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Before the United States House of Representatives Committee on Small Business

Regarding the Committee's Hearing on

"IRS Puts Small Businesses through Audit Wringer"

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Chairman Chabot and Ranking Member Velázquez:

Thank you for inviting me to testify before the House Committee on Small Business. It is an honor to provide comments today for your hearing "IRS Puts Small Businesses through Audit Wringer".

I am Kathy Petronchak, Director of IRS Practice and Procedure at alliantgroup, LP. I have been with the firm for almost three years and prior to this, I worked in a big 4 accounting firm for five years in the tax controversy area dealing mostly with medium and large businesses. Prior to coming to the private sector, I worked at the IRS for almost 29 years. My last position with the IRS was that of Commissioner, Small Business/Self Employed Division but during my executive career I also served in the Large & Mid-Size Business Division I believe this experience gives me a unique perspective into how the examination process is currently being conducted for both small and mid-size businesses.

As background, the firm of which I am a part, alliantgroup, is a leading tax service consultant for small and medium businesses across the country. alliantgroup has approximately 650 professionals located nationwide, focused on assisting small and medium sized businesses to avail themselves of proper and available tax incentives, including tax credits, designed to create U.S. jobs, promote research and investment, and otherwise help the United States remain the leader in the global economy. We also assist these businesses in tax planning, and we represent them before the IRS and state tax regulators. In providing these services, we partner with the CPA firms of these businesses. We work with over three thousand CPA firms and tens of thousands of businesses from all over the country in a remarkably diverse set of industries. Our work and daily interactions reveal that our CPA partners and clients share a common experience relating to their dealings with the IRS. Thus, we are uniquely positioned to speak to the issues you wish to discuss today.

Mr. Chairman, if there is one takeaway from my message today, it is that IRS practices and procedures during the examination of small businesses need to improve, and perhaps improve dramatically. However, I truly view this as an opportunity that can benefit both taxpayers and the IRS.

There are a number of steps the IRS can take that will improve their work and also make life easier for taxpayers, especially those with limited resources.

My testimony today focuses on challenges that small businesses face when dealing with the IRS, and more specifically, what the IRS can do to make the examination process more fair, efficient and transparent. A number of issues that I will discuss today are exacerbated by the funding problem that has plagued the IRS for a number of years now. I urge you to support adequate funding for the IRS so that it can upgrade its systems, hire new enforcement staff, train its employees to ensure competence in handling tax issues, provide timely guidance to taxpayers and ensure better service for American taxpayers as well as a fair administration of the tax code. And I want to make sure it is understood that while I believe that the IRS can improve its procedures in the handling of small business examinations, IRS employees generally try to do the right thing.

We believe there is some inconsistent treatment of small versus large businesses by the IRS, as well as differing procedures being used in audits of these businesses. It is vitally important to remember that America's small businesses do indeed have needs, interests and resources that may differ significantly from those of larger businesses. However, as I will discuss below, some of the procedures utilized in large business audits provide added transparency that would bring greater fairness to the small business examination. If these procedures were adopted for all taxpayers, the IRS can improve transparency in its examination of small businesses and better ensure they are treated fairly.

Today I would like to focus on five issues that taxpayers face when dealing with the IRS: 1) IRS fact finding and the information document request process, 2) alternative dispute resolution, 3) expert assistance, 4) the Appeals process, and 5) third party contacts.

1. IRS Fact Finding and the Information Document Request Process is Not Uniform

An important aspect of an IRS examination is the information document request process. The IRS issues to taxpayers information document requests, or "IDRs," requesting books and records and email communications, as well as requesting supporting documentation and explanations of various items on their tax returns. The documents taxpayers provide in response to the IDRs give the revenue agent the information needed to determine whether a taxpayer has taken a correct or reasonable position on its tax return. The process is often lengthy and can take a taxpayer hours upon hours to gather, organize, and explain documents. And while it is important for the IRS to conduct fact finding in an examination, it is also vital for the IRS to understand that a small business does not have the resources that the Fortune 1000 have to deal with voluminous document requests. Additionally, the taxpayer can find an audit by the IRS intimidating since they do not have frequent interactions with the IRS. Often times, a taxpayer will have to hire an outside representative, such as a CPA or attorney, to help them deal with the audit and respond to the IDRs in an orderly and timely fashion.

