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ASSISTING SMALL BUSINESSES THROUGH THE TAX CODE: RECENT GAINS AND WHAT REMAINS TO BE DONE

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BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

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ASSISTING SMALL BUSINESSES THROUGH THE TAX CODE: RECENT GAINS AND WHAT REMAINS TO BE DONE

WEDNESDAY, JULY 23, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS
Washington, D.C.

The Committee met, pursuant to call, at 3:14 p.m. in Room 2360, Rayburn House Office Building, Hon. Donald A. Manzullo [chairman of the Committee] presiding.

Present: Manzullo, Velazquez, Schrock, Akin, Beauprez, Majette, and Sanchez.

Chairman MANZULLO. Today, the Committee will consider proposals for assisting small businesses through the tax code. We will first briefly review recently enacted tax relief for small businesses, but he primary focus of the hearing is to consider additional proposals that could further aid America's ailing small businesses.

Last May, the President signed into law H.R. 2, which provides $320 billion in net tax relief to American taxpayers over the next 10 years. A considerable portion of this relief is directed towards small business.

H.R. 2 assists small businesses by increasing the small business expensing provision and by lowering marginal tax rates. In addition, the bill increase first year bonus depreciation from 30 to 50 percent.

During the last Congress, Congresswoman Nydia Velazquez and I introduced H.R. 1037, the Small Employer Tax Relief Act of 2001. In preparing to revise that bill for reintroduction into the 108th Congress, it is important to solicit the very best ideas available for assisting small businesses.

With us this afternoon are seven distinguished witnesses. The panel is comprised of both government witnesses and representatives of small business advocacy groups. We look forward to hearing your recommendations.

We have got a problem on the Floor, and Ms. Velazquez and I think that we have votes that have been rolled in the Financial Services Committee, so what I am going to do is limit your testimony to four minute period. I want to get through the group here, and I want to start with the non-government witnesses and the witnesses who have come from out of town so in case we have to adjourn this in a hurry the people that have come the farthest distances and have been inconvenienced the most at least will have had an opportunity to get their testimony heard.

Ms. Velazquez, did you have an opening statement?

Ms. VELAZQUEZ. Yes, sir.

Chairman MANZULLO. If you could go ahead and do that, I would appreciate that.

[Mr. Manzullo's statement may be found in the appendix.]

Ms. VELAZQUEZ. Okay, thank you, Mr. Chairman.

Small businesses are the engine of this economy. They are key to our recovery. Unfortunately, they face many challenges today, including inequities in federal contracting health care, federal regulations and the U.S. Tax Code.

Small businesses account for 44 percent of all federal revenue, yet they must deal with the up-front costs of taxes in addition to high compliant costs. With regard to tax compliance, there is a substantial gap between costs to large and small firms. The cost per employee for small businesses topped the cost for large firms by 114 percent.

The tax code does not have to operate in a manner to stifle growth. It can be used as a tool to ensure that this nation's small business are able to offer quality health care and comprehensive retirement plans to their employees as well as provide incentives to reinvest their cash back into their businesses.

However, the current tax code has done more to impede small business growth than encourage it. This stem from the complexity of the tax code as well as the IRS continual failure to address the impact its rules and regulations have on small businesses. As a result, small businesses are left to outsource their complex tax work which is extremely costly.

Earlier this year, this Committee looked at the ways the IRS has consistently failed to comply with the Regulatory Flexibility Act. Today, we will look beyond the regulatory structure and examine how we can change the Internal Revenue Code to account for the needs of small businesses.

Not only has the IRS failed to address the needs of small businesses in ensuring the rules and regulations, but Congress has also failed to consider the adverse effects that the tax code has on small businesses. Too often our laws, though well-intended, unfairly harm small businesses because of the one-size-fits-all approach. We must hold ourselves accountable for the burden that we place on small businesses and rectify these inequities.

In 2001, the National Small Business United released a groundbreaking report entitled "The Internal Revenue Code: Unequal Treatment Between Large and Small Firms." This report brings forth what small businesses have been claiming for years: the U.S. tax system fails them. This study showed how the Internal Revenue Code unfairly put small businesses at a disadvantage in comparison to large firms and outlined reforms for fixing the system.

Whether it is deductibility of health care for the self-employed, expensing meals and entertainment, or standard home office deductions, small business aren't able to reap the same benefits as their corporate counterparts. This tax report was a tremendous step forward in exposing the unfairness this system poses for small businesses today. I was so impressed that I made sure every member of Congress received a copy.

However, to get the changes suggested in this report passed into law, small businesses need the support of this administration. In March 2002, President Bush released his small business agenda, promising that he will simplify the tax code and provide small businesses with the relief they need.

