

~~that taxpayer service is less important—perhaps even unimportant—for compliance. We think this implicit assumption is wrong. As discussed above, we believe that taxpayer outreach and education are key components in improving tax compliance, and a failure to fund taxpayer services adequately will translate into lower tax collections.~~

~~As a separate matter, we are concerned that as Congress is directing the IRS to administer more social benefit programs (including Economic Stimulus Payments, the Making Work Pay credit, the First Time Homebuyer Credit, and a variety of provisions relating to health care reform), the IRS in relative terms is becoming less of a service organization and more of an enforcement agency. We have no doubt the IRS is capable of administering social programs, including health care. But Congress must provide sufficient funding and the IRS itself must recognize that the skills and training required to administer social benefit programs are very different from the skills and training that employees of an enforcement agency typically possess. While some enforcement measures are required to prevent inappropriate claims, the overriding objective of agencies that administer social benefit programs has traditionally been to help as many eligible persons qualify for the benefits as possible. That requires outreach and working one on one with potentially eligible individuals. If the IRS continues to ramp up enforcement while reducing taxpayer service programs, we would be concerned about its ability to administer the new health care credits and penalty taxes in a fair and compassionate way.~~

~~During the coming year, the Office of the Taxpayer Advocate will place particular emphasis on evaluating the extent to which the IRS is meeting or not meeting taxpayer needs and, to the extent the IRS is not meeting taxpayer needs, we will examine the reasons and possible solutions.~~

## **B. TAS Will Examine the Administrative Challenges Presented By New Information Reporting Requirements**

A provision in the Patient Protection and Affordable Care Act (PPACA)<sup>47</sup>, enacted in March of this year, added a new information reporting requirement that may present significant administrative challenges to taxpayers and the IRS. In particular, businesses will have to issue Forms 1099 for goods purchased after 2011, regardless of the corporate form of the vendor.<sup>48</sup> The Office of the Taxpayer Advocate is concerned that the new reporting burden, particularly as it falls on small businesses, may turn out to be disproportionate as compared with any resulting improvement in tax compliance.

Under prior law, information reporting was required for the purchase of services but was not required for the purchase of goods. A person who made payments in the course of a trade or business to a vendor totaling \$600 or more for services or determinable gains in

47 Pub. L. No. 111-148, Title IX, Subtitle A, § 9006 (2010).

48 IRC § 6041(h).

any taxable year was required to furnish an information report to the IRS, with a copy to the vendor. This report, generally a Form 1099-MISC, *Miscellaneous Income*, sets forth the total amount of the payments as well as the name, address, and taxpayer identifying number (TIN) of the vendor.<sup>49</sup>

Prior law generally did not require a person to report payments to purchase goods, presumably because the purchaser could not determine the amount that (less cost of goods sold) would have been income to the vendor. Under a longstanding regulatory regime, moreover, there was an exception for payments to corporations as well as to tax-exempt and government entities. In recent years, legislative proposals to eliminate the corporate exception and expand information reporting appeared as part of an effort to reduce the tax gap. Since 2004, the National Taxpayer Advocate has recommended legislation, in the context of reducing the tax gap or noncompliance in the cash economy, to require Forms 1099-MISC to be issued to incorporated service providers.<sup>50</sup> Similarly, the Department of the Treasury, under both prior and current administrations, has proposed legislation to eliminate the corporate exception to information reporting for services.<sup>51</sup> Neither the National Taxpayer Advocate nor Treasury recommended legislation to extend information reports to vendors of goods. In any case, the new information reporting requirements are likely intended to detect unreported income or gross proceeds.

The PPACA provision would apply to businesses of all sizes, charities and other tax-exempt organizations, and government entities. These would include, as reflected in IRS data, 26 million non-farm sole proprietorships, four million S corporations, two million C corporations, three million partnerships, two million farming businesses, one million charities and other tax-exempt organizations, and probably more than 100,000 federal, state, and local government entities.<sup>52</sup> This mass of persons making payments in the course of a trade or business will soon be required to issue information reports to sellers of goods as well as providers of services. They also will have to report payments to a for-profit corporate service provider. In addition, a business will soon be required to report payments for purchases of goods as well as property of any sort.<sup>53</sup> This new requirement has generated

49 See IRC § 6041; Treas. Reg. §§ 1.6041-1(a)(1)(i), 1.6041-6, 301.6109-1.

50 See National Taxpayer Advocate 2004 Annual Report to Congress 483; National Taxpayer Advocate 2005 Annual Report to Congress 394-396; National Taxpayer Advocate 2007 Annual Report to Congress 494-396; National Taxpayer Advocate 2008 Annual Report to Congress 388.

51 See Department of the Treasury, General Explanations of the Administration's Revenue Proposals, FY 2011 (Feb. 2010) 97, FY 2010 (May 2009) 90, FY 2009 (Feb. 2008) 61, FY 2008 (Feb. 2007) 63.

