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The Bush administration wants Congress to require additional third-party reporting of business income as a means of reducing the \$345 billion-a-year gap between what is owed in federal taxes and what is actually paid.

The Treasury Department also plans to take another look at who qualifies as an independent contractor. Changes in this definition could lead to more individuals being classified as employees and therefore subject to income tax withholding.

Proposals to close the tax gap often target small businesses and sole proprietors because that's where much of the missing money is. Understated business income accounts for \$109 billion of the tax gap, according to the Internal Revenue Service. Underreported self-employment tax accounts for another \$39 billion.

Tax gap components

COMPONENT:	GROSS TAX GAP:	Compliance with tax laws is significantly higher when third parties tell the government about payments to businesses and individuals or withhold taxes from these payments, according to the IRS.
Individual income tax underreporting	\$197 billion	President Bush's budget proposal calls for credit card companies to report their annual reimbursement payments to each merchant. This would make it harder for retailers to hide their income from credit card transactions. Credit card companies would have to withhold taxes on payments to retailers that have not provided a valid taxpayer identification number.
Understated non-business income	\$56 billion	
Understated business income	\$109 billion	
Overstated adjustments, deductions, exemptions, credits	\$32 billion	The administration also wants to require federal, state and local agencies to report payments made to government contractors and withhold taxes if necessary. The Government Accountability Office last year found that 33,000 federal contractors owed more than \$3 billion in unpaid taxes.
COMPONENT:	GROSS TAX GAP:	"As strange as it may seem, government at all levels does business with vendors who are delinquent on their taxes," says IRS Commissioner Mark Everson.
Self-employment tax underreporting	\$39 billion	Critics: Plan doesn't go far enough
All other tax gap components	\$109 billion	
Total tax gap	\$345 billion	These two proposals wouldn't pose too much of a burden on small businesses, says Giovanni Coratolo, director of small business policy at the U.S. Chamber of Commerce.

Source: Internal Revenue Service

"No one gains when one small business is able to avoid their fair share of taxes," he says. "The honest small businesses are hurt."

But he's concerned that Congress might consider more drastic measures.

In the current environment of high federal budget deficits, the new \$345 billion tax gap estimate "is like throwing red meat in front of a shark," Coratolo says.

Some members of Congress say the Bush administration's tax gap plan doesn't go far enough because it would

recover only \$3.6 billion over 10 years.

"It just nibbles at this crisis while the deficit grows," says Sen. Max Baucus, D-Mont.

If the IRS could somehow collect all of the money it's owed, "we'd come close to eliminating the deficit," says Sen. Kent Conrad, D-N.D.

Totally eliminating the tax gap, however, would require "draconian measures" that "would make government too intrusive," IRS Commissioner Everson says.

The administration's proposals for more third-party reporting of business income are "relatively modest but quite significant," Everson says. The new look at the independent contractor vs. employee definition "really will cause a firestorm," he adds.

Independent contractors under review

Two years ago, Nina Olson, the IRS's national taxpayer advocate, caused a firestorm when she suggested that Congress require businesses to withhold taxes on payments of \$600 or more to independent contractors.

Small business advocates strongly objected, contending the requirement would impose too much of a paperwork burden on businesses and tie up money that independent contractors might not even owe the government.

"We're hoping that fire has been put out," Coratolo says. "It would hurt a lot of innocent small businesses in order to capture a few bad actors."

It's too early to judge the impact of the planned look at the independent contractor definition since the Bush administration has released no details about it. But Coratolo says the relationship between a business and its employees is "completely different" than the relationship between a business and an independent contractor. Forcing more independent contractors into an employer-employee type of relationship "does not serve small business," he says.

Olson, meanwhile, thinks Congress should close a loophole that allows individuals to escape reporting of miscellaneous income by incorporating. Payments to unincorporated entities are reported to the IRS through Form 1099, and Olson thinks small corporations should be subject to the same rules.

"That's where some real money is," Olson says.

People get nervous when they know the IRS is getting information about them, she says.

"I like a society of nervous taxpayers," Olson says, "because that changes their behavior."

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