



# From the Desk of Dean Zerbe.



## Obama Budget Proposal and Taxes Part II: Tax Crackdown Will Cost Small Business

by Dean Zerbe

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One of the seemingly less controversial aspects of the Obama administration's tax proposals is related to tax enforcement. Who can object to making everyone pay what they owe? Certainly, it's better than raising taxes on law abiding folks.

The problem is that some of the administration's enforcement proposals will add big paperwork burdens and costs for small business, at a time when many are already struggling. That could put a damper on hiring, although arguably the proposals will be good for one sector--the accounting firms hired to deal with all the additional filings and requirements. (I say arguably, because in the current economy, there's a limit to how much extra accounting firms can charge their small-business clients, meaning they might have to absorb some of the extra costs themselves.)

In the Obama administration's defense, many of these proposals were first put forward by the Bush Treasury in response to pressure from Congress to address the "tax gap." (That gap--\$345 billion in 2001--is the difference between what the Internal Revenue Service estimates it's owed, and what taxpayers hand over voluntarily.) While these proposals didn't move last year, I expect them to receive serious consideration with a new administration and a Congress that is aggressively seeking new sources of revenue. That's why consideration of the burdens they would impose is crucial now. These new tax paperwork burdens come on top of an already grinding load imposed on small business. A recent IRS study estimated that small business spends approximately \$100 billion a year on tax compliance. But what's really significant is that the tax compliance burden is far higher--as a percentage of receipts and on a per-employee basis--for small businesses than for large ones, because of the fixed costs of filing returns and setting up compliance.

A study sponsored by the IRS found that while large businesses spend just 0.5% of gross receipts on tax compliance, those with revenues of \$100,000-\$500,000 spend 5% of their receipts on it. Even smaller businesses spend an even higher percentage.

Here's a rundown of what the Obama Treasury has proposed:

**Businesses would have to report their payments to other corporations to the IRS.** Currently, a business that pays an individual \$600 a year or more for services must file an information return--a Form 1099--with the IRS. But businesses don't have to file a 1099 when they pay a corporation for services. The Obama administration proposes businesses be required, beginning with payments made next year, to file 1099s for all payments for services above \$600 made to corporations (although not to tax-exempt corporations).

My concern with this, and the other information reporting discussed below is not only the burden it places on business but also what end that new burden will serve. Tax professionals are more and more cynical about the extent to which the IRS is actually looking at and matching the billions of information reports it already gets. If taxpayers (or their accountants) don't believe the IRS is looking at these reports, than issuing them won't have much affect on those who might omit income.

When I reviewed the IRS' use of information reports--while I worked at the Senate Finance Committee and, before that, the IRS Restructuring Commission--it was stunning to find how many information reports sat gathering dust in IRS closets. In addition, while in some areas the IRS does make good use of information reports by matching them with taxpayers' returns, often, due to staffing constraints and poor

management of existing resources, the IRS works only a small portion of the mismatches it finds. Making use of the 1099 issued to corporations could be far more labor intensive for the IRS than is matching 1099s issued to individuals. Congress needs to take a sharp look at what the IRS is doing with the information it already receives before considering new reporting burdens, particularly on small business.

**Business would have to verify Taxpayer Information Numbers (TINs) of contractors and withhold taxes when they can't be verified.** This is a stunner. Let's go through the steps of this new proposal from Treasury, which applies to all businesses.

1) Jane's Nursery, a small business, has to determine whether or not a contractor--say the mulch supplier--was paid more than \$600. (Presumably Jane will not have to determine whether or not the mulch supplier is a corporation because of the other changes in law discussed above.)

2) Jane next demands/receives the TIN of the mulch supplier. If Jane gets a TIN and a name, then 3a) Jane (or more likely her accountant) contacts the IRS to verify the contractor's TIN. 4a) The IRS discloses to Jane's accountant whether the TIN and name match. 5a) If the TIN and name match, Jane can make a payment for the mulch. 6a) Jane or her accountant issues a 1099 to the IRS.

Alternatively, if the small business can't get a valid TIN from the contractor, then 3b) Jane now withholds payments at a flat-rate percentage. 4b) Jane's accountant has to establish an accounting for this withholding. 5b) Jane remits these funds to the IRS. Of course, if there is no TIN provided, the IRS will not be able to associate the payment it receives with the taxpayer. In addi-



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tion, the mulch supplier, if he has trouble putting aside money for his tax payments, can demand Jane set up withholding for him.

Quite frankly, this burdensome TIN proposal must have been dreamed up by someone whose only involvement and knowledge of small business comes from buying their soy latte in the morning. I find it difficult to believe that the burden on small business (not to mention the cost of the IRS to administer) is justified by the roughly \$80 million dollars per year that Treasury optimistically claims this will raise in revenues. Congress needs to sharpen its pencils and do its own cost-benefit analysis on this and all the information proposals. Proposed start date for TIN verification: Jan. 1, 2010.

