STATEMENT OF

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BEFORE

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FOR A HEARING ON

THE GROWING TAX GAP AND STRATEGIES FOR REDUCING IT

My name is John S Satagaj, and I am the President and General Counsel of the Small Business Legislative Council (SBLC)*. I am appearing here today on behalf of the Coalition for Fairness in Tax Compliance (CFTC). I co-chair the coalition with my colleagues from the National Federation of Independent Business** and the United States Chamber of Commerce.***

Today, my goal is to address several important issues regarding the tax gap. First, I will talk briefly about the CFTC and its mission in addressing the tax gap. Second, I will share CFTC's perspective of the tax gap data and point out areas where the data can be improved in order to allow for better-targeted proposals. Third, I will illustrate a small component of the tax gap by examining the underreporting of sole proprietors and the limited information we have in this area to address the problem. Fourth, I plan to discuss the role that enforcement, education, and simplification can play in closing the tax gap. Finally, I will recommend using caution against harming the compliant taxpayer at the expense of resolving the tax gap.

THE COALITION AND ITS MISSION:

The CFTC was recently formed in response to efforts by the executive and legislative branches to address the "Tax Gap," the difference between what the federal government is owed in taxes and what it is actually paid. While it is the position of the CFTC that every individual and business should pay in a timely manner their fair share of taxes, and those taxpayers that do not fulfill this obligation place compliant taxpayers at a disadvantage; regulatory and legislative strategies to collect outstanding obligations can place excessive and obtrusive burdens on the backs of honest taxpayers.

Honest small business taxpayers are especially at risk of being subjected to needless and unwarranted regulatory burdens in an attempt to capture the few "bad actors" that do not fulfill their tax obligations. Small businesses already bear a disproportionate share of the cost of regulation.

The CFTC is a coalition of small business organizations that will fight for the rights of these honest small business taxpayers as the executive and legislative branches develop strategies to address the "Tax Gap." It is the mission of the Coalition for Fairness in Tax Compliance to fight for the rights of tax compliant small business owners by:

- Supporting the accurate use and collection of information on the source, size, and scope of the problem of tax non-compliance that forms the foundation for policy decisions.
- Supporting targeted, sensible, regulatory and legislative measures that will reduce tax non-compliance without generating undue burdens on the general small business community.
- Encouraging tax compliance by developing tax simplification proposals for sections of the tax code that are confusing and complicated.
- Opposing regulatory and legislative strategies proposed by lawmakers in an attempt to increase tax compliance that impose excessive and obtrusive burdens on honest small business owners.

We are eager to facilitate a dialogue. To that end, we have established a website at www.taxcompliancefairness.org.

WHAT IS THE TAX GAP?

Before we can begin a discussion of the causes of the tax gap and potential solutions, the first step is to establish the magnitude of the gap. The Internal Revenue Service (IRS) has estimated the “Tax Gap” to be approximately $345 billion. However $55 billion of this amount is eventually collected. It is just a timing issue. The appropriate starting number is $290 billion.

Other than making that point about the magnitude, we will leave it to others to argue about the size, or even the existence of the “Tax Gap.” We are prepared to deal with it as a reality. Whatever the actual number, the “Tax Gap” covers a broad spectrum of business activities and tax compliance activities. The sources of the gap, and therefore the possible solutions for improvement, have to be understood and evaluated as discrete, and often disparate, situations. One solution does not fit all.

Underreporting by individuals has been identified as a problem area. According to the IRS figures, $56 billion is attributable to **non-business** income. Half of the $56 billion is attributable to “other” **non-business** income, the other half is scattered among nine different income categories.

Underreporting by individuals of business income is estimated at $109 billion. Some $68 billion is attributed to underreporting by sole proprietorships. Rent and royalties underreporting is measured at $13 billion and underreporting by partnerships and S corporations is measured at $22 billion.

Overstated deductions by individuals are estimated to contribute $32 billion to the tax gap.

Underreporting of income by corporations is estimated at $30 billion, with $25 billion attributed to large corporations and the remainder to small corporations.

Underreporting of employment taxes is estimated to contribute $64 billion to the “Tax Gap.” However, that estimate is largely dependent on the re-characterization of the underreported income by individuals as earned income.

When you look at the information available, two observations immediately jump out. The aggregate "Tax Gap" is simply a collection of dozens of tax-compliance functions, business activities, and taxpayer profiles which have little or nothing in common. Solutions must be up to the task of yielding tax revenues without placing a disproportionate burden on the affected taxpayers. Second, the data and research necessary to make informed decisions does not appear to exist. There are so many questions we need to answer before we can begin to craft solutions that will be effective and not burdensome.

