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WRITTEN STATEMENT

OF

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

ON

"HOW TAX COMPLIANCE OBLIGATIONS HINDER SMALL BUSINESS GROWTH"

INTRODUCTION

Chairman Chabot, Ranking Member Velazquez, and Members of the House Committee on Small Business, thank you for the opportunity to testify today on "How Tax Compliance Obligations Hinder Small Business Growth." My name is Troy Lewis. I am the vice president and chief enterprise risk management officer at Heritage Bank in St. George, Utah. I am also a sole tax practitioner, adjunct faculty member at Brigham Young University and Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). I am pleased to testify today on behalf of the AICPA.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 145 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

The AICPA applauds the leadership taken by the Committee to consider ways to reduce the complexity faced by small businesses when preparing their taxes. Small businesses are the foundation of the U.S. economy, employing over half of the private-sector workforce and creating nearly two-thirds of this nation's net new jobs over the past decade and a half.[1]

Unfortunately, compliance with federal tax laws can act as a road block in the growth of small business. Unlike large multi-national corporations, the time spent by small businesses in complying with tax laws is much more costly because small businesses do not have the luxury of critical mass and a large customer base with which to efficiently spread non-value added compliance costs. Time devoted to complying with tax laws has an impact on business creation, job growth and economic prosperity of these small businesses.

At the same time, we recognize that tax compliance is necessary. However, to help small businesses grow, Congress and the Internal Revenue Service (IRS) should seek to lessen these compliance burdens on all small businesses. When evaluating whether or not a tax compliance requirement should be mandated for a small business, a cost/benefit analysis should first be considered. Nowhere is it more important to ask if the end result is worth the effort than in the area of tax compliance for small businesses.

[1] Small Business Administration Office of Advocacy, Frequently Asked Questions, September 2012.

Using this cost/benefit approach, may I suggest a few areas where Congress can act to reduce the burden of tax compliance in a way that allows small businesses to grow without creating undue hindrances.

IRS TAXPAYER SERVICES

It is imperative that small businesses and their tax return preparers have the ability to communicate with the IRS when preparing their taxes and addressing compliance issues. However, there has been increasingly limited access to the agency and, as reported by IRS Commissioner John Koskinen, "abysmal" level of taxpayer service this year.[2]

Our members have expressed their deep concerns regarding their ability to effectively represent small businesses and other taxpayers in an environment where the IRS service levels are so degraded that:

- During the 2015 tax season, the IRS answered only 37% of the telephone calls received from taxpayers seeking to speak with an assistor;[3]
- The average hold time for the Practitioner Priority Service telephone line reached 47 minutes;[4] and
- According to the National Taxpayer Advocate, the IRS's ability to process taxpayer correspondence in a timely manner declined by 16% since 2014, leaving a backlog of almost 79,000 cases.[5]

Through an informal membership survey we conducted earlier this year, we learned that over half of our members were either somewhat dissatisfied or very dissatisfied with the services they received from the IRS this filing season. This is no surprise considering that only 17% of our members responded that the IRS generally answered their telephone calls within 30 minutes. Most of our members were on hold for extended periods of time and other members noted that they generally had to end their own calls because they did not have the time to wait on hold for an IRS agent to answer.

As reported by one of our members, "I was on hold for over an hour and a half. When the IRS agent finally picked up the call, they needed to transfer to another agent. I had to wait on hold for another hour. Finally, I received a recorded message that the office was closed and I needed to call again the following day."

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[2] Commissioner Koskinen, Prepared Remarks of John A. Koskinen Commissioner, Internal Revenue Service, Before the National Press Club, dated March 31, 2015.
[3] National Taxpayer Advocate Report, Volume I: FY 2016 Objectives Report to Congress; Part II: Review of the 2015 Filing Season, dated July 14, 2015.
[4] Joint Operations Center, Customer Account Services, Account Management Paper Inventory Reports, Inventory Age Report, (Jan 1 – Apr 6 statistics).
[5] *Id.*

Many of our members also experienced what the IRS refers to as "courtesy disconnects." According to the IRS, they terminate telephone calls from small businesses and other callers, without taking a message or getting contact information, if the caller has been on hold for two hours. As of April 18th this year, approximately 8.8 million calls received by the IRS were subject to their "courtesy disconnect" policy, which represents an increase from approximately 544,000 over last year.[6] Nothing is more discouraging, frustrating or inefficient for a caller (whether they are a small business or a tax preparer calling on behalf of a small business) than being hung up on by the IRS after waiting on hold for two hours.