Although the administration voiced its commitment to helping small businesses get the tax relief they have, long been asking for, recent moves have shown just the opposite. The 2003 tax code is a perfect example.

The President had a $350 billion pie to provide at least some tax relief to small businesses. Instead, the bulk of the bill was aimed at providing tax relief to large corporations in the form of a dividend tax cut. The small business relief that was in the tax cut was completely inadequate.

The two provisions specifically aimed at small businesses, the bonus depreciation and increased expansion, both expire after only a few years, and not one of the proposals in the NSBU report was passed into law.

Small business deserve better. Today's hearing is an opportunity to assess the real impact of the U.S. Tax Code on our nation's small businesses. The President claims that a reduction in the top rate is a reduction in taxes for small business owners. However, the 2001 cut failed to impact the growth of small business and the acceleration of these tax codes in the 2003 package will do little to enhance the prosperity of small business owners and their employees.

So, Mr. Chairman, I look forward to the witnesses, and thank you very much for giving me this opportunity.

Chairman MANZULLO. Thank you.

We are going to go in this order: Mr. Pitrone, Mr. Quick, and Ms. Poppen, because you are from out of state, and if we have to inconvenience anybody, I want it to be the people that hang around here and not the people that come to visit.

[Laughter.]

Chairman MANZULLO. What I would suggest is I want to keep the testimony to four minutes, go immediately into your suggestions. The purpose of this is to gather suggestions, so you do not have to take two minutes to say how nice it is to be here. And then take your hottest issue. Several of you have several suggestions you want to make, but give us your best one or two so we can concentrate on that, and then, of course, we have all of your written testimony.

And the first witness is Tom Pitrone. Is that Pitrone or——.

Mr. PITRONE. I'm Sicilian. It's Pitrone.

Chairman MANZULLO. Oh, Pitrone. Well, I am Sicilian, we pronounce the vowel, and I am the Chairman.

[Laughter.]

Chairman MANZULLO. And you need to have the microphone before you, Tom, and he is the principal of The Integrity Group on behalf of the National Small Business Association. We look forward to your testimony.

STATEMENT OF THOMAS C. PITRONE, THE NATIONAL SMALL BUSINESS ASSOCIATION, AND PRINCIPAL, THE INTEGRITY GROUP, CLEVELAND, OHIO

Mr. PITRONE. Thank you, Chairman Manzullo.

Well, I just want to thank you, and Ranking Member Velazquez, for this opportunity to testify.

I am with the NSBA, which was formerly the NSBU. It is National Small Business Association, and we representing small businesses in all 50 states, 65,000 in all, and as Representative Velazquez mentioned, we commissioned the Prosperity Institute to provide the study that she referenced, so I will not dwell on that. I will just go right into the issues that we have selected as our priorities from that report.

There was three that our members felt were the most important. The first is pension parity, the second is Section 125 cafeteria plans, and the third is the tax on the money that small businesses use to pay their insurance premiums, the FICA tax on those dollars.

Pension parity is pretty simple. If you have a company you want to provide a pension, there is quite a bit of government regulation that impacts your ability to do that. Fixed cost as got to be a minimum on the simplest plan of $1,500 a year to $2,000. If you have 100 plus employees, that is easy to absorb. If you have 10 or less employees, it is almost impossible to absorb, and you cannot do it yourself.

Congress recognized that problem when they same with a simple plan which does not really cut the cost to the small businesses, just simpler. You still have to make mandatory contributions to all your employees' accounts, which is probably more than the cost of the administration, but it is simpler.

However, a simple plan caps out at an $8,000 annual contribution, a regular 401(k) plan caps out at $12,000, so there is a bid disparity between what a small business owner can put away using a simple plan and what a larger business using a 401(k) can put away.

On the cafeteria plans, it allows you to pull money out of your pay check pre-tax and set up flexible spending accounts. They are great because they allow you to pay for things with pre-tax dollars like day care for your children, but by definition a small business owner is not an employee, and so they cannot participate.

And if you cannot participate, you probably are not going to set one up, and therefore your employees are not going to be able to participate, which means that people lose the ability to provide day care with pre-tax dollars, among many other issues.

And the finally, small businesses, even though they now can deduct the cost of their insurance premiums, it is after they pay Social Security and Medicare tax. So for small business who pay both sides of that, it is a 15 percent tax on the money that they use to pay for their health insurance premiums, and that has a disproportionate impact on small business who are not making a lot of money because they are closer to the social security cutoff of about $87,000.