The IRS' Large Business & International Division (LB&I) has refined the examination process with a goal to make it more transparent and efficient – worthy goals for any examination of a taxpayer, whether large or small, from the perspective of both the IRS and the taxpayer. LB&I agents are now required to ensure that IDRs are issue focused, have been discussed with the taxpayer before being issued in final

form, and contain a response date that has been discussed with the taxpayer.[1] Publication 5125, issued in February 2016, has required agents examining the tax returns of large and mid-size companies to open up communications with companies and to work closely with them. While neither perfect in design nor implementation, this process is intended to lead to increased transparency in the examination process with issues being clearly identified by the IRS and taxpayers receiving timely feedback on the responses that have been provided. We believe the IDR process in LB&I has improved as a result of this focus.

Small business examinations do not have similar procedures in place. Rather, there are only loose guidelines on issuing IDRs. The Internal Revenue Manual provides guidance on the use of "lead sheets" and work paper organization but provides little focus on how to work transparently and collaboratively, where possible, with taxpayers. It is our experience that these procedures can lead to IDRs that cover a number of issues within one request and with what seems short response times for a voluminous amount of documents.

The two processes described here have created a difference in treatment of large and small business in IRS examinations. While LB&I appears to be pushing for clarity and efficiency during the audit process, small businesses are generally left to the decisions of the individual revenue agents, many of whom mean well. However, there are no real procedures in place in SB/SE to encourage more discussion concerning the course of an examination and, in fact, the press to close cases as quickly as possible acts to discourage transparency. This has only worsened as budgets have declined. I also would mention that one of the byproducts of this issue that we are experiencing is that in some examinations, the first clear indication of the primary issue of an examination is when a 30 day letter is received by the taxpayer. At this point the taxpayer needs to agree with the IRS or decide to file a protest with Appeals to have an impartial hearing on the issue. This is remarkably too late in the process.

To be clear, having a straightforward upfront meeting between the taxpayer and the IRS that lays out what the issues are, what the roadmap is going forward for documents and interviews, as well as expected timelines is to everyone's benefit. The taxpayer understands the concerns of the IRS and can be better responsive to IRS questions and requests for documents. Thus, we believe that the Small Business/Self Employed Division (SB/SE) should adopt many of the LB&I transparency measures.

2. The IRS is Decreasing its Use of Alternative Dispute Resolution

The IRS Fast Track Settlement (FTS) program was officially established in 2003.[2] It was created as an expedited dispute resolution option that is available for taxpayers who want to mediate their disputes with an Appeals Official acting as a neutral party. The purpose is to bring the revenue agent together with the taxpayer, so the two parties could discuss their positions and come to an agreement to settle an issue or the entire case, without having to go through the formal administrative Appeals process or to court. Although the original adoption of the program in 2003 covered only large and mid-size businesses, it was expanded in 2013 to enable all small businesses under examination to more quickly settle their differences

[1] Large Business and International Directive on Information Document Request Enforcement Process, LB&I Control No: LB&I-04-1113-009 (Nov. 04, 2013).
[2] Rev. Proc. 2003-40, LMSB/Appeals Fast Track Settlement Procedure.

with the IRS. For years FTS has been accepted as a powerful tool for taxpayers, allowing them to iron out their differences with the exam team on one or more contentious issues and reach a mutual agreement to close the case, allowing both parties to move on with their lives.

However, in recent years, our experience has been that small businesses are less likely to be accepted into the FTS process. FTS must be agreed to by both the taxpayer and the revenue agent and in recent experience, revenue agents and managers seem more reluctant to utilize this dispute resolution tool.[3] This statement is based on statistics that were shared by IRS Appeals in a March 2016 presentation at a Tax Law Conference where the number of fast track settlement cases for small businesses decreased from 230 in fiscal year 2014 to 177 in fiscal year 2015. A cause for this could be the decreased budget for the IRS. Revenue agents are spread thin, handling many cases at a time and as indicated earlier, may not be discussing issues with taxpayers early enough in an examination to facilitate the use of FTS.

Finally with respect to the alternative dispute resolution process, I must note that taxpayers and their representatives welcome the opportunity to resolve as many issues as possible at the lowest possible level. The tax community supports FTS. Although a mutual agreement may not always be reached, the use of fast track settlement and other alternative dispute resolution processes benefit both the IRS and taxpayers. Small businesses need to focus on their business at hand and having a disagreement with the tax authorities hanging over their head for a long period of time distracts from their business needs. The fast track settlement process is authorized for all taxpayers and I strongly encourage its increased use by the Service. Resource levels in examination and appeals may be driving reluctance to use the process but it can be a great benefit for all parties.