Our survey also indicated similar, unacceptable patterns with regards to delays in written correspondence. On average over half of the correspondence sent to the IRS is not responded to within 90 days of receipt.[7] Often small businesses are anxiously awaiting a response to a notice. Furthermore, the longer the response time by the IRS, the more interest and penalties are accrued as the small business attempts to resolve their issue.

We appreciate and understand that the IRS has new initiatives and vital unmet obligations and responsibilities (such as addressing identity theft), but taxpayer service must remain a high priority in order for small businesses to receive the assistance they need on tax issues.

GOOD TAX POLICY

In order to reduce the overall tax compliance burden on small businesses, the AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification, transparency and other *Principles of Good Tax Policy*.[8] We believe it is important to promote a tax system that is perceived as balanced, fair to all, administrable, economically efficient, transparent, and neutral in its effect on economic activity.

Our current tax system is heavily burdened by complexity. Multiple and duplicative tax calculations, definitions, and preferences lead to taxpayer confusion and, thus, errors and frustration. Attempts to adjust tax liabilities through special rules affecting taxable income rather than the rate schedule add to complexity. Business provisions that require retention of records solely for tax purposes increase compliance costs. We urge consideration of removing duplicative rules and definitions, and reducing recordkeeping and calculations, to achieve simplicity, without adding new complexities.

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[6] National Taxpayer Advocate Report, Volume I: FY 2016 Objectives Report to Congress; Part II: Review of the 2015 Filing Season, dated July 14, 2015.
[7] Joint Operations Center, Customer Account Services, Account Management Paper Inventory Reports, Inventory Age Report, (Jan 1 – Apr 6 statistics).
[8] AICPA's Tax Policy Concept Statement No. 1: Guiding Principles for Good Tax Policy: Framework for Evaluating Tax Proposals, issued March 2001.

It is also important for an effective tax system and informed citizenry that taxpayers understand the tax system and how it affects them. Clarity of the tax consequences of taxpayers' regular activities is a must. Transparency also helps improve voluntary compliance.

Additionally, it is critical for taxpayers to have certainty to perform any long-term tax planning. Permanence of tax provisions can have substantial impacts on the growth of small businesses. The uncertainty of tax legislation creates unnecessary confusion, anxiety and administrative financial burdens. Without permanency in the Internal Revenue Code ("Code"), we are concerned about the following consequences:

- Impact on a company's financial accounting and reporting;
- Complexity and administrative burden for taxpayers and the IRS;
- Adverse impact on small businesses and ultimately jobs and growth;
- Effect on economic decisions and tax payments; and
- Lack of transparency and certainty with short-term, retroactive extensions

We recognize that it is not always possible for each tax provision and the overall tax system to equally meet each of the ten principles of good tax policy. However, it is important to carefully balance these principles to achieve a respected and administrable tax system.

TANGIBLE PROPERTY REGULATIONS

A challenging tax compliance burden that small businesses had to deal with this year was the new final tangible property regulations (TD 9636). These tax rules, which address how businesses should report the acquisition and improvement of tangible property, comprise almost 500 pages of technical guidance and procedures.

While we appreciated that the regulations clarified some rules and provided several small business favorable provisions, we were concerned that they were significantly burdensome for many small business taxpayers because of the required retrospective analysis and reporting requirements.

The AICPA pushed hard for relief and stressed that time was of the essence as a significant portion of the burdens placed on small businesses (and their tax practitioners) would occur prior to filing season. However, despite these pleadings, the IRS issued the much-needed relief, Rev. Proc. 2015-20, on February 13, well into the filing season. Unfortunately, some small businesses and their tax practitioners had already spent time and resources attempting to comply with the new regulations prior to the IRS's issuance of relief. If the IRS had acted in a timely manner, small businesses could have been spared some administrative burden.

Currently, small businesses must prove that expensing such amounts "clearly reflects income" to deduct amounts higher than the $500 threshold. The clear reflection of income test can be challenging for any taxpayer, especially for small businesses. The test is based on the taxpayer's facts, circumstances, and interpretations of those facts and circumstances by the taxpayer and IRS. Thus, it is arbitrary and often difficult to apply. Large businesses (e.g., taxpayers with an AFS), however, are allowed the higher $5,000 threshold. Subjecting small businesses to the clear reflection of income test at merely $500, adds unnecessary complexity and compliance burdens to small businesses.