SOLE PROPRIETORS, FOR EXAMPLE

Both observations noted above can be illustrated by examining one component of the “Tax Gap”—underreporting by sole proprietors. Small businesses organized as sole proprietorships are unincorporated business. For tax purposes, the income from their business “flows through” to their personal income tax calculations. They report their income on the Form 1040. The business income and expenses are reported on Schedule C, a form that accompanies the Form 1040.

As noted above, the "Tax Gap" report issued by the IRS identifies underreporting of income by Schedule C filers as a significant source of the "Tax Gap." What do we know about them?

In tax year 2004, 20.6 million individual tax returns reported non-farm income on the Schedule C. Approximately 13 million of these businesses had gross receipts of $25,000 or less. This is an important point that I will come back to with regard to realistic, not burdensome solutions.

Of the 20.6 million returns, the number with any net income was 15 million. Of that number, 3.7 million filed on a Schedule C-EZ, meaning they had business expenses of $5,000 or less, used the cash accounting method; had no inventories; did not report a deficit from the business; had only one business as a sole proprietor; had no employees, did not itemize depreciation; claimed no deduction for home business expenses; and had no prior year disallowed passive activity losses from business.

Although we do not know much about the causes of the "Tax Gap," there is already some discussion of solutions such as more third-party reporting or the withholding of tax from income payments. I generally hold to the axiom, "Don't ask a question that you don't know the answer to." I will break my rule today. Do we know if there is a difference in underreporting in business to business transactions versus consumer to business transactions?

As you know, businesses that engage the services of sole proprietors have to issue a 1099 for amounts over $600. For years, the debate has focused on business to business (B2B) service transactions. Some suggest the current information reporting system is not working. What is the problem with the current system? Are the bulk of B2B transactions under $600? Or is there a failure to file 1099s? Are there statistics on the amount of underreporting when 1099s have been issued? For that matter, do we know how many sole proprietors receive a 1099? How many receive multiple 1099s? Can we break that information down by business activity? It seems to us if we had answers to some of these data questions, we might be able to get a better handle on the sole proprietor underreporting situation.

In recent years I have come to think the underreporting problem, to the extent it may exist, might be more prevalent in the direct consumer to business transactions. In such situations, there is no information reporting, and it does not lend itself to withholding. But, I have not seen an analysis that drills down below the generalization that sole proprietors underreport.

If a sole proprietor is primarily engaged in providing services to consumers, it will be difficult to impose a "traditional" income reporting and/or withholding requirement to close the "Tax Gap." As the recipient of the service, a consumer would be the party required to report or withhold. On a theoretical level, it is not likely this kind of new tax compliance burden would be well received. On a practical level, the number of transactions could be astounding. Without knowledge of how many sole proprietors provide services primarily to business or primarily to consumers, different solutions to closing the tax gap will have to be identified and developed. So I circle back to my questions: How many of the approximately 21 million Schedule C filers are engaged primarily in transaction with consumers?

When you look at some of the business activity sectors of sole proprietors, it also raises the question of whether one solution fits all.

Selected Sectors	Number of Schedule Cs
HConstruction Specialty Trade Contractors portion	**2.6 Million** 2.1 Million
HWholesale Trade	**350, 0000**
HRetail Trade Non-store Retailer portion Miscellaneous Store Retailers portion	**2.4 Million** 990, 000 551,143
HReal Estate	**1.2 Million**
HTransportation	**980,000**
HFinance and Insurance	**670,000**
HProfessional, Scientific, and Technical Legal Services portion Accounting Services portion Architectural, Engineering portion Management, Scientific, Technical Consulting portion	**2.9 Million** 353,000 407,000 291,000 735,000
HAdministrative and Support	**2 Million**
HHealth Care and Social Assistance Ambulatory Health Services (e.g. doctors' offices) portion Child Care portion	**1.8 Million** 869,000 694,000
HArts, Entertainment, and Recreation	**1.1 Million**
HOther Services Personal & Laundry Services portion	**2 Million** 1.3 Million

H

Another way to look at the sole proprietor sector is by size based on net income. The following are the top three sectors.

Total Sole Proprietorships Net Income	**$247 billion**
HTop Three Sectors by Aggregate Net Income	
HProfessional, Scientific, and Technical	56.9 billion
HHealth Care and Social Assistance	42 billion
HReal Estate	27.9 billion

Again, at the risk of repeating myself, what I see in those statistics are a lot of sole proprietors potentially providing services to consumers. How can we consider solutions such as third-party reporting or withholding until we have a firm understanding of how large a role a consumer plays in the transaction?

