



Economic Analysis of the Enhanced Form 1099 Information Reporting Requirements

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Summary

Beginning January 1, 2012, a business will have to file a Form 1099-MISC information return with the Internal Revenue Service (IRS) if the total amount of payments made to most businesses in exchange for goods or services is \$600 or more in a year. Previous law only required that an information return be filed for payments made in exchange for services and exempted payments made to corporations. The new reporting requirements were enacted as part of the Patient Protection and Affordable Care Act (P.L. 111-148) and are intended to increase tax payment compliance and reduce the net tax gap. The net tax gap is estimated to be around \$356 billion in 2010 after adjusting for inflation and recouped taxes. The Joint Committee on Taxation (JCT) estimates that the new reporting requirements will raise \$17.1 billion over 10 years, or about \$1.7 billion on average annually.

This report analyzes the new 1099-MISC requirements. Data on the tax gap and tax payment compliance are presented. Small businesses taxpayers are shown to be the largest single contributor to the tax gap and are also shown to have one of the highest rates of noncompliance. The JCT revenue score is used to estimate that the new requirements will reduce the tax gap by 0.50%, and increase tax payment compliance by 0.40%. The value of the new requirements is evaluated from the perspective of the revenue raised in comparison to the compliance costs imposed on businesses and the administrative costs imposed on the government.

Several proposals for change have been offered and are evaluated in this report. Legislation has been introduced by Senator Mike Johanns (S. 3578) and Representative Dan Lungren (H.R. 5141) that would repeal the new requirements, and a proposal by Senator Bill Nelson (S.Amdt. 4595 to H.R. 5297) that would modify the particular parameters of the requirements. There is some uncertainty, however, as to how exactly S.Amdt. 4595 to H.R. 5297 should be interpreted. As the amendment currently is written, it could be interpreted as increasing the reporting threshold to \$5,000 for payments in exchange for goods but not services, and exempting businesses with no more than 25 employees from the reporting requirements for payments in exchange for goods only. But at least one outside source is interpreting the amendment to imply that the \$5,000 threshold increase would apply to both goods and services and that businesses with no more than 25 employees would be exempted from reporting requirements altogether. There is a consensus that the S.Amdt. 4595 to H.R. 5297 would exempt payments made with credit and debit cards where the payment processor is already subject to reporting requirements.

Another option, which has been included in several budget proposals of both the Bush and Obama Administrations, is to require reporting for payments in exchange for goods but continue to exempt payments to corporations. Other options offered include simplifying the tax code to reduce the incentive to evade or avoid taxes, and upgrading information reporting infrastructure at the IRS to reduce the burden of being compliant.

This report will be updated as warranted by legislative changes.

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Introduction

The Patient Protection and Affordable Care Act (PPACA, P.L. 111-148) contains a provision that expands the set of transactions for which businesses are required to report information to the Internal Revenue Service (IRS). Specifically, beginning January 1, 2012, a business will have to file an information return with the IRS if the total amount of payments made to another business in exchange for goods or services is \$600 or more in a year.¹ Previous law only required that an information return be filed for payments made in exchange for services and exempted payments made to corporations. Several proposals have been introduced that would modify or repeal the recent provisions in the new law. These include proposals made by Senator Mike Johanns (S. 3578) and Representative Dan Lungren (H.R. 5141) to repeal the new requirements, and a proposal made by Senator Bill Nelson (S.Amdt. 4595 to H.R. 5297) would modify particular parameters of the reporting requirements.

The new reporting requirements are intended to reduce the tax gap, which is the difference between the aggregate amount of taxes legally owed and the aggregate amount of taxes voluntarily paid.² For 2001 (the most recent year available), the IRS estimated the gross tax gap to be \$345 billion, implying that 16.3% of taxes owed were not paid on time.³ IRS enforcement activities, coupled with late payments, recovered about \$55 billion of the gross tax gap, resulting in an estimated net tax gap of \$290 billion. The hope is that requiring businesses to report more information to the IRS will reduce the tax gap via increased taxpayer compliance. The new requirements do not increase statutory taxes.