52 These data reflect returns filed in 2009 for Tax Year 2008 where available and returns filed in 2008 for Tax Year 2007 where more current data is not available. See IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008) (covering filers of Form 1040, Schedule C and Form 1040, Schedule F); IRS Document 6149 (2009 Update) (covering filers of Form 1120, Form 1120S, and Form 1065); IRS Historical Table 21 (covering filers of Form 990 and related forms); and IRS Office of Federal, State and Local Governments, *FY 2010 Work Plan* 30-32 (stating that more than 105,000 employer identification numbers belong to government entities).

53 A ten-year revenue estimate for the legislative provision for property and corporate reporting was \$17.1 billion, and for a prior proposal containing only corporate reporting, \$3.387 billion. Joint Committee on Taxation (JCT), *Estimated Revenue Effects of the Manager's Amendment to the Revenue Provisions Contained in the "Patient Protection and Affordable Care Act"*, JCX-61-09 (Dec. 19, 2009); JCT, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, JCX-7-10 R (Mar. 15, 2010).

a great deal of concern because of its potential to create administrative burdens for businesses, vendors, and the IRS.<sup>54</sup>

First, vendors will have to furnish, and businesses will have to collect, TINs. If the vendor is a sole proprietor who uses his or her Social Security number (SSN) as the TIN, there could be identity theft concerns, especially if TINs essentially become public through routine printing on receipts. Alternatively, such a vendor could obtain an Employer Identification Number (EIN).<sup>55</sup> TAS will monitor any guidance that the IRS may set forth on the use of EINs for this purpose. If a sole proprietor uses an EIN, the IRS systematically will have to be able to associate the corresponding information reports with the SSN under which the resulting income should have been reported.

If a vendor fails to furnish a correct TIN, the business is required by law to impose back-up withholding at the rate of 28 percent of the purchase price.<sup>56</sup> In this situation, the business must prepare and file Form 945, *Annual Return of Withheld Federal Income Tax*, and make federal tax deposits at an authorized institution on a prescribed schedule. Failure to withhold an amount generally results in liability for that amount.<sup>57</sup> In the case of a purchase of goods, back-up withholding may be impracticable, because a business already may have paid the full price at the point of sale before learning that the TIN was incorrect. Alternatively, a vendor may simply refuse to sell goods to any purchaser that refuses to pay the full purchase price. Such an outcome could significantly impair the normal course of commerce. No business should have to choose between compliance with back-up withholding and losing access to vendors on the one hand, and noncompliance while keeping vendor access on the other hand.

Second, businesses will now have to keep records of all purchases sorted by TIN. Under prior law, a business may have retained sufficient records to substantiate lump-sum expense deductions. Under the new law, the business will have to segregate its records by vendor TIN to determine whether the \$600 annual threshold is met for each vendor.

Third, businesses will have to produce and transmit information reports, including many not previously required. For this purpose, small businesses may have to acquire new software or pay for additional accounting services, incurring additional costs. Moreover, if a business makes qualifying purchases from at least 250 vendors during the calendar year, it will be required to file Forms 1099 electronically,<sup>58</sup> which may require the business to pay a per-report fee charged by an e-file service provider.

54 See *Healthcare Overhaul's Tax Provisions Have Small Firms Crying Foul*, Los Angeles Times (May 17, 2010); Neil deMause, *Health Care Law's Massive, Hidden Tax Change*, CNNMoney.com (May 5, 2010); Meg Shreve, *House Republican Urges Rollback of New Form 1099 Reporting Requirements in Health-care Reform Law*, Tax Notes Today (Apr. 27, 2010).

55 See Treas. Reg. § 301.6109-1(a)(1)(ii)(D).

56 See IRC § 3406(a).

57 See IRC §§ 3403, 3406(h)(10).

58 See IRC § 6011(e)(2)(A); Treas. Reg. § 301.6011-2.

Fourth, the IRS will face challenges making productive use of this new volume of information reports. In general, the IRS's document-matching system (known as the Automated Underreporter (AUR) program) compares amounts shown on a taxpayer's tax return with amounts shown on third-party information reports like Forms W-2, *Wage and Tax Statement*, and Forms 1099. For example, it matches wages shown on a Form W-2 with wages reported on a tax return and interest shown on a Form 1099-INT, *Interest Income*, with interest reported on a tax return.

