



Tax Reduction Letter

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Statement of Margaret Milner Richardson, Commissioner of Internal Revenue, Before the House Committee on Small Business

October 25, 1995

Madame Chair and Distinguished Members of the Committee:

I appreciate the opportunity to be here today to discuss the efforts of the Internal Revenue Service to make the federal tax system fairer, simpler, and more efficient for small businesses. I have spent more than a quarter century working on tax issues -- both in and out of government. I understand that small businesses have concerns about the tax system that are unlike those of many individual taxpayers and many larger businesses.

Three out of four individuals do not itemize their deductions, and two out of three pay a flat tax at a 15 percent rate. At the other extreme, big businesses face complex rules but are undaunted because they have the resources to make sure they can minimize their tax bills. In the middle of it all is the small business that must face essentially the same rules that apply to big businesses, but without the resources to do so. I welcome the opportunity today to discuss the concerns of small business and what the Internal Revenue Service is doing to address those concerns.

My staff and I have devoted a considerable amount of time to small business issues. We recognize that we cannot expect small business owners to comply fully with the tax laws unless they first understand their tax obligations and then have the tools they need to satisfy their obligations quickly and cost-effectively. For that reason, approximately a year and a half ago, we made a commitment to do what we could to assist small businesses.

We started by going directly to small business owners to listen to them. During the spring and summer of 1994, OMB's Office of Information and Regulatory Affairs and the Small Business Administration jointly sponsored a forum here in Washington on regulatory reform for small businesses. The IRS participated, along with five other federal agencies, in a series of workshops focusing on several small business industries, and we listened to the concerns of small business owners and their representatives. At my request, the IRS held a special series of workshops as part of that regulatory forum to focus specifically on IRS issues.

To participate in this regulatory forum, I established a new IRS Office of Small Business Affairs and appointed Barbara Jenkins, who is with me here today, as its Director. I believed we needed a group of people within the IRS, reporting directly to the Commissioner, who have responsibility for focusing on the concerns of small businesses. Since that office was established, a year and a half ago, Barbara and her staff have been working hard with me and with many others at the IRS to improve the services our organization provides to small business. It is because of that work that I am pleased to be here testifying this morning.

Our opportunities for listening expanded when President Clinton announced his regulatory reform initiative in March of this year and asked that the head of each federal regulatory agency get out of Washington to talk directly with the regulated community. I chose to take that opportunity to mobilize the Office of Small Business Affairs and hold a series of small business town meetings. I personally conducted seven of those meetings in towns all across the country. We listened long and hard to the concerns of small business owners, and, when each of these meetings was over, we promised to take their concerns back to Washington and address the ones we could.

The IRS also participated this year in the White House Conference on Small Business. Our participation included representation at many of the state conferences and all the regional conferences and culminated in a presentation I made at the national conference here in Washington in June. I also had the opportunity to participate in a two-hour open Question and Answer session at the national conference, so I did a fair amount of listening to small business owners that morning.

I want to report to you today what we have learned from listening to hundreds of small business owners about the tax system, and what we have begun to do about what we have learned. I recognize that we have not heard from everyone -- and I know there are many points of view and many different stories to tell. I also recognize that we do not have the solutions to all the concerns that we have heard so far. I want to make clear, however, that no one should be suffering from the misunderstanding that the IRS is a large, impersonal organization with neither time nor desire to address the concerns of small businesses. We look forward to receiving input about our efforts from this distinguished Committee, as well as from the other members of this panel.

So far, the small business owners we have listened to have told us that they want very much to comply with their tax obligations. But, as I mentioned a minute ago, they also told us that we cannot expect small business owners to comply fully with their tax obligations unless they understand those obligations and have the proper tools to satisfy their obligations quickly and cost-effectively. Accordingly, our efforts to help small businesses have been directed at both increasing their understanding of their tax obligations and providing them with effective tools for satisfying those obligations.