There are other issues that remain open in regards to the repair regulations. The AICPA recommends that you take immediate action to increase the $500 de *minimis* safe harbor threshold for taxpayers without an AFS to $2,500, and provide for annual adjustments for inflation, to offer meaningful relief to small business taxpayers. To further reduce administrative burden on these rules, we also recommend that you expand the AFS definition to include a reviewed set of financial statements[9] to permit more business to benefit from the higher $5,000 de *minimis* safe harbor threshold.

CIVIL TAX PENALTIES

An additional concern[10] for small businesses is the numerous unfair or untargeted penalty provisions in the Code pertaining to tax compliance. Penalties should deter bad conduct without deterring good conduct or punishing small businesses which are acting in good faith.

Targeted, proportionate penalties that clearly articulate standards of behavior and that are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws. On the other hand, overbroad, vaguely-defined, and disproportionate penalties, particularly those administered as part of a system that automatically imposes penalties or that otherwise fail to provide basic due process safeguards, create an atmosphere of arbitrariness and unfairness that is likely to discourage voluntary compliance.

For example, penalties should apply prospectively to future conduct and not retroactively to conduct that was appropriate at the time the conduct occurred. Good tax policy would also suggest that we avoid strict liability provisions that do not grant the IRS discretion to take into consideration the facts and circumstances of a particular business' situation.

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[9] For a detailed explanation of the differences between a compilation, a review, and an audit, please reference the AICPA Comparative Overview document.

[10] AICPA comment letter on "AICPA Tax Penalties Legislative Proposals," dated April 11, 2013; and AICPA report on "AICPA Report on Civil Tax Penalties," submitted April 11, 2013.

The AICPA points out the following specific penalty-related issues with the current system below.

Repeal Technical Termination Rule

The AICPA recommends a repeal of section 708(b)(1)(B) regarding the technical termination of a partnership as it is a trap for the unwary.[11] Under current law, when a partnership is technically terminated, the legal entity continues, but for tax purposes, the partnership is treated as a newly formed entity. The current law requires the partnership to select new accounting methods and periods, restart depreciation lives, and make other adjustments. Furthermore, under the current law, the final tax return of the "old" partnership is due the 15th day of the fourth month after the month-end in which the partnership underwent a technical termination.[12]

A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Because this 12-month time frame can span a year-end, the partnership may not realize that a 30% change (a minority interest) in one year followed by a 25% change in another year, but within 12 months of the first, has caused the partnership to terminate.

In practice, this earlier required filing of the old partnership's tax return often goes unnoticed because the company is unaware of the accelerated deadline due to of the equity transfer. Penalties are often assessed upon the business as a result of the missed deadline. Although ignorance is not an acceptable excuse, this technical termination area is often misunderstood and misapplied. The acceleration of the filing of the tax return, to reset depreciation lives and to select new accounting methods, serves little purpose in terms of abuse prevention and serves more as a trap for the unwary.

Late Filing Penalties

Sections 6698 and 6699 impose a penalty of $195 per partner related to late-filed partnership or S corporation returns. The penalty is imposed monthly not to exceed 12 months, unless it is shown that the late filing is due to reasonable cause.

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[11] AICPA submitted letters and written statements on Option 1 and Option 2 of Chairman Camp's Small Business Tax Reform Draft: See Option 1 comments at "AICPA testimony on Small Business and Pass-through Entity Tax Reform," dated May 17, 2013; and Option 2 comments, "AICPA Comments on Option 2 of Chairman Camp's Small Business Tax Reform Discussion Draft" dated July 30, 2013.

[12] For example, a partnership that technically terminated on April 30 of the current year due to a transfer of 80% of the capital and profits interests in the partnership to be timely filed must file its tax return for that final tax year on or before August 15 of the current year.

The AICPA proposes that a partnership (or S Corporation), comprised of 50 or fewer partners/shareholders, each of whom are natural persons (who are not nonresident aliens), an estate of a deceased partner, a trust established under a will or a trust that becomes irrevocable when the grantor dies, and domestic C corporations, will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 or 6699 if:

- The delinquency is not considered willful under section 7423;
- All entity income, deductions and credits are allocated to each owner; and
- Each partner/shareholder fully reported its share of income, deductions and credits of the entity on its timely filed federal income tax return.