So those are the issues that we feel are the top priorities for correction in our tax code as being—we are not looking for something

special, we are looking for the same treatment that large businesses have on these issues. And I just want to thank you for the opportunity to testify.

[Mr. Pitrone's statement may be found in the appendix.]

Mr. SCHROCK. [Presiding]. Thank you, Mr. Pitrone. And because I am only Subcommittee Chairman, you are Mr. Pitrone.

Mr. PITRONE. Thank you.

[Laughter.]

Mr. SCHROCK. Our next witness is Roy Quick, who is part owner of the Quick Tax & Accounting Service, a small business that is headquartered in St. Louis, Missouri. And I am told that his very capable business partner and wife, Elizabeth Quick, is in the audience today, and I welcome her.

Is she here? Welcome, it is nice to have you here.

Mr. Quick is appearing in front of the Committee today to present the recommendations of the U.S. Chamber of Commerce. Welcome, Mr. Quick.

STATEMENT OF ROY M. QUICK, JR., U.S. CHAMBER OF COMMERCE, AND PRINCIPAL, QUICK TAX & ACCOUNTING SERVICE, ST. LOUIS, MISSOURI

Mr. QUICK. Thank you. Good afternoon, Mr. Chairman and Ranking Member.

I am Roy Quick, Principal of Quick Tax & Accounting Service. We applaud your dedication and interest in reducing the tax burdens faced by the nation's 24 million small businesses. The following suggestions are from the written testimony submitted.

In 2003, self-employed——.

Mr. SCHROCK. Mr. Quick?

Mr. QUICK. Yes?

Mr. SCHROCK. Could you pull the microphone closer?

Mr. QUICK. Sure.

Mr. SCHROCK. Thanks. We do not have a very good system here.

Mr. QUICK. Okay.

Mr. SCHROCK. We are trying to save tax-payer dollars, so we are using the old system.

Mr. QUICK. Okay. In 2003, self-employed individuals and partners in a partnership will finally achieve 100 percent deductibility of health insurance costs for federal tax purposes. However, these small businesses are at a definite disadvantage when it comes to the health care issue. They must pay higher premiums to insurance companies due to their small pool of workers. They also have the double whammy of also paying self-employment tax on their health insurance premiums.

This tax fairness measure will have a collateral effect of encouraging access for the three million self-employed individuals who currently do not have health insurance. As a matter of equity and fairness, the Self-Employed Health Care Affordability Act, H.R. 1873, should be passed without delay.

As a matter of equity with other retirement vehicles, the due date for the IRA contributions should be the same as the tax filing date, including extensions. Many times a sole proprietor does not have the cash to pay the balance due on his tax return, the first

quarter estimated tax payment, and fund the IRA all at the same time.

This simple change should be revenue neutral while benefiting small business and stimulate retirement savings as well.

Also, small businesses are disadvantaged in the tax code when it comes to marketing and selling their products and services. Many large companies have on-site facilities suitable for presentations, negotiations, and meals that are fully deductible as an ordinary and necessary business expense.

For the small business owner, the kitchen table or shop floor is unsuitable for marketing services or negotiating a contract, and the best alternative is usually a meeting over a meal at a local restaurant.

Currently, a small business can conduct 50 percent of the meal cost. To me, there is no difference in utilizing a restaurant to provide a presentation to a client than an in-house corporate dining facility. The restoration of full deductibility of restaurant meals as a business expense would help the restaurant industry, which is made up of mostly small businesses, and has been particularly hard hit over the last two years.

We also feel that the increase in the expensing allowance under I.R.C. 179 should be made permanent. Other areas needing relief are that legislation should be enacted to treat computers and peripheral equipment in the same manner as off-the-shelf software, ensuring cost recovery prior to obsolescence.

Second, small business owners often invest large sums improving their store front's building, interiors or shop floors to remain competitive. The recovery period for leasehold improvements is 39 years is an unreasonable span of time.

And the term "luxury car" is a misnomer in the tax code as the limitations are so narrow they restrict recovery of even modestly priced vehicles. These constraints are sorely need of updating.

The last White House Conference on Small Business ranked worker classification as the number one issue facing small business. The existing rules are too complicated, confusing and subjective.

Mr. Chairman, H.R. 1783 and the Senate companion bill introduced by Senator Bond in the 107th Congress contained objective criteria to determine who is not an employee. Included in this bill was anti-abuse language to avoid problems of wholesale reclassifications and legitimate employees as independent contractors.

In order to encourage long-term growth within the American economy, providing continued small business tax reform must be a top congressional priority. The small businesses to continue to lead the economy additional tax reforms are warranted, and those already enacted must be made permanent to encourage jobs, savings and investment. Implementation of the recommendations previously set forth will go a long way towards these ends.

