

**WRITTEN TESTIMONY
OF
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COMMISSIONER
INTERNAL REVENUE
BEFORE
THE HOUSE SMALL BUSINESS COMMITTEE
“IRS OVERSIGHT: ARE TAX COMPLIANCE COSTS
SLOWING THE ECONOMIC RECOVERY?”
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Introduction

Chairwoman Velazquez, Ranking Member Graves and members of the Committee, thank you for this opportunity to testify on the Internal Revenue Service’s efforts to assist America’s small businesses, particularly during the current economic downturn. As President Obama recently observed: “Our recovery in the present and our prosperity in the future depend upon the success of America’s small businesses and entrepreneurs.”

The IRS has two important goals – service and enforcement. We need to provide world class service to the vast majority of taxpayers trying to pay their taxes and wrestle with a complex tax code. And we need to carry out rigorous enforcement programs for those who do not meet their legal obligations to pay taxes. This isn’t an either/or proposition. We need to do both.

However, the IRS is acutely aware of the many problems confronting small businesses today – from struggling to make their payrolls, securing lines of credit, meeting their pension plan obligations and paying their taxes.

As the financial crisis deepened, the IRS took deliberate and focused action to provide assistance to individual and business taxpayers in distress while also preventing others from straying into non-compliance.

It is inevitable that during times of economic downturn, taxpayers may fall behind in paying their taxes. As IRS Commissioner, I am committed to striking the right balance between collecting the revenues needed to fund the government, and using all the tools we have available to us to work with small businesses who find themselves in difficult times.

This is a very fine line. On the one hand, as basic matter of fairness we need to ensure that American taxpayers pay their fair share and are compliant. On the other hand, we need to take taxpayers as they come, and ensure that we are treating people fairly and compassionately in these difficult times. In the end, we need to be flexible, principled, and to empower our employees to use judgment.

Assisting Small Business Taxpayers

As the economy worsened last summer, I believed it was imperative to get out in front of the changes before they overwhelmed us. We had to respond to an evolving crisis in real time and help get the nation back on the road to recovery. I pulled together my senior team to discuss and review programs that would be stressed in a deteriorating economy. Let me highlight some that affect and can benefit the small business community.

- **Offering Installment Agreements:** We have reminded examination employees of their responsibilities to consider collectability during the pre-audit phase. They were also reminded of their ability to offer installment agreements at the end of an audit when taxpayers are having difficulty satisfying their obligations immediately, thereby enabling them to minimize interest and penalty charges.
- **Postponement of Collection Actions:** IRS employees may suspend collection actions in certain hardship cases where taxpayers are unable to pay. This includes instances when the taxpayer has recently lost a job, is relying solely on Social Security or other assistance or is facing devastating illness or significant medical bills. If an individual has recently encountered this type of financial problem, IRS assistants may be able to suspend collection without further documentation to minimize the tax burden on the taxpayer.
- **Added Flexibility for Missed Payments:** The IRS has flexibility in working with previously compliant individuals in existing Installment Agreements who have difficulty making payments because of financial hardship. The IRS may allow a skipped payment or a reduced monthly payment amount without automatically suspending the Installment Agreement.
- **Prevention of Offer in Compromise Defaults:** Taxpayers who are unable to meet the payment terms of an accepted OIC will receive a letter from the IRS outlining options available to help them avoid default.
- **Expedited Levy Releases:** The IRS will speed the delivery of levy releases by easing requirements on taxpayers who request expedited levy releases for hardship reasons.
- **What If Scenarios:** The IRS recently added a special area on its web site focused on the financial downturn. Taxpayers with financial problems who discover they can't pay when they file their 2008 tax returns have options available. IRS.gov has a list of "What If?" scenarios that deal with payment and other financial problems. These scenarios, in question-and-answer format, provide information on specific actions taxpayers can take. Taxpayers unable to pay in full can contact the IRS to discuss additional options to pay.