INCREASING UNDERSTANDING

Small Business Education

The most direct and effective way of increasing the understanding of small business owners about their tax obligations is to provide them with a workshop or training program where they can get personal instruction and ask specific questions. Currently, every IRS office conducts a taxpayer education program that incorporates taxpayer workshops on a wide variety of tax topics, including workshops on small business tax issues. In response to hearing about the need for better education programs for small business owners, we are now exploring how we can customize the workshops to specific industries and how best to use our workshop resources to get small businesses the kind of training they need most. Already, we have conducted industry-specific small business programs, which have been successful and well-received. For example, in

New Hampshire, we held a workshop for restaurant owners and, in Austin, Texas, we held a workshop for small businesses dealing in international trade.

We are also exploring the possible development of a more extensive education program in partnership with the Small Business Administration's Small Business Development Centers. Such a partnership would provide tax information and education to all small business owners using the Centers and could result in a much wider distribution of tax information at the local facilities in the SBDC network.

Small Business Tax Education Kit

Today, I brought with me an information kit. The kit contains material designed to educate small business owners on a variety of topics like employment taxes, record keeping requirements, and self-employed retirement plans. We distribute these kits to about 2,500 organizations nationwide, including colleges, universities, and business training centers. These organizations then use the materials in programs for teaching small business owners about the federal income tax system.

As part of our effort to improve small business education and because of what we learned in our town meetings, we are now working with an outside contractor that specializes in producing educational materials to make the contents of the kit more helpful.

IRS Notices

We recognize that we can help small business owners understand their tax obligations not only through formal education programs but also through providing them with clear, helpful information when we contact them about a specific problem or task. We learned in our regulatory reform workshops and at our town meetings that some of our written notices, hundreds of thousands of which are issued to small businesses each year, are often not helpful to those small businesses.

In response, we have begun a complete overhaul of our taxpayer notice system. Our notice redesign project will improve the quality, content, and format of our notices so that small business owners -- indeed, all taxpayers -- can understand and know how to respond to a notice without having to call us for an explanation. Our goal is to have several of our high-volume notices redesigned by the end of this year. We have also begun a broader notice reengineering project to take a hard look at our use of notices and to make cost/benefit determinations about that use. The Office of Small Business Affairs is part of these notice reinvention efforts so that the needs and concerns of small businesses are properly taken into account.

Regulatory Reinvention

The IRS can also improve understanding of the tax laws through regulatory reinvention. When talking about regulatory reinvention or "reg reform," I think it is important to point out that the IRS is somewhat different from many other government regulatory agencies. In general, the IRS issues regulations to interpret specific tax rules written by Congress and to help taxpayers better understand and meet their tax obligations. That is, our regulations generally do not impose new requirements or sanctions on taxpayers. Rather, they typically describe requirements and sanctions imposed by Congress and attempt to give taxpayers guidance on how to comply with them. As a result, the IRS is often cited for not issuing regulations quickly enough rather than for

issuing too many regulations. For example, last December, the GAO reported on interviews it held with businesses about the burden of government regulations and cited the IRS's problem as a lack of regulations, not an excess. The GAO report stated:

Of those [tax advisors and officials of the businesses interviewed] who cited difficulties with the IRS, problems identified were ... the amount of time IRS takes to issue regulations For many tax provisions businesses depend upon IRS regulations for guidance in complying with the code and correspondingly reducing their burden. Without timely regulations, according to some respondents, businesses must guess at the proper application of the law and then at times amend their decisions when the regulations are finally issued. n1

Because our regulations serve this important purpose of helping taxpayers understand their obligations, we found in the workshops that were part of the SBA/OMB Forum on Regulatory Reform that most small business owners think the IRS regulatory process should be improved and streamlined so that more useful regulations can be issued more efficiently. This was echoed in our town meetings. The small business owners we talked to asked for (1) simpler regulatory language; (2) earlier involvement in what regulations say; and (3) an easier way to access regulatory information.