And I thank you.

[Mr. Quick's statement may be found in the appendix.]

Mr. SCHROCK. Thank you very much.

This is obviously a St. Louis, Missouri day because our next witness is Janet Poppen, who is the President of Poppen & Associates in St. Louis, and she is appearing before the Committee today on

behalf of Women Impacting Public Policy. And I understand that Congressman Todd Akin is your congressman.

Ms. POPPEN. Yes, he is.

Mr. SCHROCK. And I am going to turn it over to Todd for a more formal introduction.

Mr. AKIN. Thank you, Mr. Chairman.

It is a pleasure to make the introduction. Janet, in fact, is President of Poppen & Associates. That is a CPA firm that she formed in 1995 with her son, Gavin, I believe. And Janet is not only a dedicated advocate of small businesses in St. Louis, but also nationally. She has received numerous awards for her efforts, including the Missouri Society of Certified Public Accountants Distinguished Service Award for the year 2000.

Janet has over 25 years of experience providing financial and tax service. She is a member of the National Association of Women Business Owners and a member of the Regional Commerce and Growth Association Public Policy Council in St. Louis,

And it is a pleasure, Janet, to welcome you here. Thank you.

STATEMENT OF JANET K. POPPEN, WOMEN IMPACTING PUBLIC POLICY, AND CEO, POPPEN & ASSOCIATES, ST. LOUIS, MISSOURI

Ms. POPPEN. Thank you, Representative Akin. I appreciate your introduction.

Mr. Chairman, it is a pleasure to be here, and I am going to talk really fast. I want to commend what you are doing here today. It is so important to us, and there is a specific bill, H.R. 1873, it is in my testimony. It allows the self-employed individuals to deduct their health insurance expenses from self-employment tax, before the calculate self-employment tax, and this is so long overdue. It is an gross inequity; 15.3 percent tax right now is paid on the health insurance premiums.

Again, there are the inequities in the pension system and the deductions that are available.

I guess our message from WIPP, Women Impacting Public Policy, is that fringe benefits treatment in the tax code should be the same no matter how you are organized. Whether you are a C corp, an S corp, and LLC, a partnership or a sole proprietorship, the amount of complexity that is in the tax code based on form of doing business is outrageous. You know, if you want to do something for small business, give us one set of rules and let us stick to them, and a start is 1873.

Automobile expense is the next biggest boondoggle I think most of us have ever seen, and this impacts small businesses much more than the larger businesses, particularly in the automobile leasing area. The rules are again extremely complex.

But what we want to bring to the table today is something that we are going to call the simplified employee benefits plan. The Section 125 plans that were talked about are very expensive in terms of administration for small businesses, and we would like to take this proposal using similar to a SEP plan. You know, the government has an SEP prototype plan.

If there were for small businesses such a plan as the simplified benefits plan, we could roll those benefits—the child care expense

that my employees have that I cannot afford a special 125 plan and the monthly maintenance fees for that, plus the—you know, long-term care insurance someone else wants to purchase, or any other health costs that they may have, their deductibles, this type of thing.

In a larger business, they can absorb the costs of the various benefits administrators for all those types of plans, but this is plan that has not been suggested before, and we would like to put it before you and see if there is not something that you could do for small business, and our employees.

We employ over a third of the people in the—a third of the employees belong to small businesses, and these people typically do not have access to these tax-deferred salary plans. We would like to see you do something for them, and it could be done fairly simply.

We do have a benefits advisor in WIPP, and she would be happy to work with you on details in fleshing this out a little bit.

I would also like to talk about the MSAs and the HRAs and the flexible spending accounts. We want to encourage you to allow greater contributions by both employees and employees. You know, one of the problems in lumping the plans together under the simplified benefit plan is that we have only employer contributions allowed. We need to have employee using a salary tax deferred plan as well as the employer being able to put tax-deductible monies into these plans for employees. It would certainly open the benefits field for small businesses.

And I thank the Committee for taking its time and bringing us to D.C. so that we can present this to you. Again, Representative Akin, thank you for the kind introduction, and I am out of time.

Mr. SCHROCK. You are and you did it right on time. That is great. We thank you.

Ms. POPPEN. Thank you.

Mr. SCHROCK. Thank you very much for coming.

Ms. POPPEN. Thank you.

[Ms. Poppen's statement may be found in the appendix.]

Mr. SCHROCK. Now we are going to go back to the local folks, or when I was growing up what we called the "townies." And we are going to start with Tom Sullivan, who is the Chief Counsel for Advocacy at the U.S. Small Business Administration.