Under the expanded reporting regime, however, the amounts on the information reports and the tax returns will not match under the rules for at least two reasons. First, total annual payments under \$600 will not be reported by the purchaser on Form 1099 but must be reported by the vendor. While the \$600 threshold existed under prior law, if a significant proportion of a vendor's proceeds comes from small purchases, PPACA reporting would be underinclusive. Second, the goods market is subject to a high rate of returned items that result in refunds to the purchaser. If a business purchases and then returns goods, the vendor does not have any income. Yet depending on how the purchaser's record-keeping system is set up, a Form 1099 may be filed showing the purchase (particularly if the purchase occurs in one tax year and the return occurs in the following tax year).<sup>59</sup>

Fifth, the expanded requirement for reporting sales of goods or services to corporations raises an important point – an information report is merely a return that itself may be erroneous.<sup>60</sup> Nevertheless, if an information report shows income not included on the corresponding tax return, the IRS may issue a so-called CP 2000 notice of underreported income.<sup>61</sup> This notice is a form letter explaining that income information in IRS files does not match entries on the tax return and advising the taxpayer to respond. At this point, the taxpayer may have to prove a negative. Consequently, the IRS would have to develop a process for verifying and using information reports to establish an accurate amount of gross proceeds.

Sixth, the IRS has authority to impose monetary penalties against businesses that fail to file information reports.<sup>62</sup> The new volume of information reports could exacerbate under-assessment of penalties in some cases and overassessment of penalties in others. On the one hand, the IRS will have a difficult time detecting incidents of aggregate payments of \$600 or more in a year by a small business to one vendor. On the other hand, failure to file could be explained by a number of complications. In particular, the IRS has announced that filing under § 6041 generally will not be required with respect to purchases made by credit card

59 It is unclear if a returned amount would be gross proceeds "in consideration for property" within the meaning of PPACA § 9006.

60 For example, in *Portillo v. Comm'r*, 932 F.2d 1128, 1131, 1134 (5th Cir. 1991), *rev'g in part* T.C. Memo. 1990-68, the IRS asserted a deficiency of tax based on purportedly unreported income reflected on a Form 1099 that turned out to be erroneous. The IRS had taken the position that the "Form 1099 was presumed correct." Noting that for a taxpayer it is never easy to prove a negative, the Court of Appeals for the Fifth Circuit held that the IRS "had some duty to investigate" the accuracy of the information report.

61 See IRM 4.19.3.1 (Sept. 1, 2009).

62 See IRC § 6721.

that are reportable under another provision that is effective in 2011.<sup>63</sup> At any rate, it will be challenging for the IRS to sort these payments out. In our view, it is highly likely that the IRS will improperly assess penalties that it must abate later, after great expenditure of taxpayer and IRS time and effort. Thus, the National Taxpayer Advocate will review closely any regulations that the IRS may promulgate on this issue.

Finally, the PPACA reporting requirement could have distortionary effects on taxpayer behavior. Many large vendors already have computer systems that can track purchases by customer. They are likely to advertise that they will track each customer's total purchases and send them a report at the end of the year that business customers can use to comply with the Form 1099 filing requirement. Small businesses seeking to minimize recordkeeping burden thus will have an incentive to use large vendors that can produce these reports for them. As a consequence, small businesses that lack the capacity to track customer purchases may lose customers, leaving the economy with more large national vendors and less local competition.

During the coming year, TAS will examine the impact of the new reporting requirements more closely, assessing both the anticipated improvements in tax compliance and the burdens the requirements are likely to impose on millions of small businesses. Our principal focus will be on the new requirement to report on purchases of goods (whether from a corporation or unincorporated business). Depending on what our examination reveals, we may propose administrative or legislative recommendations to modify the provision.

### ~~C. The National Taxpayer Advocate Remains Concerned About IRS Collection Practices that Do Not Promote Future Voluntary Compliance and Can Unnecessarily Harm Taxpayers~~

~~The National Taxpayer Advocate is concerned about the IRS's failure to fully implement its announced initiatives to help taxpayers who are experiencing economic difficulties. In December 2008, the IRS announced an expedited process to assist financially distressed homeowners whose refinancing or sale of their homes was hampered by the IRS's filing of a notice of federal tax lien (NFTL).<sup>64</sup> An IRS news release discussed lien subordinations (i.e., the process by which an NFTL becomes secondary to another creditor's lien) and lien discharges (for payment of the IRS lien interest, the IRS will remove the lien from a specific property in order for the title to be transferred). Moreover, in 2009, the IRS kicked off the tax filing season by announcing assistance to financially distressed taxpayers, including the postponement of collection actions, added flexibility for missed payments, an additional review for offers in compromise on home values, prevention of OIC defaults, and~~

63 See IRS News Release, *Prepared Remarks of Douglas H. Shulman, Commissioner of Internal Revenue, Before the American Payroll Association & the American Accounts Payable Association 28th Annual Congress*, IR-2010-68 (May 27, 2010); IRC § 6050W; Prop. Treas. Reg. § 1.6041-1(a)(1)(iv), 74 Fed. Reg. 61,294 (Nov. 24, 2009).

64 IRS News Release, *IRS Speeds Lien Relief for Homeowners Trying to Refinance, Sell*, IR-2008-141 (Dec. 16, 2008).