Opponents of the recent change in law often argue that (1) the revenue generated does not justify the increased compliance cost imposed on businesses, (2) the new requirements will be too burdensome to small businesses, and (3) due to accounting methods some businesses use, the information reported to the IRS will not assist them in identifying noncompliant taxpayers and therefore does not help in reducing the tax gap. Proponents of the new requirements often argue that (1) small businesses are already subject to reporting requirements for payments in exchange for services, (2) small businesses already have extensive record keeping requirements for things such as inventory and payroll, which are often handled with computer software, and that the marginal cost to small businesses of the new requirements is small, and (3) any cost from the new requirements should fall over time, mitigating the burden on small businesses.

This report provides a general overview and analysis of the information reporting requirements from a business tax perspective. Data is presented on the extent to which misreporting of tax liabilities is estimated to occur. The ability of the new reporting requirements to close the tax gap

¹ The law technically expands the reporting requirements to include amounts paid in consideration of “property and other gross proceeds,” and not simply goods. The term “goods” is used in this report since it has been adopted by many of those debating the issue. For a legal analysis of the new reporting requirements see CRS Report R41359, *Form 1099 Information Reporting Requirements as Modified by the Patient Protection and Affordable Care Act*, by Carol A. Pettit and Edward C. Liu.

² For more information on the tax gap see CRS Report R40219, *Tax Gap, Tax Enforcement, and Tax Compliance Proposals in the 111th Congress*, by James M. Bickley.

³ The noncompliance rate is the percentage of the aggregate tax liability that taxpayers do not pay voluntarily and timely for a given year.

and the effect on small businesses is examined and evaluated. The report concludes by discussing a number of policy alternatives.

Information Reporting Requirements

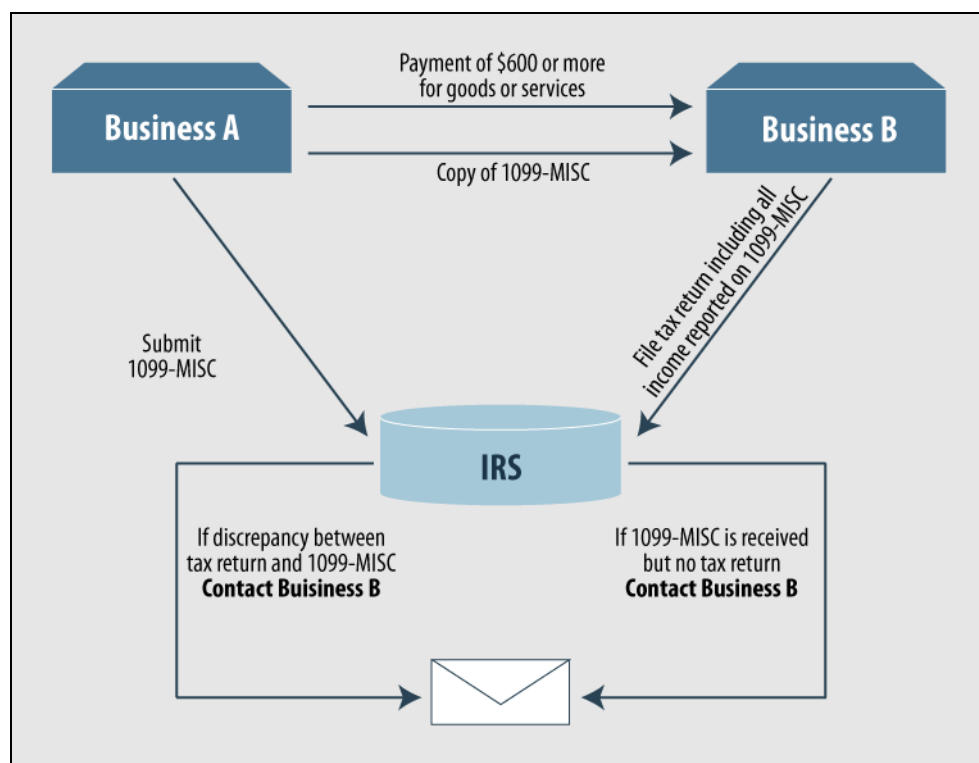
Currently, businesses and federal, state, and local government agencies, as well as certain other organizations are generally required to complete and submit a Form 1099-MISC information return with the IRS for payments (called nonemployee compensation) of \$600 or more for services provided by a business in a year. The payer enters the payee business's legal name, taxpayer identification number (TIN), mailing address, and the dollar amount paid. The payer submits the 1099-MISC to the IRS and sends a copy to the payee business for their records. Failure to receive a 1099-MISC does not exempt the payee business from reporting money received on their tax return. Payments made in exchange for goods and payments made to corporations currently do not require a 1099-MISC. If the payee business fails to provide their TIN, upon request the payer is generally required to withhold 28% from all subsequent payments due to that business.