Failure to Disclose Reportable Transactions

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Code. For penalties assessed after 2006, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction (or the decrease that would have been the result if the transaction had been respected for federal tax purposes). If the transaction is a listed transaction (or substantially similar to a listed transaction), the maximum penalty is $100,000 for individuals and $200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the maximum penalty is $10,000 for individuals and $50,000 for all other taxpayers. The minimum penalty is $5,000 for individuals and $10,000 for all other taxpayers.

The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to the penalty. The Commissioner may, however, rescind all or a portion of a penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote efficient tax administration and only after the taxpayer submits a lengthy and burdensome application. In the case of listed transactions, the IRS has no discretion to rescind the penalty. The statute precludes judicial review where the Commission decides not to rescind the penalty.

The AICPA proposes for an amendment of section 6707A to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we propose an amendment of section 6664 to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

9100 Relief

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list[13] of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities. We do not believe small businesses are likely to abuse or exploit hindsight, as the IRS would continue to have discretion as to whether to grant relief for each specific request.

Form 5471 Penalty Relief

On January 1, 2009, the IRS began imposing an automatic penalty of $10,000 for each Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, filed with a delinquent Form 1120 series return. When imposing the penalty on corporations in particular, the IRS does not distinguish between: a) large public multinational companies, b) small companies, and c) companies that may only have insignificant overseas operations, or loss companies. This one-size-fits-all approach inadvertently places undue hardship on smaller corporations that do not have the same financial resources as larger corporations. The AICPA has submitted recommendations[14] regarding the IRS administration of the penalty provision applicable to Form 5471. Our recommendations focus on the need for relief from automatic penalties assessed upon the late filing of Form 5471 in order to promote the fair and efficient administration of the international penalty provisions of the Code.

MOBILE WORKFORCE

Another burden on small businesses that Congress should address involves the tremendous burden of tracking and complying with the many different state non-resident employee tax withholding and reporting rules for just a few days of work by an employee in a non-resident state. The state personal income tax treatment of nonresidents is inconsistent and often bewildering to multistate employers and employees.

H.R. 2315, the Mobile Workforce State Income Tax Simplification Act of 2015, introduced by Representative Bishop on May 14, 2015, addresses this issue. We are pleased that

[13] AICPA comment letter on "Tax Reform Administrative Relief for Various Statutory Elections," submitted January 23, 2015.
[14] AICPA comment letter on "Recommendations – Automatic Penalties assessments Policy with the Late Filing of Form 5471", dated March 26, 2013.

members of this Committee cosponsor this bill, and hope many others of you will also consider cosponsoring it. The AICPA strongly supports H.R. 2315 and urges Congress[15] to enact this legislation to help small businesses in this country ease their non-resident state income tax withholding and compliance burdens.

Small businesses must understand each of the states' treatment of non-resident employee withholding and assessment of taxes and the unique de *minimis* rules and definitions. Currently, 43[16] states plus the District of Columbia impose a personal income tax on wages, and there are many different requirements for withholding income tax for non-residents among those states. There are seven states that currently do not assess a personal income tax.[17] Employees traveling into all the other states are subject to the confusing myriad of withholding and tax rules for non-resident taxpayers.

A number of states have a de *minimis* threshold, or exemption for non-residents working in the state before taxes must be withheld and paid. Others have a de *minimis* exemption based on the amount of the wages earned, either in dollars or as a percent of total income, while in the state. Further complicating the issue is that a number of these states have reciprocity agreements with other, usually adjoining, states regarding the withholding of non-resident state income taxes.

Where many businesses once tended to be local, they now have a national reach. This change has caused the operations of even small businesses to move to an interstate basis. Because of the interstate operations of these companies, many providers of services to these companies, such as certified public accountants (CPAs), find that they are also operating on an interstate basis. What once were local taxation issues have now become national in scope, and burdens must be eased in order to promote interstate commerce and ensure businesses run efficiently. These burdens take significant resources away from operating their business.

