

**WRITTEN TESTIMONY OF
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BEFORE THE
HOUSE SMALL BUSINESS COMMITTEE
ON THE IRS AND SMALL BUSINESSES: ENSURING FAIR TREATMENT
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Introduction

Chairman Graves, Ranking Member Velazquez and Members of the Committee, thank you for the opportunity to appear before you today to discuss tax matters affecting small businesses.

The mission of the IRS in regard to small businesses, and indeed to all taxpayers, is to provide quality service by helping them understand and meet their tax responsibilities, and to enforce the law with integrity and fairness to all.

The IRS takes seriously the need to provide excellent service to small business taxpayers. Small businesses and self-employed taxpayers in the U.S. are vital to our country as engines of economic growth, and the IRS needs to do its part to ensure that they can move full speed ahead and flourish. This assistance takes a number of forms to help taxpayers avoid unintentional errors in attempting to comply with the tax laws. Small businesses, from sole proprietors who file Form 1040 with a Schedule C to small corporations and partnerships, continually must face the task of familiarizing themselves with complex aspects of the tax code. Some of these provisions change from year to year, making it important for taxpayers to update their understanding each year. Assisting taxpayers with questions before they file their returns prevents inadvertent errors and reduces burdensome post-filing notices and other correspondence from the IRS.

The IRS believes it is important to conduct outreach to small businesses on changes to the tax law and the latest in filing requirements. The operation of this outreach reflects the widespread use of tax professionals by small business owners. Because the vast majority of small businesses and self-employed individuals use professional return preparers, the IRS partners with thousands of industry and small business organizations, including minority-owned business associations, tax professional and payroll associations and other government agencies to extend and amplify our outreach and education efforts.

A major component of our outreach efforts involves the meetings, symposiums and seminars we sponsor for small business owners and the tax practitioner community each year. In FY 2012, the IRS held more than 2,000 of these events, which were attended by more than 163,000 business owners and tax professionals.

Increasingly, the IRS is employing technology to reach small business owners and help them fulfill their tax obligations. Our website, IRS.gov, includes a section that is devoted to small businesses and contains a wealth of videos, audio presentations and webinars on a wide range of tax topics, such as employment taxes, electronic filing and retirement plans geared toward small business.

We also assist business taxpayers by operating a special toll-free telephone line dedicated to small businesses, corporations, partnerships and trusts. Callers can get help with, for example, business returns or business accounts, employer identification numbers and federal tax deposit issues. A separate toll-free line for practitioners is staffed by IRS representatives specially trained to handle their questions and resolve their clients' account-related issues.

IRS-published products are also important resources for small business taxpayers. These include the Tax Calendars which provide highlights on tax topics, resources, instructions and important dates. Our electronic publication, *e-News for Small Businesses*, includes the latest IRS news releases and announcements. The quarterly *SSA/IRS Reporter* is a collaborative effort with the Social Security Administration that provides information on payroll taxes and other employee issues.

IRS Enforcement Programs

Even as we seek to ensure that our service to small businesses meets high standards, the IRS also must carry out a rigorous enforcement program. This includes administering a balanced examination program that helps ensure that taxpayers accurately report their income, deductions and credits. This also includes administering our collection program, which seeks to collect assessed tax liabilities.

The IRS collected more than \$50 billion in total enforcement revenue in Fiscal Year (FY) 2012, the third year in a row the enforcement revenue exceeded that level. The amount collected in 2012 was actually lower than in 2011 and 2010, for a number of reasons. For example, the economic slowdown contributed to lower enforcement figures, as most enforcement dollars collected resulted from audits of returns for years during the slowdown. Another factor behind the FY 2012 numbers reflected changes in agency staffing and budget resources. After a nearly flat budget in FY 2011, the IRS' FY 2012 budget was reduced by \$305 million. This reduction affected the level of staffing available to deliver service and enforcement programs. Overall full-time staffing has declined by more than 8 percent over the last two years, and staffing for key enforcement occupations fell nearly 6 percent in the past year. In 2013, the IRS absorbed an additional \$618-million reduction in its budget due to sequestration, which will have further negative impacts on IRS performance, including performance in enforcement programs.