The Form 1099-MISC is used to report information about transactions other than those involving nonemployee compensation. For example, the 1099-MISC is used to report information on rents, royalties, attorney fees, golden parachute payments, certain types of deferred compensation, medical and health payments, and crop insurance payments, among others. In 2006, there were a total of nearly 85 million 1099-MISCs corresponding to over \$6 trillion in payments by more than 5 million taxpayers that were submitted to the IRS.⁴ Just under half of the 1099-MISCs that were submitted were the result of transactions other than those involving nonemployee compensation.

Beginning January 1, 2012, the reporting requirements will change in two principal ways as a result of the Patient Protection and Affordable Care Act (PPACA, P.L. 111-148). First, the types of payments for which the reporting requirement will apply will expand to include payments for goods in addition to payments for services. Second, payments to corporations will no longer be automatically exempt from reporting requirements. The Joint Committee on Taxation (JCT) has estimated that these changes will increase federal tax revenue by \$17.1 billion over 10 years, or roughly \$1.7 billion per year.⁵

⁴ U.S. Government Accountability Office, *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238, January 2009, pp. 9-10, <http://www.gao.gov/new.items/d09238.pdf>.

⁵ U.S. Congress, Joint Committee on Taxation, *Estimated Revenue Effects of The Amendment in the Nature of A Substitute to H.R. 4872, the "Reconciliation Act of 2010," as Amended, in Combination with the Revenue Effects of H.R. 3590, the "Patient Protection and Affordable Care Act ('PPACA')," as Passed by the Senate and Scheduled For Consideration by the House Committee on Rules on March 20, 2010*, 111th Cong., 2nd sess., March 20, 2010, JCX-17-10.

Figure 1. Mechanics of the Form 1099-MISC Reporting Requirements

Source: CRS.

Notes: Figure illustrates information reporting requirements beginning January 1, 2012, under P.L. 111-148.

The objective of information reporting is to increase taxpayer compliance. The information returns give the IRS some ability to cross-check what is reported by taxpayers. For example, if the IRS receives a 1099-MISC, but does not receive a tax return from the corresponding taxpayer, they can contact the taxpayer to resolve the discrepancy. And if the IRS receives both a 1099-MISC and a tax return, they can compare the two and verify the income reported. This cross-check mechanism is illustrated in **Figure 1**. In some instances, the IRS's cross-check system may ultimately lead to an audit of a business's tax return.

Data on Information Reporting and the Tax Gap

The IRS has very little information on compliance with existing information reporting requirements.⁶ This limited amount of information is because the IRS only knows when a 1099-MISC is filed and not when one should have been filed but was not. Most of the information reporting noncompliance is thought to occur among small businesses. According to the Government Accountability Office (GAO), there were approximately 50 million small businesses in 2005, of which 8% filed a 1099-MISC.⁷ But, again, it is impossible for the IRS to know what

⁶ This paragraph was based generally on the following report, from which all statistics reported here come from: *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238, January 2009, <http://www.gao.gov/new.items/d09238.pdf>.

⁷ A small business is defined here as a business with less than \$10 million in assets.

fraction of the other 92% of small business should have filed a 1099-MISC, but did not, or what fraction simply were not required to file a 1099-MISC. As the GAO points out, the relatively small percentage of small business submitting 1099-MISCs is not necessarily an indication that businesses are not complying with 1099-MISCs reporting requirements. Given that small business, particularly sole proprietorships, represent the single largest component of the tax gap, it may be reasonable to suspect that there is some information reporting noncompliance among this group of taxpayers.

The IRS has more information on the estimated \$345 billion gross tax gap for 2001.⁸ Underreporting accounted for the largest component (\$285 billion) of the gap, followed by underpayment (\$33 billion) and nonfiling (\$27 billion). The largest noncompliance component of the tax gap—the \$285 billion due to underreporting—came from the following segments of the tax system: \$197 billion in individual income tax, \$54 billion in employment tax, \$30 billion in corporate income tax, and \$4 billion in estate taxes. When the individual tax gap is disaggregated into its various line-items the largest single source of underreporting (\$68 billion) is found to be single-owner businesses known as (sole) proprietors (see **Table 1**). Single owner businesses may also be a large contributor to the employment tax gap since underreporting of income likely allows for self-employment tax evasion as well.