American Recovery and Reinvestment Act: Net Operating Loss Guidance

Madame Chairwoman, the American Recovery and Reinvestment Act of 2009 (ARRA) is also providing some valuable tools to help small business in this difficult economic climate.

On March 16, 2009, the IRS announced that small businesses with deductions exceeding their income in 2008 can use a new net operating loss (NOL) tax provision to get a refund of taxes paid in prior years. The new net operating loss provisions could throw a lifeline to struggling businesses, providing them with a quick infusion of cash. Moreover, the IRS wants to make it as easy as possible for small businesses to take advantage of these key tax benefits.

The new provision, enacted as part of ARRA, enables small businesses with an NOL in 2008 to elect to offset this loss against income earned and allows a carryback of five years instead of the normal rule of two-years. The IRS released legal guidance in Revenue Procedure 2009-19 on March 16, 2009, outlining specific details.

With the economic downturn and the new law, the IRS expects record numbers of small businesses to be eligible for the refunds. The IRS is taking special steps to ensure timely processing of these refunds to help small businesses during this difficult period.

Small businesses with large losses in 2008 may be able to benefit fully from those losses now, rather than waiting until claiming them on future tax returns.

To qualify for the new five-year carryback provision, a small business must have no greater than an average of \$15 million in gross receipts over a three-year period ending with the tax year of the NOL. Businesses with more than \$15 million in gross receipts still qualify to carry back their 2008 NOL for two years.

Generally small businesses that are not corporations (including sole proprietorships filing schedule C with their Form 1040) may accelerate a refund by using Form 1045, Application for Tentative Refund.

The IRS has ensured proper staffing for expedited refunds; will be closely monitoring these filings; and will provide additional staff as needed to process these forms. The IRS will work to issue refunds within 45 days or even earlier to the degree possible.

In addition, Questions and Answers have been posted on the IRS Web site. Small businesses that file Form 1040 can also call 1-800-829-1040 with NOL questions. Corporations can contact 1-800-829-4933 with NOL questions.

Improving the Small Business Taxpayer Experience

The IRS is always looking for ways to better serve the small business/self employed taxpayer – from setting up their businesses to staying compliant. For example, the IRS

Small Business Examination group has a monitoring tool in place to capture taxpayer feedback on our examination process. We use taxpayer satisfaction information as an overall gauge of how the IRS is performing and to reduce taxpayer burden during the audit process.

Within the survey, we look to specific issues or factors which have a negative impact on our examinations – and ultimately on tax compliance. Some of these include the length of the audit process or taxpayers not fully understanding the audit outcome or adjustments made. Utilizing the periodic feedback, we analyze these issues and trends and use them as opportunities for improvement, such as training.

The IRS has also undertaken several initiatives to address the quality of the examination process, such as the Exam Process Improvement Challenge (EPIC). Other initiatives that help provide a seamless taxpayer experience include:

- **Fast Track Settlement:** The IRS is also vigorously pursuing Fast Track Settlement (FTS) for field cases. FTS is designed to settle cases more quickly than is possible with traditional Appeals procedures. This process is especially beneficial to taxpayers who have a tax liability in dispute that is greater than \$25,000. In FTS, the examiner brings in an Appeals official to facilitate settlement while the case remains at the group level. FTS is being piloted in eight cities throughout the country.
- **Offer-in-Compromise –** The IRS is studying a simpler case resolution process for taxpayers who file related OICs (e.g., joint filers filing separate OICs on joint liability).
- **Cross-IRS Study –** The IRS Small Business and Self Employed and Wage and Investment divisions and the Taxpayer Advocate Service are working together to identify opportunities to resolve taxpayer collection issues earlier and provide for operational improvement opportunities.
- **Lien Assistance –** We have changed our procedures to better assist taxpayers with lien releases. When a taxpayer cannot pay the full amount on a lien where there is a pending real estate transaction or refinancing, we provide them information about partial discharges and subordinations, a reference to the publications, and the telephone number to call.