In response to the request for easier access to simple explanations of regulatory requirements, we recently implemented a procedure that should help all taxpayers, but which was particularly designed for small businesses without specialized legal counsel. Under this procedure, each new regulation is accompanied by a brief, one or two-page description, in non-technical language, that sets forth the subject matter of the regulation, describes the taxpayers who may be subject to it, and instructs the reader on where to go for further information and how to provide comments to the IRS. Within the next two weeks, these summaries will be available on FedWorld, a government-sponsored electronic information service, accessible via the Internet. Our intent is to provide small businesses with a simple and inexpensive way of finding out what regulatory actions we are taking and how they can get involved in the process.

To facilitate involvement of small businesses in the regulatory process further, it was suggested in the SBA/OMB Forum on Regulatory Reform that we extend the comment period we normally provide for proposed regulations from 60 days to 90 days. We responded immediately by doing just that. In addition, next year, we plan to put the entire text of all our new regulations and proposed regulations on the Internet, and we will allow taxpayers to comment on proposed regulations by transmitting their comments to us electronically. We believe these changes to our current Federal Register procedures will make it easier for taxpayers, especially small business owners, to become involved in our regulatory process.

We have also recently completed some important regulatory housekeeping. As part of the President's Regulatory Reform Initiative, this summer we conducted a page-by-page review of all our existing regulations and, based on that review, have proposed to withdraw more than 30 obsolete regulations, amounting to over 160 pages in the Code of Federal Regulations. We are now waiting for public comment on that proposal and hope to be able to eliminate these regulations by year-end.

Publications

Most small businesses can meet all of their federal tax responsibilities without ever referring to official IRS regulations. The IRS issues hundreds of free information publications, many of which are designed to provide guidance to businesses on all their tax obligations including those originating in regulations. n2 Publication 553, for example, provides taxpayers with guidance on tax law changes occurring during the year. Publication 334, Tax Guide for Small Business, provides in one place comprehensive tax information for sole proprietorships, partnerships, and corporations regarding filing, deposit, and regulatory requirements. Several publications explain rules regarding specific topics, such as qualified retirement plans.

One of the responsibilities of our Small Business Affairs Office is to work with our Tax Forms and Publications Division to ensure that the needs of small business are being met by these publications. For example, as a result of feedback received at our IRS town meetings, Publication 583, Starting a New Business and Keeping Records, is being revised to better explain record keeping requirements for small businesses, and should be available to the public in early January.

Specific Small Business Issues

Perhaps one of the most important ways we can increase small business owners' understanding of tax obligations is to be on the look out for specific issues they face and to address those issues reasonably and efficiently. In the past two years, we have issued administrative guidance addressing many small business issues in this manner. Where the source of complexity is statutory, we generally work with the Treasury Department to help craft legislative proposals that would provide additional relief for small businesses.

I want to mention three specific issues we have recently addressed administratively.

Worker Classification:

We know that an issue of great concern to small businesses is how workers are classified -- in other words, whether they are employees or independent contractors. The participants of the White House Conference on Small Business identified worker classification as their number one issue of concern.

Worker classification depends on a common-law standard which essentially asks whether the business has the right to "direct and control" the worker. The courts have traditionally looked to a variety of evidentiary factors in applying this test, and the IRS has therefore adopted those factors in examining this issue. The problem has been that the factors are too numerous, too complex, and many of them just do not fit for particular businesses. What is needed are simple, uniform definitions of "employee" and "independent contractor." This, of course, the IRS cannot provide under current law.

I have said in public several times recently that it does not matter to the IRS whether a worker is classified as an employee or an independent contractor, so long as the worker, whether under the withholding rules or under the rules governing the self-employed, is paying his or her proper amount of taxes. Essentially, our agents should be doing the best they can to make an accurate worker classification determination under the complexity that is the common law. A straightforward definition would ease our burden, as well as the burden on taxpayers.