The IRS also has information on tax payment compliance by the required amount of information reporting. **Table 1** displays the individual income component of the underreporting tax gap by information reporting and withholding requirements. Only 1.2% of wages, salaries, and tips, which are subject to substantial information reporting and withholding requirements, were underreported. In contrast, 57.1% of nonfarm (sole) proprietor income, which is subject to little or no information reporting, was underreported. This correlation holds more generally across reporting requirements categories as one moves from the top of **Table 1** (more stringent) to the bottom of **Table 1** (less stringent).

Table 1. Individual Income Tax Underreporting Gap, 2001

Category	Tax Gap (\$B)	NMP ^a
Items Subject to Substantial Information Reporting and Withholding	10.5	1.2%
Wages, salaries, and tips	10.5	1.2%
Items Subject to Substantial Information Reporting	9.1	4.5%
Interest income	1.6	3.6%
Dividend income	1.1	3.7%
State income tax refunds	0.6	11.6%
Pensions & annuities	4.2	4.1%
Unemployment Compensation	^b	11.1%
Social Security benefits	1.1	5.8%
Items Subject to Some Information Reporting	50.6	8.6%
Partnership, S-Corp, Estate & Trust, etc.	22.0	17.8%

⁸ The following two paragraphs are based generally on: U.S. Department of the Treasury, Internal Revenue Service, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance*, Washington, DC, August 2, 2007, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

Category	Tax Gap (\$B)	NMP ^a
Alimony income	^b	7.2%
Capital gains	11.0	11.8%
Deductions	13.5	5.4%
Exemptions	4.2	5.4%
Items Subject to Little or No Information Reporting	110.1	53.9%
Form 4797 income	3.3	64.4%
Other income	22.6	63.5%
Nonfarm proprietor income	68.0	57.1%
Farm income	5.8	72.0%
Rents & royalties	13.4	51.3%
Total Statutory Adjustments	-3.0	-21.1%
Other Items	17.1	26.3%
Credits	17.1	26.3%
Total	197.4	18.0%

Source: U.S. Treasury, Internal Revenue Service, February 2007

- a. NMP = Net Misreporting Percentage, the net amount of income or offset misreported divided by the amount that should have been reported.
- b. Less than \$0.5 billion.

Economic Analysis

The following economic analysis discusses the debate over the two components of the new 1099-MISC requirements—the effect the requirements will have on the tax gap and tax compliance, and the effect the requirements will have on small businesses. The policy of enhancing reporting requirements is then evaluated considering these two effects.

Effect on the Tax Gap and Tax Payment Compliance

The JCT has estimated that the new information reporting requirements will generate \$17.1 billion in increased tax revenue over a 10-year period. This estimate implies that the new provision will increase federal revenue by about \$1.7 billion per year, on average. As discussed previously, the 2001 net tax gap was estimated to be \$290 billion. When this figure is adjusted for inflation, it suggests that a ballpark estimate of the 2010 tax gap is \$356 billion dollars.⁹ Therefore, the extra \$1.7 billion in revenue generated from the new information reporting requirements is estimated to reduce the tax gap by 0.50%, or one half of a percentage point.

The JCT estimates also imply an increase in tax payment compliance as a result of the new reporting requirements. Tax payment compliance is the amount of taxes voluntarily paid over the

⁹ The inflation adjustment is made using the Consumer Price Index – All Urban Consumers (CPI-U). The CPI-U was 177.1 in 2001 and 217.3 through June 2010. Source: <ftp://ftp.bls.gov/pub/special.requests/cpi/cpiat.txt>.

amount of taxes owed. According to the IRS, their estimate of the tax gap is consistent with an 83.7% tax payment compliance rate. Adjusting for inflation, the enhanced information reporting requirements are estimated to increase taxpayer compliance from 83.7% to 84.1%, or less than one half of a percentage point.

Most of the reduction in the tax gap that is expected to result from the new 1099-MISC requirements is due to the alteration in the cost-benefit structure of tax evasion. When deciding to pay taxes or not, businesses are thought to weigh the expected cost of evading taxes with the expected benefit. The expected cost of evading taxes is the probability of being detected (audited) multiplied by the cost of being detected (back taxes, interest, penalties, etc). The expected benefit is the unpaid tax liability. Because the new 1099-MISC requirements increase the actual or perceived probability of being audited, and therefore the expected cost of evading taxes, businesses should be expected to increase the amount of legally owed taxes that they pay.