As an aside, I thought it interesting that the Information Reporting Program Advisory Committee (IRPAC), the group that advises the IRS on reporting burdens, recommended that the reporting threshold (currently $600 on a Form 1099 Misc.) for health care professionals should be increased to $5,000. The IRPAC said, “We believe this change in the reporting threshold will not adversely impact the tax gap since it is our understanding, and our expectation that most, if not all, of the medical providers are compliant taxpayers. This understanding is based upon the nature of the business that they conduct as licensed and regulated medical service providers.”

I do not know if their conclusion is correct or not, but if you look at the tables above, this sector is a rather large segment of the sole proprietor community by number or by net income. It is hard to reconcile these various observations without a comprehensive research analysis.

The sole proprietor sector is just one example. I believe you will find we really do not know enough yet about the causes of underreporting to craft solutions.

ENFORCEMENT, EDUCATION OR SIMPLIFICATION

Now, as I promised, back to the gross receipts statistics for sole proprietors. Thirteen million are reporting less than $25,000 in gross receipts. Thirteen million. When I look at the number what comes to my mind is that we cannot “audit our way out of this.” Yes, there will be anecdotal information about the need for better and more audits, but there is simply no way we can allocate the resources to reach the very taxpayers whom the aggregate “Tax Gap” data has identified. This would suggest we need to find non-enforcement solutions.

Even then, when we do identify the causes, we still need to find non-burdensome solutions. Thirteen million sole proprietors with less than $25,000 in gross receipts. Even if we make a wild assumption that they are only reporting half of their income, what solutions can we find that will produce new revenues that won’t impose extraordinary burdens on the smallest of small businesses?

Taxpayer education must remain one of our primary tools. We believe the IRS has made significant headway since it was given the mandate almost a decade ago to pursue more aggressive education outreach. It will take a long time to reach the 20 million or more small businesses (indeed as most of us in the trade association world know, one cannot get discouraged about how many we reach with our message), but we would submit it is not only appropriate, but essential that we continue to try. Success is hard to measure but I suppose, ultimately, if we can get the “Tax Gap” reduced, and education is a primary component, then we know we have been successful.

I would be remiss if I did not state again our belief that tax simplification **would** reduce the “Tax Gap.” For small businesses, particularly the sole proprietors, the challenges of divining the purpose and meaning of the tax code are formidable. Does the IRS have any figures on how much income is underreported because people do not understand the tax code? It is important to understand why there is noncompliance with the tax code. The complicated and often contradicting laws that make up the tax code form a barrier in many cases to compliance with the tax code. Inadvertent errors and confusion are often caused by complex laws. These same complex laws also contribute to intentional noncompliance. Many who do not understand the tax code may perceive unfairness in the code. Studies have shown that these same people use this feeling of unfairness to justify their noncompliance to themselves.

RESPECT

Finally, it is incumbent upon all of us to make sure we treat the compliant taxpayer with respect. After all, the vast majority of our revenues are collected through voluntary cooperation with a high compliance rate of 86 percent. It is important that we reserve the label “Tax Gap” for only those proposals which are truly related to addressing the “Tax Gap.” We fear we will see various revenue offsets labeled as “Tax Gap” closers. In many cases, the revenue offsets alter long time policies upon which compliant taxpayers have fairly and honestly relied. What message do we send to the compliant taxpayer to label these items as “Tax Gap” closers?

Conversely, we must make certain “Tax Gap” initiatives are enacted for that purpose, not for the sake of revenue raising. A prime example of a “Tax Gap” initiative that spiraled out of control was the enactment of withholding on government contractors. A lot of compliant taxpayers got pinned with a cash flow penalty under that proposal in the name of “closing the tax gap.”

In conclusion, we look forward to working with the Administration, Congress, and others to understand the nature of the “Tax Gap” and to find reasonable, effective non-disproportionately burdensome solutions. However, we view this challenge as a long-term project.

Thank you.

* SBLC is a permanent, independent coalition of nearly 60 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views.

**NFIB is the leading advocacy organization representing small and independent businesses. A nonprofit, nonpartisan organization founded in 1943, NFIB represents the consensus views of its members in Washington and all 50 state capitals. NFIB's mission is to promote and protect the right of our members to own, operate and grow their businesses.

***The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.