Tom is no stranger to this Committee, having appeared before us on several occasions during the past year and a half, and he will briefly review the tax benefits for small businesses contained in H.R. 2, the Jobs and Growth Act enacted into law just two months ago. He will also provide us with his recommendations for further assisting small business through the tax code.

Maybe my colleagues can correct me here, but this is the third day in a row we have been with Tom Sullivan, and I think House rules say that he if he appears one more day, I am allowed to claim him as a dependent.

[Laughter.]

Mr. SCHROCK. So we are going to look into that, and if that is the case you belong to me after tomorrow. We are glad to have you here, Tom. Thanks.

STATEMENT OF THE HONORABLE THOMAS M. SULLIVAN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ASSOCIATION

Mr. SULLIVAN. Thank you, Mr. Chairman. Actually, I am here because new rules allow for us to keep frequent flyer miles. I was told that if I appeared here enough that those miles will accumulate.

[Laughter.]

Mr. SCHROCK. He works two blocks away, so I do not know.

Mr. SULLIVAN. Mr. Chairman, Congressman Velazquez, Members of the Committee, thank you for allowing me to testify this afternoon.

The Office of Advocacy is an independent office within SBA, so the views expressed here do not necessarily reflect the views of the administration or the SBA. My statement was not circulated within the administration for comment or clearance.

Advocacy promoted a number of the provisions in the President's jobs and growth package, and we were pleased with the bill's emphasis on small business. Many of the provisions in the law received widespread support from small business during congressional consideration. These provisions will have a significant positive impact on small business.

First and foremost, the Jobs and Growth Act provided useful changes in Section 179 expense and have been long sought by advocacy, many of you, and the small business community.

Section 179 has been useful for small businesses. Using 1999 tax data, 69 percent of the businesses that elected to expense their purchase were sole proprietors and individual farmers. Expensing simplifies capital purchase and has the effect of reducing the cost of purchasing capital goods.

Last night, I spoke with Paul Cunningham, who owns the Schreiner's Restaurant, they are a National Restaurant Association member in Fond du Lac, Wisconsin. Schreiner's is a destination restaurant where, because of its tradition of home-cooked meals, seven different pies baked every day, reasonable prices and a friendly, family atmosphere, customers drive for hours—often making the three-hour drive from Chicago—to eat there.

Paul and his general manager, Michael, told me that the average distance his customers travel to eat at Schreiner's is 60 miles, and he talked about—last night when we talked, he talked about his long-term desire to update equipment. The restaurant first opened in 1938 and Paul bought the restaurant from Bernie and Regina Schreiner 10 years ago, and according to Paul, in our conversation, the Jobs and Growth Act that just passed two months ago comes at a perfect time because he can now spend the amount necessary to buy new equipment, replacing things that are 30 years old.

The Office of Advocacy study on the federal regulatory burden in 2001 showed the tax compliance costs for small firms was roughly twice as much as their larger counterparts. Tax compliance costs are $1200 per employee for very small firms versus $562 for larger firms. That is a significant handicap for small business. Anything Congress can do to further simplify tax compliance would provide relief to small businesses from the burden of this disadvantage.

Research by my office that goes into greater detail in my written statement shows that providing certainty in the tax code gives

small businesses the confidence to make decisions for the long-term viability and growth. Giving small business the ability to invest with confidence in their future is good for business and good for our economy.

The specific recommendations that are in great detail in my written statement are making increased expensing permanent, permanently repealing the death tax and repealing the alternative minimum tax.

I do apologize to the Committee that the example I used of Schreiner's Restaurant was not in my written statement. I was not able to reach Paul, the owner, until last night which was after the deadline to submit it to the Committee.

Thank you.

[Mr. Sullivan's statement may be found in the appendix.]

Mr. SCHROCK. Next time bring him with his pies. That would be most welcome, believe me.

[Laughter.]

Mr. SCHROCK. Our next witness this afternoon is—is it Nina or Nina?

Ms. OLSON. Nina.

Mr. SCHROCK. Nina. I had an Aunt Nina, so I thought I had better ask. And since I am only the Subcommittee Chair, I will do as you wish.

Ms. OLSON. Thank you, sir.

Mr. SCHROCK. Ms. Olson is the National Taxpayer Advocate at the IRS, and as the National Taxpayer Advocate Ms. Olson serves as an advocate for taxpayers to the IRS and Congress. A number of the recommendations included in past national tax payer advocate reports to the Congress concern small businesses, and we look forward to hearing your recommendations for assisting small business through a very cumbersome tax code. Thank you.

STATEMENT OF THE HONORABLE NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE

Ms. OLSON. Thank you, Mr. Chairman, for inviting me here today.