The rather small revenue estimates and increase in tax compliance suggest that the probability that a taxpayer is audited as a result of the new requirements is expected to be rather small. This expectation may be due to a rational choice on the part of the IRS. That is, if they conclude that in most cases the unpaid taxes that they will recoup will not justify the cost of conducting more audits then the IRS would arguably not increase their audit rate. The IRS may make this determination because a large portion of the tax gap is probably comprised of small unpaid tax liabilities spread out over a large number of individual business taxpayers.¹⁰ The resources needed to collect many of these tax liabilities could exceed the increased revenue.

Given this, it is very difficult to project the effects of information reporting enhancements. It is possible that with aggressive document matching by the IRS reducing of the tax gap could eventually be significantly greater, as compliance with reporting dividend and interest income is quite high (see **Table 1**).

Effect on Small Businesses

Opponents of the new information reporting requirements primarily express concern with the effect on small businesses, arguing that the increased cost of complying with the new reporting requirements will burden small businesses to the point that they limit hiring, forego certain investments, or reduce the number of vendors they do business with. Preparing and mailing 1099-MISCs has the potential to increase costs, as thousands of these documents may be required. The preparation costs are arguably not insignificant because of the need to obtain the taxpayer identification number (TIN) of every business that a taxpayer bought at least \$600 worth of goods and services in a year from. A business may provide their TIN voluntarily, but are only required to provide it upon request. Opponents of the new reporting requirements claim that most business only provide it upon request, requiring taxpayers to contact a potentially large number of firms during tax seasons. This problem is likely to diminish over time as businesses become accustomed to providing their TIN. In addition, a business's TIN does not change so to the extent that the same vendors are used repeatedly, there will be no need to incur a cost in obtaining this information each subsequent year.

¹⁰ If the tax gap was largely due to a concentration of taxpayers that were not paying their taxes, the IRS would likely already have conducted an audit since the benefit of doing so would exceed the cost.

Empirical evidence tends to show that small businesses do in fact bear higher costs for tax compliance as a fraction of their size, when compared to larger businesses.¹¹ This finding appears to be due to the infrastructure larger businesses have in place to reduce tax compliance costs such as automated systems and internal tax personnel. To the extent that the new information reporting requirements increase compliance costs, existing research suggests that these costs may be disproportionately impact small businesses. Whether such costs will actually have the detrimental effects that opponents claim, however, depends on the degree to which compliance costs increases. At this time there do not exist any reliable studies that examine the cost to small businesses of the new reporting requirements.

Still, there are several reasons that small business may be able to avoid at least a portion of any additional cost in the short run, and experience a decrease in any remaining costs in the long-run. First, small businesses are already expected to file a 1099-MISC for the purchase of services in excess of \$600. Thus, to some degree, small business should have infrastructure in place and experience with information reporting. Moreover, there are some simplification aspects to the new requirements, as businesses will not have to distinguish between goods and services, or between corporate and non-corporate firms, which would reduce compliance costs. And for those small businesses that are not complying with existing information reporting requirements, it is not consistent accounting to include the cost of becoming compliant with existing requirements as a part of the cost of complying with the new requirements.

Second, one of the assumed costs of the new requirements is the additional recording keeping and paperwork that will result. But most businesses, including small businesses, should already have some system in place for such things as finances, inventory, payroll, and taxes, which presumably would lessen the additional burden of enhanced information reporting. Third, the IRS has indicated its intent to attempt to mitigate the burden in situations where duplicative reporting may occur. According to IRS Commissioner Douglas H. Shulman,¹²

the IRS will look for opportunities to minimize burden and avoid duplicative reporting. That is why we will be spending the next several months soliciting input from businesses of all types and sizes before proposing regulations to implement the law. We will also look to service providers who help those businesses understand and adapt to new laws and regulations, to help us craft a process that is as efficient as possible. We know that there is no “one-size-fits-all,” so we want to hear your ideas.

As a first step towards meeting this objective, the IRS has proposed exempting all transactions that would normally require a 1099-MISC, but that are carried out using a credit or debit card. This change is proposed because credit and debit card payment processors are required to file an information return with the IRS stating the total amount of credit and debit payments received by each business. Each business will receive a copy of the information return from the credit/debit payment processor. Since the IRS will already have information reports on credit and debit transactions, this allows them to exempt such transactions from additional 1099-MISC reporting.