We know, however, that we cannot wait for these more wide-ranging changes to be accomplished. On August 2 of this year, the National Director of our employment tax programs testified on the subject of worker classification before this Committee's Subcommittee on Taxation and Finance. At that time he announced that the IRS was developing changes to our approach to the worker classification issue in our employment tax audits. I would like to update the Committee on the initiatives that were announced at that hearing.

First, we announced that we were requiring the approval of our national office here in Washington of all large worker classification projects. This means that if one of our local offices wants to start a project for examining worker classification in an entire market segment or geographic area, national office approval is required. These procedures have now been implemented, and we believe they will ensure uniform treatment and appropriate use of the IRS' resources.

Second, we said that we would develop training materials for IRS examiners handling worker classification issues that emphasize the principle that using independent contractors can be a legitimate business practice that will not be challenged by the Service. We are now developing this material and a draft should be available early in November for review and comment by the private sector, including small business. We expect to complete the training of our examiners by the end of January 1996.

In addition to these initiatives announced at the August 2 hearing, we have now completed a thorough review of our existing employment tax compliance programs. As a result of this review, we are taking steps to ensure that our audit approach on the issue of worker classification embodies the following principles:

- Worker classification issues should be resolved as quickly as possible and as early in the administrative process as possible.
- Worker classification issues should be resolved uniformly throughout the country.
- Resolution of worker classification issues should take into account a taxpayer's past compliance with section 530, as well as the common law standard.
- The IRS' compliance programs should encourage correct classification and correct reporting of payments to workers.
- Reclassification of workers who have legitimately been treated as independent contractors must be avoided.

The IRS plans to propose for public comment a new initiative based on these principles early in November, at the same time training materials are released.

Restaurant Worker Tip Reporting:

For many years, the IRS and the restaurant industry have struggled with difficult issues regarding the proper reporting of tips received by restaurant workers. After long negotiations and careful listening to the industry, some of which occurred during my town meetings earlier this year with

small businesses, we announced in May that we had developed an agreement on reporting issues with a coalition of food service industry representatives. This agreement is known as the Tip Rate Alternative Commitment or "TRAC."

Under TRAC, an employer who voluntarily agrees to the commitment must establish reasonable procedures to report future tips, establish a program to educate all employees who receive tips, and deposit federal employment taxes on those workers promptly. In return, the IRS generally will agree not to initiate an examination of the employer that might result in an assessment of tax for its employees' unreported tips for prior years. Currently, we are developing a training package for agreement participants, and it will be available next month.

Our success has been highly acclaimed across the country. For example, a member of the board and past president of the Oklahoma Restaurant Association, David Egan, was quoted in the Sunday Oklahoman as saying that "this is a remarkable workout between the restaurant industry and the IRS."

I want to congratulate the restaurant industry on this shared success. I think the TRAC agreement is a very fine example of what we can do with the most difficult of issues if we set out to cooperate with private industry and agree to respect one another's interests.

Entity Classification:

My last example of a difficult small business issue we are addressing is the determination of whether an unincorporated business should be taxed as a partnership or as a corporation. Currently, that determination is made under a complicated set of regulations based on old case law. For the well-advised, those rules are easily manipulated to achieve a desired result, but at the same time the rules are extremely complex and full of pitfalls for smaller entities without sophisticated counsel. Therefore, in March of this year, we proposed a major initiative to allow unincorporated businesses simply to elect whether they want to be classified as a partnership or a corporation. This new classification election will be quick, simple, and hassle-free, and will save resources for both taxpayers and the government.

Since we announced this idea in March, we have received about 50 formal letters of support from groups representing tens of thousands of small businesses. At a July 20, 1995 public hearing, we heard testimony from many private sector witnesses who also expressed overwhelming support for the initiative. We hope to propose regulations implementing this concept as early as the end of this year, and to finalize new rules next year.