General Outreach to Small Businesses

The Internal Revenue Service is dedicated to helping small businesses owners – primarily Schedule C filers – especially those facing hardship as a result of the economic downturn. Eighty percent of small businesses use professional return preparers, and many of these taxpayers belong to industry and small business organizations and associations.

Our outreach and education strategy relies on critical third-party relationships with preparers and the organizations that assist and represent small business owners. We work with thousands of industry and small business organizations, tax professional and payroll associations, women and minority-owned business associations and government agencies to leverage our outreach and education efforts to small business owners.

As a result, we are able to provide small business owners with the information they need to avoid compliance problems and relieve burden, and to keep them informed of legislative changes that can affect their tax responsibilities, such as the American Recovery and Reinvestment Act.

We use a number of methods and channels to get our message out to small business owners, provide guidance and answer their questions. In FY 2008, IRS participated in over 2,600 meetings, symposiums and seminars attended by over 162,000 small business owners and tax professionals. For example in FY 2008, IRS held 135 Small Business Forums which provide an open avenue of communication between IRS and trade and industry groups.

Our stakeholders alert the IRS about issues that are a burden to their members, provide feedback on policies, practices and procedures and learn new ways to assist small businesses in navigating through the IRS. The Forums also allow members to receive the latest small business information from IRS and provide an opportunity to share feedback and concerns on behalf of their members.

At the local level, we have special units dedicated to conducting similar meetings attended by representatives of organizations that assist small business owners, such as trade and professional associations, chambers of commerce, small business development centers, and Better Business Bureaus.

By working with these organizations through the Forum process, we are able to communicate to thousands of small business owners. These groups get the word out in a variety of ways, such as through their national and local chapter meetings, on their websites, in articles in newsletters and magazines, and at continuing education programs.

Our strong third-party relationships also enable us to provide quality education to small business owners through our Small Business Tax Workshop program. IRS facilitated 410 of these structured workshops in FY 2008 which cover tax topics from starting to closing a business. Industry groups provide classroom venues and tax professionals provide instructors. These workshops are advertised on IRS.gov and are held all over the country.

In addition to working with industry and tax professional organizations, our Governmental Liaison division helps us develop productive relationships with other national and state governmental agencies to provide outreach and education to small business owners. For example, we work closely with the Small Business Administration. As a result, we recently held joint agency “Webinars” for small business owners covering

timely economic downturn topics, such as identity theft and IRS relief for taxpayers in difficult financial situations.

The IRS also holds National Phone Forums on a regular basis, advertised on IRS.gov. These free seminars typically include thousands of participants covering topics of interest to small business owners and the tax professionals who assist them, such as “Correspondence Examinations – Understanding the Process and Working Together,” “Recordkeeping for Small Businesses,” “How to Navigate IRS.gov,” “Identity Theft,” “Choosing a Preparer in English and Spanish” and “Disaster Assistance Information.”

Our website, IRS.gov, is also one of the best resources for small business owners. It has a comprehensive section devoted to small business and self-employed taxpayers, including a companion website just for this community, called the Small Business Resource Guide. We know that the economy has presented many challenges to small business owners, and our website addresses a number of job, debt and tax-related questions, as well. The Business and Specialty Tax toll-free number is dedicated to answering tax questions for small business owners.

Finally, we publish several helpful products for small business owners who may not have access to IRS.gov, including the Tax Calendar which notes key filing and payment dates, and the Virtual Small Business Workshop DVD. Industry groups and tax professionals order these products from us, and make them available to small business members and clients.

The IRS is also dedicated to providing taxpayers with correct information the first-time asked, and to provide quick resolutions for unanswered questions. We use an Issue Management Resolution System (IMRS) to collect questions/issues that are raised by our stakeholders, and send them to subject matter experts throughout the IRS to be resolved.

Not only does this system allow us to respond in a timely manner to our stakeholders, it also allows us to track trends where taxpayers may misunderstand procedures and law, and to develop new outreach products and programs to improve understanding and relieve burden. We expect IMRS to play a large role in resolving questions that arise about the ARRA.