¹¹ Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses*, Internal Revenue Service, Report to the Department of Treasury, Washington, DC, May 2002, and Joel Slemrod and Marsha Blumenthal, “The Income Tax Compliance Cost of Big Business,” *Public Finance Quarterly*, vol. 24, no. 4 (October 1996), pp. 411-438.

¹² Douglas H. Shulman, Prepared Remarks of IRS Commissioner Douglas H. Shulman Before the American Payroll Association and the American Accounts Payable Association, Internal Revenue Service, IR-2010-68, Washington, DC, May 27, 2010, <http://www.irs.gov/newsroom/article/0,,id=223835,00.html>.

Thus, small businesses can avoid the 1099-MISC compliance costs by conducting transactions with credit or debit cards. Existing research suggests that small businesses already use credit cards extensively.¹³

Finally, while small businesses may still face some additional costs to be compliant with the new requirements, these costs should fall over time. For example, businesses will become more familiar with which transactions require a 1099-MISC filing and which do not. Additionally, some may choose to purchase software to assist in the completion of their 1099-MISCs. These costs will be borne upfront, implying that the additional cost of the new reporting requirements will decrease over time.

Perspective on the effects of the new reporting requirements on small businesses can also be gleaned from looking at the financial sector. Financial institutions are required to send each person they pay at least \$10 of interest to in a year a copy of a Form 1099-INT. This requirement includes even small community banks that may have several thousand customers. These banks may have incurred a somewhat large cost upfront, but they appear to have been able to function in face of the requirements.

Perspective can also be gained by looking at the experiences of other countries. Currently, all other developed nations except the U.S. have a national value-added tax (VAT).¹⁴ A VAT requires all businesses, even small firms, to record and report an extensive amount of tax information. It could be argued that if a VAT, which is more administratively burdensome than the 1099-MISC requirements, can be successfully instituted then enhanced 1099-MISC reporting can be implemented as well. As is discussed when policy alternatives are presented, small firms could be partially reimbursed for the cost of the new requirements, a concept borrowed from the administration of Canada's VAT.

Policy Evaluation

The rather small impact on the tax gap could lead one to question the effectiveness of the new reporting requirements, although there is considerable uncertainty about this effect. There are two ways to evaluate the effectiveness of the new requirements. The first approach involves a cost-benefit analysis. Given that the government must raise revenue, the benefit of this provision is the \$1.7 billion increase in annual tax revenue. The cost of the provision are the compliance costs imposed on businesses and the administrative costs imposed on the federal government (IRS) as a result of the new requirements.

While the JCT estimate provide an approximation of the benefit of this provision, there are no reliable estimates of the compliance costs imposed on small businesses and the IRS. The analysis in the previous section suggests that the costs to businesses may be lower than many argue, however, there is still considerable uncertainty about actual costs. Similarly, there is uncertainty over the administrative cost to the IRS, which partly depends on how the IRS uses the information. On the one hand, if the IRS simply relies on their current infrastructure then the

¹³ Charles Ou and Victoria Williams, *Lending to Small Businesses by Financial Institutions in the United States*, Small Business Agency, in *Small Business in Focus: Finance*, Washington, DC, July 2009, pp. 9-38, <http://www.sba.gov/advo/research/09finfocus.pdf>.

¹⁴ CRS Report RL33438, *A Value-Added Tax Contrasted With a National Sales Tax*, by James M. Bickley. Some systems, however, exclude small businesses.

additional cost is probably small. On the other hand, if the IRS uses the information to increase audits or invests in new infrastructure to process the increased volume of new information, the cost would increase, but the cost would be partially offset by increased revenue due to increased enforcement. The new requirements would be seen as an effective way of decreasing the tax gap if cost to businesses and the government were less than the resulting increase in revenue.

The second approach involves comparing the new reporting requirements to alternative policy options for increasing small business tax compliance. The difficulty with other options, aside from reform of the tax system, is that they likely require a greater commitment of resources from the IRS. But a substantial portion of the tax gap, mainly the amount attributed to small businesses, is comprised of small unpaid tax liabilities spread out over a large number of individual taxpayers. The resources needed to recover these unpaid taxes would likely be rather large—larger than the amount of taxes recovered, and almost certainly larger than the resources required by the IRS to meet the new reporting requirements.

