



Testimony

Before the Committee on Small
Business, House of Representatives

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SMALL BUSINESSES

IRS Considers Compliance Burden in Tax Administration, but Needs a Plan to Evaluate Its Payment Card Information Pilot

Statement of J. Christopher Mihn, Managing Director,
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Chairman Chabot, Ranking Member Velázquez, and Members of the Committee:

I am pleased to be here to discuss our report on small business tax compliance burden, which is being released today.¹ Given the important role small businesses play in the U.S. economy, reducing the cost of compliance with the tax code may free up resources to expand, hire new employees, and further contribute to economic growth. At the same time, we have previously reported that small businesses are a significant contributor to the annual tax gap—the difference between taxes owed and taxes paid on time. Therefore, a key challenge the Internal Revenue Service (IRS) faces is balancing efforts to minimize taxpayer burden with efforts to encourage voluntary compliance with the tax code.

One way IRS is seeking to achieve this balance is by piloting a payment card matching program. Under a 2008 law, payment settlement entities—such as credit card companies and third-party network payers like PayPal—began reporting to IRS the gross payments they process for each participating merchant on IRS Form 1099-K, *Merchant Card and Third Party Network Payments*.² In 2012, IRS began the payment card pilot to research and test ways to use Form 1099-K data to most effectively and efficiently improve voluntary compliance, detect noncompliance, and minimize burden on small business taxpayers.

My remarks today highlight the key findings of our report on small business tax compliance burden and IRS's payment card pilot.

To conduct this work, we analyzed Treasury and IRS data, research, and other documentation and interviewed agency officials. We used our guidance on program design evaluation to assess IRS's payment card pilot evaluation plan. More detailed information on our objectives, scope, and methodology can be found in our report. We conducted the work on

¹GAO, *Small Businesses: IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts*, [GAO-15-513](#) (Washington, D.C.: June 30, 2015).

²26 U.S.C. § 6050W; 26 C.F.R. §§ 1.6050W-1, 1.6050W-2.

All of a merchant's payment card transactions are reportable on Form 1099-K. However, third-party network transactions are only reportable if a merchant's aggregate amount of such payments for the year exceeds \$20,000 and if the aggregate number of transactions exceeds 200.

which this statement is based in accordance with generally accepted government auditing standards.

Most Small Businesses Are Individuals, but Most Small Business Income Is Generated by Partnerships and Corporations

Small businesses make up 99 percent of all businesses, according to estimates produced by Treasury's Office of Tax Analysis using 2010 taxpayer data.³ For these estimates, small businesses are defined as individuals or entities with substantive business activity but with less than \$10 million in total income and deductions. Approximately 69 percent of small businesses (about 16 million) are individuals who report business income and the remaining 31 percent (or roughly 7.3 million) are partnerships or corporations. Individuals generated only 23 percent (or \$1.4 trillion) of the total income of all small businesses, whereas small business partnerships, S corporations, and C corporations accounted for the majority—77 percent (or about \$4.5 trillion)—of total small business income. Overall, small businesses with at least one employee (not including owners)—a group that only makes up about 20 percent of the small business population—produce about 71 percent of total small business income.

Tax Compliance Burdens Vary Depending on a Small Business's Size, Number of Employees, Entity Type, Industry, and Other Characteristics

Small businesses are required to undertake a number of tax compliance-related activities that create burden. The tax compliance burden associated with these activities varies by characteristics of the small business. Some of these characteristics include the business's size as measured by its assets, entity type, number of employees, and industry. These activities can be grouped into general categories:

- **Income tax activities.** Every year, small businesses need to maintain tax-related records and file income tax returns. Some small businesses are required to pay estimated income taxes quarterly. The type of small business dictates the income tax returns and related schedules that need to be filed. Some of the returns include a set of schedules embedded in the form—found within the income tax return—while some small businesses and individuals with business income must attach a mandatory schedule to their return.

³See [GAO-15-513](#), appendix II, for detailed information on the scope, methodology, and research analyzed for these estimates.

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- **Employer-related tax activities.** Small businesses with employees are responsible for reporting, withholding, and depositing employment and unemployment taxes. The number of employment tax reports and deposits required depends on the number of employees and the resulting employment tax liability owed at a particular time. Small businesses also report health care and retirement information. The information reported for these areas depends on a business's number of employees.
 - **Third-party information reporting and industry-specific tax activities.** Small businesses are required to report on certain transactions they enter into with other entities. For example, using Form 1099-MISC, small businesses report items such as rent payments and payments to nonemployees. IRS uses this information to verify compliance by comparing the income or expenses reported by third parties to the income or expenses reported by small businesses on tax returns. Some small businesses may have industry-specific requirements to pay excise taxes, including environmental, communications, and fuel taxes.