Indeed, the IRS is taking extraordinary efforts to publicize the ARRA’s tax relief provisions. Again, because we have such an extensive network of third-party relationships with national and local industry and tax professional organizations, we have contacted over 2,600 of them to provide initial guidance on the new legislation.

Since enactment, we have provided ARRA information at many venues all over the nation, including Small Business Forums and industry, payroll and practitioner meetings, seminars and symposiums. We continue to provide more information as it becomes available to these partners, and to provide explanations and guidance on IRS.gov.

IRS Compliance and Examination Programs

The IRS continues to administer its examination programs within today's difficult economic climate where balance and judgment become all the more important. The economic downturn has left many small businesses in a precarious position.

We have also communicated to our small business examination employees the importance of recognizing that individual taxpayers or businesses being audited may be experiencing hardships as a result of the current economic conditions. As I noted in the introduction to my testimony, we need to take taxpayers as they come, and ensure that we are treating people fairly and compassionately in these difficult times. In the end, we need to be flexible, principled, and to empower our employees to use judgment.

Additionally, IRS operating divisions that interact with small businesses are coordinating issues more than ever before. Our Small Business Examination group is working with Appeals to provide a more expeditious resolution of audit issues which may have reached an impasse. Our Fast Track Settlement initiative process allows the taxpayer/representative to meet with our Examination and Appeals personnel to discuss unresolved issues, explore alternative resolutions to achieve consensus which brings closure to the issue. This approach decreases the amount of time the audit is open and reduces the overall burden on the taxpayer.

Asset Smoothing

IRS efforts to assist small businesses also extend to their retirement plans. Asset smoothing is a good example. The Pension Protection Act of 2006 (PPA) mandated significant changes in the rules for determining minimum funding contributions for qualified defined benefit pension plans. In general, the minimum contribution to a plan for a plan year depends on a comparison of the value of the plan's assets as of the beginning of the plan year with the plan's "funding target" (i.e., the present value of all benefits accrued as of the beginning of the plan year) and the plan's target normal cost (i.e., the present value of benefits expected to accrue or be earned during the plan year).

In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets. In such a case, the minimum required contribution for the plan year generally is equal to the sum of the plan's target normal cost for the year and a portion of the funding shortfall for that year and prior plan years.

PPA provided that the value of plan assets generally is the fair market value of the assets. However, the value of plan assets may be determined on the basis of the *averaging* of fair market values under certain circumstances. PPA also provided that any averaging must be adjusted for contributions to the plan and distributions to participants.

The Department of the Treasury and the IRS proposed regulations in 2007 that permit the value of plan assets to be determined on the basis of averaging. Under the proposed regulations, the average value of plan assets generally is increased for contributions that

are included in the last valuation date during the averaging period, but that were not included in the prior valuation dates during the averaging period. Similarly, the average value generally is decreased for distributions included in the last valuation date during the averaging period, but that were not included in the prior valuation dates during the averaging period.

Due to some issues raised by the pension plan community in interpreting the legislative intent of the provision, smoothing was specifically permitted as part of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), in accordance with Treasury guidance.

On March 16, 2009, the IRS issued guidance interpreting the asset smoothing provisions in WRERA. It allows actuaries to take advantage of asset smoothing in 2009 without redoing their asset calculations for the 2008 plan year.

Additional Pension Guidance, Assistance and Education

In addition to the asset smoothing regulation, the IRS provides other guidance and assistance to small businesses and entrepreneurs concerning setting up and maintaining pensions under normal circumstances and also in today's difficult economic climate.