Potential Policy Alternatives

There are several policy approaches available to Congress as the debate over the new information reporting requirements continues. This section discusses a number these options as well as several other that are related to reducing the deficit.

Repeal Enhanced 1099 Reporting Requirements (Senator Johanns's and Representative Lungren's Proposal)

Repeal of the new information reporting requirements is a policy option if Congress concludes that the burden on businesses and the government from increased reporting exceeds the revenue increase. As discussed above, while there are reasonable estimates as to the how much this provision may reduce the tax gap, there are no similar estimates of the cost imposed on the IRS and taxpayers as a result of the increased complexity of the tax administration. It could be more or less than the expected revenue, but at this point, this question remains unanswered. Senator Mike Johanns and Representative Lungren have introduced Senate and House versions of a bill (S. 3578 and H.R. 5141) that would repeal the new requirements.

Repeal Certain Requirements

The requirement that payments to corporations must be reported could be eliminated while retaining the requirement that payments for both goods and services to small businesses be reported. A major reason for extending the reporting requirements to corporations is the growing share of corporations that are taxed as pass-through entities (Subchapter S corporations). But S corporations constitute a relatively small share of businesses—about 12% of all businesses, compared to sole proprietorships which represented about 72% of all businesses.¹⁵ As previously mentioned, however, requiring that payments made to corporations be reported prevents taxpayers from having to distinguish between corporate and non-corporate businesses.

¹⁵ Figures as of 2003. See Table 1 in CRS Report R40748, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, by Mark P. Keightley.

Alternatively, the requirement that payments for goods be reported could be eliminated, with the reporting of payments for services expanded to payments made to corporations. This proposal is one that has been included in several budget proposals of both the Bush and Obama Administrations.

Reevaluate Requirements in the Future

Due to the questions surrounding how burdensome the new reporting requirements may be on taxpayers and the IRS, Congress could choose to proceed with the new reporting requirements and reevaluate the policy after they have been in place for a year or two. The estimates of how much revenue the new requirements may generate are still just estimates. After the new requirements take effect, the IRS should have a better idea about how tax compliance and the tax gap were affected. They should also be able to get some sense of the distributional impact. For example, are the new requirements primarily increasing compliance among a particular group of taxpayers? If so, Congress could adjust the parameters of the requirements to better suit the objectives of the policy.

Increase Dollar Threshold (Senator Bill Nelson's Proposal)

The \$600 threshold that payments must meet to trigger the reporting requirements has not changed since at least 1954. An option available to Congress is to increase this threshold. A higher threshold would ease the burden many small businesses claim the new requirements impose since it would presumably reduce the number of transactions that require a 1099-MISC to be completed. At the same time, since fewer transactions would require a 1099-MISC, a higher threshold could reduce the ability of the reporting requirements to generate revenue.

A straightforward approach to determining a higher dollar threshold would be to simply adjust the current \$600 threshold for inflation since 1954. Doing so yields an inflation adjusted threshold of \$4,846, which is roughly in-line with a proposed threshold of \$5,000 contained in Senator Bill Nelson's amendment to H.R. 5297 (S.Amdt. 4595).¹⁶ There is some uncertainty, however, as to how exactly Senator Nelson's proposal should be interpreted. As the amendment currently is written, it could be interpreted as increasing the reporting threshold to \$5,000 for payments in exchange for goods but not services. But at least one outside source is interpreting the amendment to imply the \$5,000 threshold increase would apply to both goods and services.¹⁷ Regardless of whether the threshold is increased for all payments or just particular ones, annual adjustments to the threshold would prevent the compliance burden on taxpayers from rising over time due to inflation. At the same time, since inflation is variable this policy would add some uncertainty about the threshold amount each year.

¹⁶ Calculation based on the CPI-U, which was 26.9 in 1954 and 217.3 through June 2010.

¹⁷ Brett Ferguson, "Democrats Offer Small Business Legislation Amendment With Easier Form 1099 Rules," *Daily Tax Report*, August 9, 2010.

Exempt Small Businesses (Senator Bill Nelson’s Proposal)

Small businesses could be exempted from the new reporting requirements if Congress determines that they are disproportionately burdened.¹⁸ Proponents maintain exempting small business from the reporting requirements will not undermine the compliance objective a great deal. One of the objective of the requirements is to indentify income of the small business recipients. To the extent that the majority of payments made to small business come from larger business, the income of small firms would still be identified.