As you know, each December the National Taxpayer Advocate submits a report directly to Congress in which I identify the 20 most serious problems facing taxpayers and make administrative and legislative recommendation to mitigate those problems.

One of our recommendations addresses a common problem facing a husband and wife who co-own an unincorporated business, such as a family farm. Under current tax law, this couple must file a partnership return for the business which can require very complex recordkeeping and reporting.

In practice, most of these businesses take a short cut. The file a single sole proprietorship schedule reporting all income to one spouse. Unfortunately, this results in only one spouse accruing social security quarters and being eligible for Social Security, disability, survivor or Medicare benefits. This disparity can have devastating effects on the small business of the ineligible spouse is disabled or dies. The couple does not have the income to replace that spouse's labor.

We propose that married couple who co-own and operate an unincorporated business be permitted to file a single sole proprietorship or farm schedule, and then allocate the profit or loss between them. That way each can pay self-employment tax on his or her share.

Because this election would be only available to couples who file joint income tax returns, it will not affect the amount of income tax due, and for most taxpayers it should have no impact on the amount of self-employment tax payable since the vast majority of these businesses report income below the social security wage cap.

We believe this proposal is a win/win situation. It simplifies the tax laws, reduces burden on small taxpayers, it eliminates an area of noncompliance that is completely inadvertent, and helps protect small businesses from potentially devastating losses.

We are pleased that the House of Representatives passed this proposal as part of H.R. 1528 in mid-June of this year.

Our other proposals for what I call tax sanity for small business take the same common sense approach. For example, we believe that the current due date for electing subchapter S corporation status is counterintuitive and leads to taxpayer confusion and missed deadlines.

Our proposal aligns the active making the S election with a significant due date of filing the first corporate income tax return, and thus significantly reduces the changes of botching the election.

Other proposals include permitting self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment, creating a de minimis threshold for applying passive loss limitations, permitting income averaging for commercial fishermen to the same extent it is available to farmers under current law, repealing the AMT, and my personal favorite, the one-time stupid act penalty waiver for the failure to pay and failure to file penalties when the taxpayer is a first-time filer or has a history of compliance.

My office is open to suggestions for improving the tax system. We now have an e-mail address available at our web page at IRS.gov for taxpayers, including members of Congress, to submit proposals to improve the tax system.

Thank you for the opportunity to appear here today to discuss these recommendations. I am please to answer any questions you may have.

[Ms. Olson's statement may be found in the appendix.]

Mr. SCHROCK. Where have you been all my life?

[Laughter.]

Mr. SCHROCK. Gosh, a lot of people at the panel at the table were shaking their heads yes, so obviously you struck a responsive cord there. Thank you very much.

Our next witness is Dan Mastromarco who recently authored a lengthy study for the National Small Business Association on the unequal treatment in the tax code between large and small businesses, and we are very much looking forward to having you summarize the findings of what I am told is a very fascinating study.

Thank you for being here.

STATEMENT OF DAN R. MASTROMARCO, PRINCIPAL, THE ARGUS GROUP

Mr. MASTROMARCO. Thank you. As you know, I authored the study. I will try to keep this to four minutes because I know that following somebody by the name of Quick and WIPP, you know, helps keep your attention focused on that.

But let me ask just one small favor. I believe the Committee hearing could more properly be named "Removing Penalties Against Small Businesses." Because if one were to review the debates over the 10,000 code sections in the code, one would find that each was haled as a victory by its sponsors.

But in the 90 years since Teddy Roosevelt filed his two-page return tax rules span 40,000 pages of interminable sentence of very small type that when strung together occupy five volumes of translucently thin paper that requires a lawyer with an exceptionally high tolerance for boredom to read.

Albert Einstein said preparing his return was too difficult for a mathematician. It takes a philosopher.

[Laughter.]

Yet the code grows. The greatest assistance, Mr. Chairman, you can provide is repeal the misguided assistance of the past 100 congresses.

Free market economists——.

Mr. SCHROCK. We may be good, but we are not that good.

[Laughter.]

Mr. MASTROMARCO [continuing]. Should have but one directive. This is the directive: Inflict the least amount of harm.

Now, I will leave the reflections of past successes to others, only to say really that the Jobs and Growth Act begins the very long process of removing penalties that I refer to in my study. Rather than listing all the inequities in the study, causing the panel to miss the next vote, probably the rest of the legislative year, I will mention just a few.