- Pension funding waivers for “temporary substantial business hardship”. A waiver of a year's minimum funding requirement is authorized by Internal Revenue Code § 412(c)(1) in cases where compliance with the funding requirement would impose a temporary substantial business hardship on the employer. Factors taken into account in determining such hardship include whether:
 - The employer is operating at an economic loss.
 - There is substantial unemployment or underemployment in the trade or business and in the industry concerned.
 - The sales and profits of the industry concerned are depressed or declining.
 - It is reasonable to expect that the pension plan will be continued only if the waiver is granted.
- Automatic 7-year schedule to fully fund a year's shortfall. If a plan's benefit liabilities exceed its assets in a year, the Code does not require the employer to fully fund the shortfall that year. Rather, pursuant to Code § 430(c)(2), the amount of the funding shortfall may be contributed to the plan in 7 installments over that year and the next 6 years.

Public Outreach and Education

- Publications. The IRS publishes numerous publications of interest to small business pension plan sponsors. For example, Publication 560, *Retirement Plans for Small Business*. This IRS publication provides a plain-English discussion of the key features of pension plans and other types of retirement arrangements for small businesses. Specifically, this publication covers:

- What type of plan to set up.
- How to set up a plan.
- How much to contribute to a plan.
- How much of the contributions are deductible.
- How to treat certain distributions.
- How to report information about the plan to the IRS and employees.
- Basic features and rules that apply to pension and other retirement plans.

This and other retirement plan-related publications are available online at <http://www.irs.gov/retirement/sponsor/index.html> or by calling 1-800-TAX-FORMS.

- Newsletter. Since 2004, the IRS Employee Plans Division (TE/GE) has published the *Retirement News for Employers* newsletter – a free, periodic publication with retirement plan information of interest to employers, including small businesses. The Winter 2009 issue is available here: http://www.irs.gov/pub/irs-tege/rne_win09.pdf.
- IRS Website. The “Retirement Plans Community” is one of the six key links on IRS’s home page. Inside the link, the site map identifies information and helps direct visitors to the pension-related features they are seeking. For example, at <http://www.irs.gov/retirement/sponsor/index.html>, employers can find plain- English discussion and information regarding the tax rules, filings, and correction of mistakes that apply to pension plans.
- Email. Since 2002, the IRS has maintained an email address -- RetirementPlanQuestions@irs.gov -- that anyone (including small businesses and their owners and employees) may use to ask questions related to proper operation and tax-qualification of their pension plan. In 2008, the IRS responded to 1,991 such emails.
- Employee Plans Toll-Free Telephone “Hotline”. Since 1999, the IRS’s Employee Plans Division (TE/GE) has operated a toll-free hotline that anyone may utilize, on an anonymous basis, to seek immediate answers to questions related to their pension plan. The hotline received approximately 75,000 such calls in FY 2008. The phone number is 1-877-829-5500.
- Speeches and Webcasts -- Employee Plans Customer Education and Outreach. Pension experts in the IRS’s Employee Plans Division (TE/GE) participate each year in over 300 retirement plan-related public speeches and webcasts in locations throughout the United States (and on the Internet), with a total audience of over 120,000. The IRS website posts a schedule of upcoming presentations: http://www.irs.gov/pub/irs-tege/upcoming_confs.pdf.

Tax Gap

Madame Chairwoman, the last subject I would like to discuss is the tax gap. In 2006, the IRS updated its estimate of the overall gross tax gap for Tax Year 2001 – the difference

between what taxpayers should have paid and what they actually paid on a timely basis – to be \$345 billion. IRS enforcement activities, coupled with other late payments, recover about \$55 billion of the tax gap, leaving a net tax gap of \$290 billion for Tax Year 2001.

As with prior estimates, the updated estimate of the tax gap shows that the largest component of this gap – more than 80 percent – comes from underreported taxes. Underreported *income* tax is the largest component of this; non-filing and underpayment of tax comprise the rest of the tax gap. Clearly we must do a better job to get taxpayers to report their income.

Conclusion

Madame Chairwoman, I want to thank you again for the opportunity to testify today on what the IRS is doing to help small business owners on the road to economic recovery. We have made some progress but more needs to be done. We look forward to working with you, the Committee and staff to make sure that this great engine of economic growth and prosperity continues to operate at its full potential.