There are several issues that arise with this option. The first is determining how small is small. Senator Nelson’s amendment to H.R. 5297 (S.Amdt. 4595) would provide some sort of an exemption for businesses with no more than 25 employees. Again, there is some uncertainty over how Senator Nelson’s proposal should be interpreted. It could be interpreted as exempting these small businesses only in the case of payments for goods. But at least one outside source is interpreting the amendment to imply that small firms would be exempted across-the-board.¹⁹

Second, some have expressed concern that businesses might make employment decisions based on a employment-based definition of small business. For example, a firm with 26 employees could decide to terminate one employee so as to obtain relief from the reporting requirements. While such response could happen in theory, whether or not businesses will react in this way is an empirical question that remains unanswered. To the extent that this is a concern, an asset-based or gross receipts-based small definition could be employed.²⁰ An across the board definition of small business, whether it be employment-, asset-, or gross receipts-based may not be flexible enough to deal with industry differences. Some industries are naturally comprised of large number of small businesses. As a result, some industries could effectively exempt from the reporting requirements although they may have low compliance rates.

Reduce Burden on Small Businesses

There are a number of modifications that Congress might consider to reduce any burden on small businesses. One common complaint among businesses is that when completing a 1099-MISC they must include the payee’s tax identification number (TIN). For some businesses who work with a large number and range of vendors, obtaining all the required TINs could be quite burdensome. To reduce the burden businesses could be required to include their TIN on receipts, invoices, and websites.

Another impediment to compliance is an IRS requirement that those submitting paper 1099-MISC use a form printed with special red ink that can be scanned by the IRS. The GAO found that in 2006 nearly 90% of those taxpayers submitting a 1099-MISC used the paper format, although the majority of forms were submitted with a special electronic filing submission system

¹⁸ There are other employment-based regulations and requirements in existence. For instance, the Patient Protection and Affordable Care Act (P.L. 111-148) makes available a health insurance tax credit to certain businesses with no more than 25 employees.

¹⁹ Brett Ferguson, “Democrats Offer Small Business Legislation Amendment With Easier Form 1099 Rules,” *Daily Tax Report*, August 9, 2010.

²⁰ For example, the American Recovery and Reinvestment Act of 2009 (P.L. 111-5) provided businesses with \$15 million in gross receipts an opportunity to extend the carryback period for up to five years for net operating losses incurred in 2008.

that is required to be used if a taxpayer submits more than 250 forms. The GAO recommended that the IRS could upgrade its scanning technology to allow for the submission of generic 1099-MISC forms downloaded from its site. Alternatively or additionally the IRS could establish a free online entry and submission mechanism. The current electronic submission system requires a taxpayer to purchase special software or pay a vendor to complete their submission.²¹

Reimburse Small Businesses

Small businesses could be partially reimbursed for the cost of complying with the new information requirements. Small businesses in Canada are partially reimbursed for the burden placed on them from the administration of a VAT. For example, a small business could be reimbursed the cost of postage for every 1099-MISC sent to the IRS and another business. The reimbursement could come in the form of a business tax credit. Reimbursement via the tax code, however, could increase an already complex tax code.

Other Options to Reduce the Deficit

There are a number of alternative approaches for meeting the objective of reducing the deficit as well as the tax gap. Perhaps the most far-reaching entails reform and simplification of the tax system.²² Economists generally believe that an easily understood tax system with a broad tax base and low tax rates minimizes economic distortions and promotes greater taxpayer compliance. This is because such a system increases the cost to taxpayers of evading or avoiding taxes. Economic distortions are reduced because decisions are driven more by economic motives rather than tax planning motives.

If the reason for reducing the tax gap is to lower the deficit or finance particular programs than another option is to reduce government spending. The federal deficit is the difference between federal tax revenue and federal spending. Thus, the government may adjust either the revenue side via taxes and enforcement efforts, or by adjusting spending.

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²¹ See Table 1 on page 26 of *Tax Gap: IRS Could Do More to Promote Compliance by Third Parties with Miscellaneous Income Reporting Requirements*, GAO-09-238, January 2009, <http://www.gao.gov/new.items/d09238.pdf>.

²² See CRS Report R40414, *Tax Reform: An Overview of Proposals in the 111th Congress*, by James M. Bickley.