Consider the dysfunctional operation of the nondiscrimination rules. Who could be against nondiscrimination? It's kind of like the Patriot Act. Everybody should be for it. But consider, for example, that Code Section 79 provides an employee may exclude group life insurance from income. That is worth a lot. $50,000, that is worth if you qualify. However, 85 percent of the plan participants—this the law—must be other than key employees, which are employees who own at least five percent of the employer.

Well, I have got a simplification proposal for the code. Why not just take Section 79 and rewrite it to say that small firms cannot provide life insurance until they have at least 10 employees, because that is precisely what that proposal says. And it also says that cafeteria plans, dependent care assistance plans, educational plans are not available if you own two percent of the business.

Well, one might ask with all these nondiscrimination rules who is being discriminated against? In this case, it is small firms subsidizing tax breaks for their large firm competitors.

Let me skip to my recommendations, and I offer several suggestions.

First, introduce a small business penalty relief act. Few elected officials pass up the opportunity to criticize the Internal Revenue

Service, even though they are simply a bureaucracy to implement the rules that Congress has passed. The key to assisting small firms is to help tax writers see a small business penalty relief act as a way of transforming their rhetoric into action.

Second, look towards a systemic solution. One idea would be to pass a law requiring members of Congress to actually own a small business for five years. I am not sure that you would do that.

Mr. SCHROCK. Stepping over the line a little bit.

[Laughter.]

Mr. MASTROMARCO. Well, another probably less problematic suggestion might be to require Finance Ways and Means Committee members to actually file their own tax returns.

But barring that, another way of doing it would be to require the Joint Tax Committee, when they provide the revenue estimates, to analyze the distribution of those benefits by the size of firm.

And lastly, I will just add this because I am over my time, consider fundamental tax reform. Look to fundamental tax reform, and analyze it. Do not reject it because it is politically risky. Consider the effects of what it would do to for small business because, in my view, the income tax will only be truly simplified when it resides in a paragraph in an American tax book on history.

[Mr. Mastromarco's statement may be found in the appendix.]

Mr. SCHROCK. Thank you very much.

Well, our last witness, certainly not the least, you have sat in the middle. You probably thought you would be done by now I am sure, is Dena Battle, the Manager of Legislative Affairs for the NFIB, the National Federation of Independent Business, and the nation's largest small business group.

Ms. Battle is no stranger to this Committee, and we are looking forward to hearing what she has to tell us for tax priorities for small business advocated by NFIB.

Thanks for coming.

STATEMENT OF DENA BATTLE, MANAGER OF LEGISLATIVE AFFAIRS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Ms. BATTLE. Thank you very much. Thank you, Mr. Chairman, Distinguished Members of the Committee, I am happy to be here testifying on behalf of NFIB.

I would like to highlight a few of the improvements that NFIB would like to see made in the tax code.

First and foremost, we would like to see finishing the job of providing full deductibility of health care costs for the self-employed. We are part of a coalition that is advocating on behalf of H.R. 1873, the Self-Employed Health Care Affordability Act sponsored by Chairman Manzullo, and I would just echo what has already been said; that the self-employed should not have to pay——.

Ms. VELAZQUEZ. Excuse me. And Congresswoman Velazquez.

Ms. BATTLE. I am very sorry.

Ms. VELAZQUEZ. Thank you.

Ms. BATTLE. Absolutely, and thank you for your work on behalf of that legislation.

And I would just say that self-employed should not have to pay Medicare and FICA taxes on health care costs.

The second change to the tax code that Congress should make is establishing a standard home office deduction. If a small business owner rents space in an office building, then the owner simply deducts the rent and utilities from their taxes. However, if the small business owner has an office in their own home, the process is much more complicated.

In the case of a home-based office, the small business owner has to depreciate the actual room in their home. Because of the complicated process, many business owners never take these legitimate deductions.

The third change to the tax code that we believe would dramatically impact small business owners is updating automobile expensing. Many of you might have heard during the recent debate on the tax plan the SUV loophole.

Congress never intended to create an incentive for small business owners to buy larger cars. However, changes in the tax code sometimes come with unintended consequences.

Under the current law small business owners are allowed to expense up to $100,000 of equipment in a taxable year. However, Congress does not allow small business owners to expense automobiles. There is one notable exception. Congress did allow for the expensing of vehicles that were over 6,000 pounds for farmers and construction equipment. Cars or vehicles under 6,000 pounds still have to be depreciated.

Not only are small business owners required to depreciate vehicles under 6,000 pounds, Congress also decided to impose further limitations to prevent the purchase of luxury vehicles. This might seem reasonable until you realize that Congress defines a luxury vehicle as any car over $15,300. The result of this law is that there is a disincentive in the tax code for small business owners to buy cars under 6,000 pounds. The NFIB believes that Congress should allow all vehicles regardless of weight to be expensed.