In FY 2012, the IRS audited approximately 1.65 million returns, of which 21 percent were small business returns. For FY 2011 the percentage was 22 percent, and for FY 2010, 21 percent. This group includes filers of Schedule C and Schedule F, along with small corporations, S corporations and partnerships. The 2012 small business audit rate

equates to only 0.2 percent of all returns filed, and 1.3 percent of small business returns filed.

In conducting its examination program, the IRS uses a variety of techniques to focus exam resources on the areas of greatest compliance risk. As returns are processed, a majority of them are scored by a computer program for compliance risk, with a higher score indicating a higher probability that a change will be recommended during an examination. While the computer score is the most frequent reason for selecting a return for examination, there are other reasons a return may be selected. These include the need to reconcile what is reported on a taxpayer's return with third-party information provided on forms such as W-2s or 1099s.

In addition, a small business may be randomly selected for audit under our National Research Program. The results from examinations conducted under this program are used for research purposes. The information gained from these audits helps us improve our audit selection criteria and update our estimates of the tax gap, which is the amount of taxes owed but not paid on time.

The type of audit a taxpayer may undergo depends on the number and complexity of issues involved. A single issue questioned on a return will generally give rise to a correspondence audit, while multiple issues will likely result in a face-to-face exam.

For all exams, the average additional tax recommended in FY 2012 was \$23,345. Within that total, the average additional tax recommended for self-employed individuals was \$11,880 and for small corporations, \$28,988. For all taxpayers, the average cost to the IRS of a correspondence exam in FY 2012 was \$400, compared with \$324 in FY 2010. The average cost of a field exam to the IRS in FY 2012 was \$6,232, down from \$7,248 in FY 2010.

Ensuring Fair Treatment for Small Business Taxpayers

In going about our work in the enforcement area, the IRS realizes that many small businesses face substantial economic challenges, even as the economy recovers. We have worked diligently to communicate to our employees the importance of recognizing that individual taxpayers and businesses being audited may be dealing with financial hardships, and we have encouraged our employees to be flexible in these situations.

Increasing our employees' flexibility allows them to respond appropriately to taxpayers with financial troubles. Even as our economy recovers, too many small business owners continue to struggle to make their payrolls, secure lines of credit, contribute to their employees' retirement plans and stay current with their taxes. For that reason, we will continue to make sure that our employees have the guidance and the discretion they need to assist small businesses with the service they need and deserve.

One major example of our efforts to help individuals and small business owners in this regard is the Fresh Start initiative, which began in 2011. Under this initiative, we have

increased flexibility in our collection program to help taxpayers who are struggling financially. For example, we made it easier for taxpayers to obtain lien withdrawals after paying back taxes owed, and allowed liens to be withdrawn when a taxpayer signs a Direct Debit Installment Agreement (DDIA). Another provision helps more small businesses get access to Installment Agreements if they sign up for a DDIA and have less than \$25,000 in unpaid taxes. We also changed our rules for Offers in Compromise (OIC) so that more taxpayers could qualify for a streamlined OIC.

We have continued to refine the Fresh Start initiative, and further increased flexibility in our collection program in 2012. This includes easing failure-to-pay penalties for unemployed taxpayers, and expanding our Allowable Living Expenses (ALE) standard. The standard is used to provide taxpayers a fair and consistent amount to live on while they repay tax debts.

As part of our work to ensure fair treatment for small business taxpayers, we continue our focus on taxpayer burden reduction, through such efforts as simplifying forms and publications and streamlining policies and procedures. For example, as part of our effort to implement Executive Order 13610, "Identifying and Reducing Regulatory Burdens," in January 2013 we announced a simplified method for claiming the home office deduction. This new option is expected to help owners of home-based businesses by significantly reducing the paperwork and recordkeeping burden associated with calculating the deduction for business use of a home.