IRS has developed several models to provide information for assessing the impact of the tax code and IRS programs on taxpayers. Estimates produced by these models indicate that burden increases with the size of businesses, whether measured in terms of assets, receipts, or employment; however, burden per dollar of assets or receipts or per employee declines with size because of economies of scale. For example, according to IRS, corporations and partnerships with 1 to 5 employees have an estimated tax compliance burden of \$4,308 to \$4,736 per employee, but corporations and partnerships with more than 50 employees have a much lower estimated per employee burden—\$182 to \$191.

IRS's Decision-Making Framework Includes Consideration of Small Business Compliance Burden

IRS's strategic plan identifies reducing taxpayer burden as a strategic goal. Additionally, the *Internal Revenue Manual* lists guiding principles to help employees consider how a policy could affect compliance burden. For example, under the guiding principle "leverage existing data," the manual directs employees to consider if there are opportunities to leverage data that is already collected by IRS or by accessible third parties.

IRS provided examples of how it works with internal and external stakeholders to reduce taxpayer burden on small businesses. For example, IRS collaborated with Treasury and external stakeholders to

develop a simplified method for some small businesses to calculate a home office deduction, which was introduced in January 2013. Previously, businesses had to complete a complex property depreciation calculation.

We interviewed small business representatives who acknowledged IRS's external stakeholder outreach efforts and how they have been effective in identifying opportunities to reduce compliance burden. However, they also described a number of areas where small business compliance burden could be further reduced. These areas include issues related to IRS customer service, filing requirements, lack of or delayed official guidance, and compliance contacts. While IRS is aware of many of these concerns and, through various initiatives, has made efforts to address these issues, continued attention to these areas will be key to effectively reducing compliance burden. In many cases we have made recommendations that, if implemented, could help to reduce these burdens.⁴

IRS's Overall Evaluation of Its Payment Card Pilot Has Several Strengths, but Does Not Fully Address All Elements Necessary to Effectively Assess Results

In an effort to improve tax compliance among small businesses while minimizing the burden on compliant taxpayers, IRS began piloting a program in 2012 that compares payment data from payment settlement entities (such as credit card companies) with income reported by small businesses. IRS is testing ways to use the payment data to detect underreporting of taxable income while minimizing small business taxpayer burden. IRS's evaluation plan for pilot activities integrated many characteristics of a well-designed evaluation. As a result, IRS has been able to make rapid, ongoing assessments of pilot activities and continually incorporate changes based on what has been learned. This approach has allowed IRS to test many hypotheses simultaneously while limiting the number of small business taxpayers affected by the pilot.

However, the overall evaluation plan for the pilot lacks characteristics of each element that are necessary to ensure a quality evaluation. For example, IRS has not clearly defined the stages of the pilot or measurable goals that it can use to determine when the pilot has moved from one stage to the next, or if it should move. Without defining the stages and establishing related metrics, IRS will not be able to articulate

⁴See [GAO-15-513](#), appendix IV, for a list of selected open recommendations.

the pilot's status at critical points in time. Further, it will not be able to justify the investment of additional resources if it cannot demonstrate progress toward those goals. In addition, IRS has not developed a full evaluation plan for the pilot. Among other missing elements of a quality evaluation, IRS has not developed evaluation questions, identified evidence-based evaluative criteria, or documented limitations. We recommended that IRS clearly define the stages of the payment card pilot and establish measurable goals for determining when the pilot advances from one stage to the next. We also recommended that IRS develop an evaluation plan that addresses the missing elements. IRS agreed to incorporate an evidence-based assessment of the payment card pilot that includes identifying clearly defined pilot stages and implementing an evaluation plan with measurable goals. IRS stated it will provide a more detailed response to our recommendations after our report is released.

In conclusion, the tax compliance burden faced by small businesses can vary considerably depending upon a number of factors. Through its research and outreach activities, IRS is cognizant of the compliance cost to taxpayers and explicitly considers this burden in administering the tax code. IRS's new payment card matching program has the potential to enhance the agency's ability to identify noncompliant small business taxpayers while minimizing taxpayer burden. However, IRS has a long road ahead in determining whether, and how, the payment card pilot program and its many activities can be fully implemented.

Chairman Chabot, Ranking Member Velázquez, and Members of the Committee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

GAO Contact and Staff Acknowledgments

If you or your staff have any questions about this testimony, please contact James McTigue, Jr., Director, Strategic Issues at (202) 512-9110 or mctiguej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony are Brian James, Assistant Director; Sonya Phillips, Analyst-in-Charge; Courtney Liesener, Robert MacKay, James R. White, Nell Williams, Robert Gebhart, Kirsten Lauber, Donna Miller, Edward Nannenhorn, Karen O'Connor, Andrew Stephens, and James Wozny.

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