3. Assistance and Decision Making by Unseen Third Parties Eliminates Transparency and Rights of Small Business Taxpayers to be Heard

In an IRS audit, the revenue agent has traditionally been the point of contact for the taxpayer and is supposed to be the individual that manages the audit and makes the ultimate determination. There are instances when specialists are needed for an examination and the IRS has a formal process for agents to request assistance from specialists such as engineers, appraisers, and computer audit specialists. However, we have experienced instances where some SB/SE agents hand cases off to specialists when valuation or highly technical issues are being addressed. While this assistance is necessary, the process is often mysterious and the taxpayer is left in the dark regarding who is conducting and deciding their examination. There are times the agent does not notify the taxpayer that he/she has turned the case over to a specialist or that he/she is consulting with a specialist or subject matter expert.

This practice of an unknown specialist/expert making the decision on a taxpayer's case prevents small businesses (and in this instance, some large businesses) from knowing and understanding what is actually going on in their audit. They are left uncomfortable about what information is actually being shared and what is the basis for the IRS determination. In other situations, revenue agents have told our taxpayers that a specialist/expert is advising on their audit, but will not allow the taxpayer access to the

[3] Federal Bar Association Tax Law Conference, Practice and Procedure Symposium, Recent Developments at Appeals Panel (March 4, 2016).

expert. We are even told by agents that they may agree with our position but have no authority over their own examination. The perfect situation is where the taxpayer is aware that an expert/specialist is assigned to the examination and they have access to that individual to discuss the facts and law involved in the issues being addressed.

My firm has advised a number of small businesses where this happened to them. For example, a revenue agent who lacks expertise or experience may simply hand the case over to an IRS engineer or technical expert and have them make the ultimate decision that is written up in an examination file. In the best case scenario the specialist/expert is involved in the case and openly advising on document requests and participating in discussions with the taxpayer. However, there is another area in which budget cuts have had a pernicious impact on the process. The specialists may not have adequate time to do a quality job. For example, in some of our cases revenue agents have only "consultations" with specialists/experts on a case rather than a real referral. Having only hours and not weeks to work an issue related to a specific taxpayer may not lend itself to a specialist being fully informed of the facts in a particular case. Moreover, in some of these cases, the taxpayer is not aware that this has occurred or has not had an opportunity to discuss technical conclusions that have been made. My firm has encountered situations in which the taxpayer did not know this happened, until a FOIA request was made for documents from the revenue agent's administrative file in preparation for Appeal.

There is another recent experience with SB/SE agents that creates a greater concern in the exam process for small businesses and whether they are being treated fairly. Recently we have been advised informally by revenue agents that there is a new approval process for their final reports by a "technical specialist." Agents have not specified who is reviewing their lead sheets and workpapers prior to discussion and issuance to the taxpayer of a report. They have indicated that the specialists are looking at these and that their hands are tied in determining the proposed adjustment for those taxpayers. This is particularly troublesome if the specialist is making the ultimate decision when they are not intimately familiar with the facts of the taxpayer. To the extent this is happening, it is the antithesis of the transparency that should occur in an examination.

As an example, my firm recently encountered a case in which the revenue agent told my client, a small business owner, that he was going to sustain a majority of the business' tax credit at issue. However, the agent then told our client that he had to have a specialist review his final report. Several weeks later, the agent told us that the specialist had directed him to close the case, sustaining very little of the tax credit. The agent's manager informed us that he did not have the authority to reverse the specialist's decision or to offer fast track settlement as an alternative dispute resolution. Sadly, situations like this lead to perceptions that the IRS is not treating taxpayer's fairly although I would note that the agent actually doing the examination was apologetic about the practice.

Taxpayers understand the role of IRS is to enforce the tax law. However, when they perceive that they are being unfairly treated anger at the IRS will increase and voluntary compliance will ultimately suffer. Part of being treated fairly is knowing who is working or advising on a particular taxpayer's examination and how the outcome of that examination may be impacted by them. A clear communication of all those working on a case and providing technical direction is not a big ask by a taxpayer. It may also

be a budget issue, but ensuring that agents are properly trained for the issues they are being asked to examine benefits the IRS and taxpayers alike when they can be discussed and resolved in a more efficient manner.

4. The Appeals Process and Clouds on the Horizon

Before heading to court, the final administrative step a taxpayer can take to contest an adverse determination by a revenue agent is through IRS Appeals. The IRS Office of Appeals is "an independent organization within the IRS whose mission is to help taxpayers and the Government resolve tax disagreements."[4] Taxpayers can present their arguments and negotiate a settlement with an IRS Appeals Officer. I appreciate the vital and important work of Appeals and want to state how important IRS Appeals is for so many small businesses seeking a fair review of their tax issues without having to go to court.

While the role of IRS Appeals is greatly appreciated by those seeking resolution there are improvements that taxpayers would like to see. While I addressed alternative dispute resolution earlier I did not note that one of the benefits is the speed of decisions that can be reached. The goal for small business is to make a decision within 60 days of an application being accepted. While there is not always agreement in FTS there is always the option to pursue a regular appeal on the case.