**Penalties for lapses in information reporting would be increased.** There will almost certainly be penalties and interest payments for any errors Jane or her accountant make in TIN verification. In fact, the new administration proposes in the budget to significantly increase penalties for failures by taxpayers to file an accurate information report--doubling current penalties as well as more than tripling the maximum penalties per year.

**More individual taxpayers would have to file information reports.** On top of all this TIN matching and additional information reporting, the new administration proposes to expand who will be required to file information reports--to include those who rent out a house, an apartment or two, or rent their home for the summer. Currently, if you receive some rental income but are not in the trade or business of rental real estate (say, you have a separate day job in another industry and own just a few properties) then you do not have to file 1099s. No more. For example, if the administration's proposal becomes law, you, the landlord, will have to send in a 1099 to the IRS when you pay that plumber \$600 to fix the leak at the house you rent out (and don't forget to verify the plumber's TIN or otherwise withhold!).

**Local governments will have to report too.** If misery loves company, small business will be happy to know that the IRS will be authorized under the administration's budget to require information reporting starting Jan. 1, 2010 on all non-wage payments by federal, state and local governments when they purchase property (not real estate) or services. Why are governmental entities not subject to the more onerous TIN verification? Who knows? As California goes bankrupt, I presume they've budgeted for doing this work--although it's doubtful the IRS would ever penalize a state, given its historical reluctance to penalize a government entity for anything.

One last point on information reporting: A shadow over all this vast expansion of information reporting is the fact that this depends on people (many who will not be accountants) inputting all the information and data on the 1099 correctly. There is a small circle of hell at the IRS that is reserved for people who receive an incorrect 1099. I have been stunned to hear stories from accountants about individuals who receive an incorrect 1099--sometimes issued maliciously (say, by a former spouse or business partner) to get the taxpayer in trouble.

The IRS' policy on this shows how incredibly far the agency still has to go to meet its goal of world-class service. The IRS states that it is the individual's responsibility to get a corrected 1099--good luck accomplishing that from an ex-spouse, angry former partner, etc.--and even an ordinary snafu is extremely difficult to unwind. Congress should ask the IRS to show how it is going to handle these problems befitting a world-class services organization.

The new administration's proposals for information reporting add to an ever-increasing burden that is being placed on small business during this struggling economy. But if Congress does not hear from small business, it is certainly possible they will pass. It's your choice: Write your representatives a letter today or pay your accountant to fill out scores of 1099s tomorrow.

For those who want to read comments on this article or provide their own public comments the link to the article at Forbes is:

<http://www.forbes.com/2009/06/08/taxes-crackdown-small-business-personal-finance-renters-tax.html>

This discussion of LIFO was not included in the *Forbes.com* column, but readers may find this information helpful.

*LIFO--From my discussions with accountants across the country, I know possible LIFO repeal is of great interest to a significant number of businesses -- from wineries in Napa to car dealerships in Florida. The administration has proposed ending LIFO beginning effective the first tax year after December 31, 2011. The one-time increase in gross income would be taken into account ratably over the first year and the following seven years (so effectively an eight-year phase-out). The focus of this repeal by the administration is not only the increase in revenues it provides (approximately \$60 billion over 10 years) but also as an effort to "get big oil" -- which benefits from paying lower taxes under LIFO.*

*At the moment, it seems less likely that LIFO repeal will happen this year (unless some tax bills move unexpectedly and need revenue offsets) but repeal is certainly high on the to-do list next year. Obama campaigned on repeal of LIFO, it's in the budget and it has significant support from many in Congress -- especially the majority. However, there is an ongoing fight on two fronts: whether LIFO repeal will apply to non-publicly traded companies and/or to extend the proposed phase-out period. At the moment, I don't think Congress has heard enough from affected businesses (and their accountants) to compel them to limit LIFO repeal to just publicly traded companies. On the positive side, it does appear that there is sentiment to expand the phase-out period -- perhaps to nine years (not including the initial year). Proposals for a phase-in beyond that would face a tough road I understand from scoring gurus because that would be outside the 10 year budget window and limit the score. Please feel free to email me at dean.zerbe@*



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alliantgroup.com if you have any questions about the administration's budget or Washington in general.

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Dean Zerbe is alliantgroup's National Managing Director. Dean was formerly Tax Counsel for the Senate Finance Committee and was a key player in all the major tax legislation that has been passed in the last seven years. Dean speaks throughout the country and meets with accounting firms and their clients to discuss the outlook for short-term and long-term changes in tax policy as well as ways accounting firms can help their clients lower their tax bill.

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