Another aspect of ensuring that small business owners receive fair treatment involves ensuring that they have recourse in tax disputes with the IRS. It is important to note that my plan of action for improving IRS operations, which I will describe in more detail later in my testimony, includes enhancing mechanisms for taxpayer recourse. The IRS does have the Taxpayer Advocate Service (TAS) to assist taxpayers having difficulty resolving issues with the IRS, but we concluded in our recent report that these mechanisms are not well understood by taxpayers and therefore are not being sufficiently leveraged.

Therefore, we are taking action to raise taxpayers' awareness of their rights and of the tools at their disposal for resolving issues, such as TAS. We need to be sure that all IRS employees are aware of their responsibilities with respect to ensuring taxpayers know their rights, and in particular, ensuring that taxpayers know how to engage TAS when they feel they are being treated inappropriately or are encountering excessive bureaucratic obstacles. The IRS leadership is committed to working with the National Taxpayer Advocate to evaluate the training provided to all IRS employees in this regard and modify it, as appropriate, to make necessary improvements to fill whatever gaps may exist in the current process or actual behavior.

It is important to note that all of the outreach, education and burden-reduction initiatives I have described in my testimony depend on the IRS receiving adequate resources to fund them. It is imperative that we be able to continue to reach out to small business owners to help them file income and payroll taxes, understand tax law changes and seek help from us in cases of financial hardship. The IRS has absorbed significant cuts in our budget in

the last few years, and we have made major strides in reducing costs and finding efficiencies in our operations. Additional significant cuts to the IRS budget have the potential to weaken our ability to deliver our service and enforcement programs, including those dedicated to assisting small business owners.

Charting a Future Path for the IRS

Before concluding my testimony, I want to give the Committee a brief overview of the work we have been doing over the past several weeks to chart a new path forward for the IRS, as these efforts are important to all taxpayers, including the small business community. We have initiated a robust action plan to address needed improvements that we believe will help restore and sustain the public's trust in the IRS.

The report we released last month describes a number of important findings, aggressive actions and next steps for the IRS. The problems with the 501(c)(4) application process that were uncovered by the Treasury Inspector General for Tax Administration (TIGTA) have created significant concerns for individual and business taxpayers, and it is incumbent upon us to take swift action to ensure accountability, fix the problems that occurred and thoroughly examine other aspects of IRS operations.

Over the past month, an ongoing review of the events described in the TIGTA report has shed further light on the management failures that occurred within the IRS and the causes of those failures. There was insufficient action by IRS leaders to identify, prevent, address and disclose the problems that emerged with reviews of applications for tax-exempt status. Our report outlines management deficiencies and the steps that must be taken to correct them.

Of note, there is no current evidence of the use of inappropriate screeners or other types of criteria in other IRS operations beyond those discussed in the TIGTA report. We recognize, however, that there is public concern over the criteria the IRS adopted to review applications for tax-exempt status, a concern shared by the Committee as expressed in its recent letter to the IRS. Because we realize that more needs to be done to evaluate our screening criteria and procedures, we are establishing a review process by which screening criteria and procedures across the IRS will be periodically assessed to safeguard against any risks of inappropriate criteria.

We are also continuing to review the full range of IRS operations, processes and practices to focus on how we deliver our mission today and how we can make improvements in the future. In that way, we will develop a better understanding of organizational risks wherever they exist in the IRS. We have a great deal of work ahead of us, and the IRS is committed not only to correcting the problems that have occurred, but also to continuing other important work of the agency.

Conclusion

Mr. Chairman, Ranking Member Velazquez, thank you again for the opportunity to testify today on the IRS service and enforcement efforts in relation to small businesses. As we continue to chart a path forward for our agency and determine what improvements are needed in IRS operations, we will do everything possible to ensure that small businesses are treated fairly and given the assistance they need to comply with our nation's tax laws. This concludes my statement, and I would be happy to answer your questions.