Compared to FTS timelines, a hurdle for small businesses with IRS Appeals, is the length of time it takes to render a decision. Again, due to budget cuts, Appeals Officers have incredibly large caseloads, and may be unable to hear cases for months. This means that the taxpayer's tax returns and status with the IRS is in a sort of purgatory, as it has to wait on the Appeals Officer to hear its case. While our small business owners are most appreciative of the opportunity to attend the conference and have a frank discussion with Appeals they are not as thrilled about the time it takes to hear a final decision.

Due to the positive experience with Appeals in the past I am concerned with some changes to the Internal Revenue Manual regarding future conference practices. It has been noted that face-to- face conferences will continue with the consent of Appeals but taxpayers will be offered telephone and virtual conferences as first options. If small business owners are not given an opportunity to have a face-to-face meeting it would be a major setback for them.

Further, there is a perceived lack of uniformity in the decisions reached by Appeals. As with SB/SE, there are no objective standards that Appeals must use to analyze a case. In fact the Internal Revenue Manual states there is "no substitute for preparation, judgment, and common sense"[5] to conduct a conference. Appeals employees must analyze the merits of a case based on the hazards of litigation – i.e. the risk that a court would find an issue favorable for the taxpayer. Congress should ensure that Appeals weighs the hazards of litigation uniformly-small businesses with limited resources should not be at a disadvantage from large businesses that have law firms on speed dial. Some have the perception that small businesses may be at a disadvantage in Appeals discussions because all are aware that a small

[4] IRS.gov, Appeals (last updated April 19, 2016), *available at* https://www.irs.gov/individuals/appeals-resolving-tax-disputes.
[5] IRM 8.6.1.4 (Oct. 01, 2016)

business does not have the resources to go to court. A lack of resources is not a litigation hazard. Appeals needs to recognize this perception exists and take what actions it can to counter it.

5. Third Party Contact Procedures Need to be Reformed

The IRS often reaches out to third parties that are not under audit, but will have information and documents on the taxpayer that is under audit. Such contacts are not impermissible in certain circumstances, but the IRS must give the Taxpayer under audit "reasonable notice" of such a contact.[6] While these contacts are often times justified as necessary to corroborate a taxpayer's records/testimony or to obtain otherwise unavailable data, we are seeing increasing use of the contacts that warrant concern.

I would like to echo the findings made by Nina Olson, the National Taxpayer Advocate in her 2015 Annual Report to Congress. Ms. Olson raises a number of interesting points. First, the IRS is not always effective in providing notice to taxpayers, often times only providing them Publication 1, *Your Rights as a Taxpayer* or some similar general notice at the beginning of the exam and not at or anywhere near the date of a third party contact. Such notice is useless and does not effectively apprise taxpayers that such contact will be made, to whom it will be made, or that the taxpayer can request a third party contact report from the IRS. Second, the Taxpayer Advocate Service found that the IRS did not first ask taxpayers for the information requested from third parties in 22.8 percent of examination cases. This is unacceptable given the extraordinarily important taxpayer privacy protections that go out the window with third party contacts.

Ms. Olson also discussed other valid concerns: the disclosure of confidential taxpayer information protected under IRC § 6103; that taxpayers are often not given the prior opportunity to volunteer information on their own; that third party contact requests can be vague; and that the IRS does not automatically provide periodic third party contact reports.

In our experience, it appears the IRS has seemingly been using these contacts on an increasing basis in general examinations where we represent the taxpayer, often times when the IRS already has the information they request from third parties, and other times when they haven't even requested the information in the first place. Requesting the information from third parties in these situations is intrusive, burdensome and needless. It creates an unnecessary burden for small businesses, and the practice of issuing third party contacts should be modified to ensure notice and an opportunity to respond prior to the time a third party contact is to actually be initiated. I would encourage the Committee to review closely Ms. Olson's concerns and to ask for her views on what steps should be taken to ensure taxpayer's rights are being protected.

Conclusion

Thank you Chairman Chabot and Ranking Member Velázquez for allowing me to testify today on this important topic of the IRS and small businesses. Small businesses are vital to jobs and growth of our

[6] 26 USC § 7602(c).

economy. I commend the Committee for its work and oversight in ensuring that small businesses receive fair treatment and good service from the IRS- a goal that I believe is widely shared at the IRS. Ensuring that small businesses are on at least an equal footing with large companies in front of the IRS is a good start. I hope today I was able to highlight major issues small business owners are facing when dealing with the IRS.