stipulate:

- The IRS cannot interfere with a taxpayer's right to an impartial hearing before the IRS Appeals division. The procedures for appeals and "triggers" for the process by which taxpayers may access them would be clarified and strengthened (with exceptions for frivolous tax positions);
- The agency is more restricted in its use of designated summons and in designating cases for litigation to their original intended purposes. One exception is that "listed transactions" (e.g., tax shelter schemes) would still fall under special discretion for cases designated for litigation; and
- The IRS could not contract with private law firms to conduct examinations.

The Chairman's Modification of the Senate Finance Committee Chairman's Mark of the Taxpayer Protection Act of 2016 contained the provision of S. 2809 pertaining to hiring outside counsel.

However, at the time this testimony was submitted to the Subcommittee, introduction of a House companion bill to S. 2809 was imminent. The Subcommittee's vigorous support for the entirety of S. 2809's House companion, in standalone form as well as amendment language, would be helpful toward getting these reforms enacted in the 114th Congress. There are several legislative vehicles, besides the Taxpayer Protection Act, which could afford opportunities for doing so.

Time for a Small Business Taxpayer Bill of Rights. Eighteen 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 (ADR) 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. Many business owners are already familiar with some form of ADR in mediating issues with customers, so this process would not be as intimidating to them as Tax Court or District Court venues.
- 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. This scenario is not entirely foreign to small businesses, which are often begun and conducted by married couples who might strictly segregate their roles in the company's operations. Furthermore, 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.

These types of changes are thoughtfully incorporated in legislation known as the Small Business Taxpayer Bill of Rights, introduced in the House as H.R. 1828 by Rep. Thornberry. The legislation has, in various forms, been introduced in several Congresses now.

NTU's members were elated to see lawmakers come together in a bipartisan fashion last year in enacting a statutory codification of NTA's version of the Taxpayer Bill of Rights, via the extenders legislation. But H.R. 1828, as well as other reforms being developed in the Senate Finance Committee (and discussed during an April markup) merits the Subcommittee's attention. Among these was an amendment developed by Senators Grassley, Thune, and Cardin to tax identity theft legislation. Although it was authored prior to the extenders legislation's codification of the Taxpayer Bill of Rights, the remainder of this amendment could still answer to many purposes under discussion in today's hearing. Highly desirable elements include clarified lien notice filing procedures, expedited "hardship" relief for businesses subjected to levies, and a new consultation requirement that will ensure that the IRS bureaucracy seeks early, systematic input from the Taxpayer Advocate before new regulations are published.

Finally, I must remind the Subcommittee that there are still judicial areas to explore in the quest to improve taxpayer rights. Although the laws provided for certain exceptions, citizens 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. 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.

It is critical to move as many of these reforms as possible to the President's desk quickly; they need not, and should not, languish until the next Congress.

Conclusion: Diverse Businesses, Common Concerns

Small business owners and self-employed individuals have varying reactions to the examination process, from relative calm, to annoyance, to great apprehension. I have even made the acquaintance of a writer – Stanley Rich – who staged a theater production parodying his own audit experience, entitled "Taxpayer! Taxpayer!". But across this emotional gamut, there are substantive policy matters that both Congress and the Executive Branch should address now. Members of the Subcommittee should be at the center of this effort, and can have a tremendously positive influence on behalf of small business taxpayers. NTU's staff and supporters stand ready to assist you.

I am most grateful to all of you for engaging in this hearing and for devoting so much attention to these lengthy remarks.