The complex filing rules impact everyone who travels for work. The recordkeeping and the requirement of having to withhold and file many state non-resident tax returns for just a few days of work in various states is overly burdensome and too complicated for both employers and employees. Additionally, the amount of research that goes into determining what each state law requires is expensive and time-consuming. A small firm or business

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[15] AICPA written testimony before the House Committee on the Judiciary Subcommittee, Regulatory Reform, Commercial and Antitrust Law on Nexus Issues: Legislative Hearing on H.R. 2315, The "Mobile Workforce State Income Tax Simplification Act of 2015," H.R. 1643, the "Digital Goods and Services Tax Fairness Act of 2015," and H.R. __ the "Business Activity Tax Simplification Act of 2015", dated June 2, 2015.

[16] Note that New Hampshire and Tennessee, which are included in the 43 states, do not tax wages and only subject to tax interest and dividends earned by individuals.

[17] The seven states with no personal income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming.

will often be required to engage outside counsel to research the laws of the other states on an ongoing annual basis.

This issue affects all industries – retail, manufacturing, real estate, technology, food, services, etc. The current system as a whole unnecessarily creates complexity and costs for both employers and employees, without yielding a substantive benefit to most states. H.R. 2315 is needed to solve this problem and burden for small businesses.

Having a uniform national standard for non-resident income taxation, withholding, and filing requirements, as H.R. 2315 provides, will enhance compliance and significantly relieve these unnecessary administrative burdens on businesses and their employees. Additionally, H.R. 2315 provides a needed 30-day de *minimis* exemption before an employee is obligated to pay taxes to a state in which they do not reside. Many small businesses need Congress to enact this legislation.

TAX RETURN DUE DATE SIMPLIFICATION

Another challenging compliance issue for small businesses is the current illogical order of due dates for various types of tax returns. Taxpayers and preparers have long struggled with problems created by the inefficient timeline and flow of information. Federal Schedules K-1s are often delivered late, sometimes within days of the due date of taxpayers' personal returns and up to a month after the due date of their business returns. Late schedules make it difficult, if not impossible, to file a timely, accurate return. The current inefficient timeline of tax return due dates is a problem for taxpayers as well as their tax practitioners.

The AICPA strongly supports this provision. It would alleviate the problems mentioned above by establishing a logical set of due dates, focused on promoting a chronologically-correct flow of information between pass-through entities and their owners. The proposal includes the changes as follows:

Current Tax Due Dates:

- March 15: S corporation and C corporation Forms 1120S and 1120; and
- April 15: Individual, Trust and Estate, and Partnership Forms 1040, 1041, and 1065

Proposed Tax Due Dates:

- March 15: Partnership Form 1065;
- March 31: S corporation Form 1120S; and
- April 15: Individual, Trust and Estate, and C Corporation Forms 1040, 1041, and 1120

The provision would also revise the extended due dates to be six months after the original filing due dates for all these forms, except the trust and estate Form 1041, which would be extended five and half months.

The AICPA urges you to support this provision to change due dates for tax returns of partnerships, S corporations and C corporations because it would:

- Improve the accuracy of tax and information returns by allowing corporations and individuals to file using current data from flow-through returns that have already been filed rather than relying on estimates;
- Better facilitate the flow of information between taxpayers (i.e., corporations, partnerships, and individuals);
- Reduce the need for extended and amended tax returns; and
- Simplify tax administration for the government, taxpayers, and practitioners.

CONCLUDING REMARKS

The AICPA has consistently supported tax reform simplification efforts and permanent tax legislation because we are convinced such actions will significantly reduce taxpayers' compliance costs and encourage voluntary compliance through an understanding of the rules. The uncertainty of tax legislation creates unnecessary confusion, anxiety and administrative financial burdens. Good tax policy would promote a tax system that is balanced, economically efficient and transparent.

We encourage you to examine all aspects of the tax code to improve the current rules that have led to compliance hurdles for small businesses and administrative complexity. For example, additional relief is needed for small businesses with regards to the tangible property rules, penalty provisions need to consider their effect on voluntary compliance, and employers operating across state lines need a uniform standard on non-resident income tax withholding rules. The income tax deadlines should also promote an efficient flow of taxpayer information to provide small businesses sufficient time to file timely, accurate returns.

Finally, if small businesses are going to be allowed to grow, it is imperative that the IRS's taxpayer service issues are addressed. Small businesses and their tax preparers need to be able to contact the IRS regarding their compliance issues.

Again, Mr. Chairman, thank you for the opportunity to testify. I would be happy to answer any questions.