PROVIDING EFFECTIVE TOOLS

As I have mentioned, small business owners told us that they need to understand their obligations, but that they also need to have the proper tools to be able to comply with those obligations quickly and with little cost. I would like to describe some of the things we are working on to give small businesses those tools.

Access to Tax Information and Assistance

We have improved taxpayer access to tax information. For example, since December of last year, taxpayers have been able to get copies of most IRS forms and publications electronically from

the Internet or by dialing into FedWorld, and they have been able to get them on a CD ROM. These documents can be down-loaded to personal computers and printed at the taxpayer's home or office.

The IRS has also joined with the Department of Commerce and 14 other government agencies to establish the U.S. Business Advisor -- a one-stop Internet shop that directs small business owners to government information available on-line, including the electronic IRS cite for forms and publications I just mentioned.

For small business owners seeking specialized tax assistance, the IRS was a partner in the development of the first U.S. General Store for Small Business opened in Houston, Texas in July of this year. This store, which is supported by 14 other federal agencies, provides one-stop government service to businesses, ranging from assistance in complying with regulations, to solving tax problems, to obtaining loans. The IRS now has two full-time employees working in the Houston Store and is working with other federal agencies on plans for the development of additional General Stores in other locations across the country.

The concept of providing one-stop assistance to small businesses is not new to the IRS. Our Buffalo Assistance Center recently celebrated its second anniversary of offering one-stop service for prospective or existing business owners. During its first two years, the Center has helped over 10,000 small businesses across the country by providing one-on-one counseling, group seminars, assigning employer identification numbers, and providing answers to specific questions.

We are also working to expand the tax information and assistance we make available on the Internet. Next year, information available on FedWorld will be broadened to include "Dear IRS," a searchable list of frequently-asked tax questions, and answers to those questions, as well as a "Tax News" service to help businesses, practitioners, tax software companies, and the media stay on top of the latest tax developments. In addition, the technical tax topics that are now available on our TeleTax system -- an automated telephone assistance line -- will be made available on FedWorld, and several of our publications for businesses will be presented in an electronically searchable format.

Forms and Paperwork

Although our tax forms are frequently cited in discussions about complexity, I would point out that often complexity in the forms simply reflects a complex area of the law, and that our forms can be quite useful in helping taxpayers comply with their obligations. Our basic approach to developing forms and instructions has been to allow taxpayers to complete them without having to seek out provisions of the law or regulations. At the same time, we understand the need to keep the forms as simple as possible, and we are continually working to do so.

For small businesses, we recently introduced a new Schedule C-EZ, used by sole proprietors to compute their net profit for the year. The Schedule C-EZ allows taxpayers to compute their net business profit on only three lines, instead of the 36 lines that are included on the full Schedule C. Nearly 2 million taxpayers are now using the new Schedule C-EZ.

Last December, we simplified reporting of employment taxes by removing non-payroll reporting requirements, such as backup withholding, from the Form 941. This change reduced paperwork burden for an estimated 6 million employers and saved them 13 million hours in reporting time

annually. In addition, Form 1065, used to report partnership income, was revised significantly in 1993. We changed reporting requirements for balance sheets and assets to reduce burden for an estimated 800,000 small businesses.

As you know, the Administration strongly supported the Paperwork Reduction Act of 1995, which became effective just three weeks ago. This new law substantially increases opportunities for the public to participate in the notice and comment period for proposed forms and paperwork requirements in proposed regulations. The law will increase the public's opportunity for comment on paperwork requirements, and we at the IRS are hopeful that it will bring a substantial increase in the number of thoughtful suggestions we receive from the public for form simplification.

While we are working hard to reduce paperwork burden by streamlining the content of our information requests from taxpayers, we also believe that the ultimate solution to paperwork issues lies in finding ways to use new technologies so that taxpayers can communicate with their government as easily as they communicate with many segments of the private sector. We have recently made great strides in devising alternative, user-friendly methods of filing tax information with the IRS.

We continue to expand our programs for electronic return filing. Many small businesses are self-employed individuals filing the Form 1040 with the Schedule C or Schedule C-EZ. These returns can now be filed by electronic means quickly and with much fewer errors so that chance that there will be a need for post-filing correspondence with the IRS will be reduced significantly.

In October of 1994 we began a pilot program to allow employers to file their quarterly payroll tax returns (Forms 941) by electronic means. The IRS has received and processed more than 100,000 such returns so far and intends to expand the program because of its success. In January, we will begin to test in the State of California a project that will allow small businesses to meet their federal and state employment tax filing requirements with a single electronic transmission.

Record Keeping

At our small business town meetings, we were asked to focus some of our efforts on our record keeping requirements, so we have been doing just that. I asked a task force in the national office to work with our Office of Small Business Affairs to review all our small business record keeping requirements. The group came up with 35 recommendations for easing these requirements. Our next step, scheduled to begin next month, is to test these recommendations with small businesses.

But even more exciting is the fact that, last month, we announced perhaps the most significant change in the record keeping area in years. Since 1962, the threshold for which businesses are required to have a receipt for a travel or entertainment expense had been \$25. Effective on October 1, we raised that threshold to \$75. We know that, for small businesses in particular, the \$25 threshold had been difficult. The new threshold should make record keeping a lot less challenging for both businesses and employees and is part of our ongoing efforts to make government work better and cost less for everyone.

Payment Tools

We are also working to make it easier for businesses to make their tax payments. We have developed an electronic federal tax deposit system, which we call TAXLINK, that allows businesses to make their payroll and estimated tax deposits by making a phone call, rather than by taking a trip to the bank to deposit a check with a paper coupon. We have heard about some small business owners having to close their businesses for hours in order to drive to the nearest bank to make their deposits. Hopefully, TAXLINK will eliminate this kind of counterproductive activity.

We are now studying whether TAXLINK adequately takes into account all the needs of small businesses. For that purpose, we conducted an extensive customer satisfaction survey of current TAXLINK users to determine whether we needed to make any changes. We were extremely pleased to see the results of that survey. Approximately 98 percent of the businesses using TAXLINK are satisfied with the system. When asked if TAXLINK saved them time, 86 percent said "yes" and, when asked if TAXLINK was easy to use, 79 percent also said "yes." Our goal now is to make sure that small businesses are aware of the benefits of this new system and that it is available to them today.

Before closing, I want to point out that all our programs involving electronic and telephonic filing, paying, and assistance, many of which I have discussed today, are our most promising from the perspective of giving small businesses the tools they need to comply with their obligations simply and inexpensively. But I also note that these programs are only possible because of investments we have made so far in Tax Systems Modernization. The future growth and success of these important programs, which again are our most promising, depends entirely on our ability to continue these investments in the future.

CONCLUSION

We at the IRS are committed to addressing the concerns of small business owners about difficulties they face in understanding and satisfying their tax obligations. I have attempted to outline for you this morning some of our early successes and to indicate to you where we plan to concentrate our efforts in the coming months.

We are anxious to continue building on the progress we have made in the past two years. Unfortunately, because of the current budget environment and the significant reductions that have been proposed in our FY96 appropriation, our ability to deliver the kinds of services all taxpayers, including small businesses, deserve will be severely curtailed. But, despite budget constraints, this agency will continue to strive to make the tax system less taxing for individuals, small businesses, and large businesses as well.

As I said at the outset, I look forward to any comments or suggestions the members of this distinguished Committee may have on our efforts and would be happy to answer any questions you may have at this time.

FOOTNOTES:

n1 Tax System Burden: Tax Compliance Faced by Business Taxpayers (GAO/T-GGD-95-42, December 9, 1994).

n2 For example: Publication 15, Employer's Tax Guide; Publication 535, Business Expenses; Publication 534, Depreciation; Publication 594, Understanding the Collection Process.