These are just a few examples of tax code improvements that would have a significant impact on small businesses. There is still much work that needs to be done. Our members are constantly frustrated with the complexity of our tax code, and they pay millions of dollars annually for accountants and tax advisers. More and more of them face the nightmare of the alternative minimum tax every year, and they are still paying costly fees to attorneys and accountants to avoid losing their business to the death tax.

But this hearing is a sign of the progress being made. Mr. Chairman, Members of the Committee, Ranking Member Velazquez, thank you for your efforts on behalf of small businesses.

[Ms. Battle's statement may be found in the appendix.]

Mr. SCHROCK. Thank you very much, and thank you all for being here and for your statements today.

And yes, we do mean business, and you have the main Chairman—who says Pitrone instead of Pitrone—who is very keen on solving some of these problems, and I think there are many members on this Committee on both sides of the aisle who want very much to fix this problem. It is a huge problem and it needs to be fixed.

I would like all of you to prioritize your recommendations, and in your opinion what is the single most important initiative for as-

sisting small business owners through the tax code, the one thing that you think would help the most?

We will start with Mr. Pitrone.

Mr. PITRONE. I would have to say the parity for pension plans would be a big benefit for small businesses.

Mr. SCHROCK. Mr. Quick.

Mr. QUICK. Mr. Chairman, I would say the ability to make the health insurance premiums deductible for self-employed from—eliminate them from payroll tax.

Mr. SCHROCK. Ms. Poppen.

Ms. POPPEN. I would say the simplified benefits plan would be our priority.

Mr. SCHROCK. Tom, do you have any thoughts on that?

Mr. SULLIVAN. yes, I would agree with Congresswoman Velazquez, and urge for permanence, permanence in the types of deductions that are available under the Jobs and Growth Act.

Mr. SCHROCK. Okay. Ms. Olson.

Ms. OLSON. I would say clarification of the worker classification rules.

Mr. SCHROCK. Mr. Mastromarco.

Mr. MASTROMARCO. All of the above.

Mr. SCHROCK. All of the above. You are too politically correct, are you not?

Ms. Battle?

Ms. BATTLE. It seems to me that many of the issues that were brought up today are merely examples of simplifying the code.

Mr. SCHROCK. Yes.

Ms. BATTLE. And making the tax code simpler for small businesses is really what we need to do.

Mr. SCHROCK. Okay. I think in the interest of time I am going to defer to Ms. Velazquez and see if she has any comments.

Ms. VELAZQUEZ. Sure. I want to thank all the witnesses. This is an important hearing that will help us, well, discuss and work hard to make sure that those issues that are important to small businesses will—that we here in Congress and the White House, also the administration will pay the kind of attention that we put into some other issues, because I have to tell you that when it comes to promoting economic recovery in our nation and having the opportunity to pass a tax cut that was supposed to create and stimulate the economy, what I saw out of the $350 billion tax cut that we passed was that big businesses were the winner.

And so that is my first question, and it will go to Mr. Sullivan. As part of the President's small business agenda, he promised small businesses that he will provide them with a permanent tax relief that they needed. And one of the things that he promised was increased expensing. And while the 2003 tax cut did increase the expensing limit, the administration and the Republican leadership decided to sunset this provision in 2005, to make room for the dividend tax cut.

So I am interested to see what is your opinion about that. I know that you said that that is one of the issues that we should make—you know, that you agree with me.

Mr. SULLIVAN. I agree with you in making the provision permanent. I disagree with you that the President's small business agen-

da implementation has been opposite of his March statement in 2002.

Ms. VELAZQUEZ. Well, you know, last year the President released his small business agenda in March. A year and a half later we could go throughout the five important items that he put into that agenda, and I could tell you that none of those items has been addressed.

But I would like to hear from NFIB because I know that you were quite active in making sure that small businesses were not left behind, out of the $350 billion, and you are outraged that instead of giving small businesses a permanent relief on expensing, that at the end it was sunsetted.

Ms. BATTLE. Well, we certainly were very happy when the President initially put out his plan that called for a permanent Section 179 increases. And we would have liked to see that pass through Congress.

We are sort of used to taxes sometimes sunsetting in Congress. It happens because of rules in the Senate.

Ms. VELAZQUEZ. Especially for small businesses.

Ms. BATTLE. Well, that has certainly been the case with tax repeal and also with Section 179, and with other things. But ultimately we do feel that what passed in H.R. 2 will be very beneficial to our members. The accelerated rate cuts were a top priority for our members, and we are very hopeful that the Section 179 expensing limits will be made permanent by Congress.

Ms. VELAZQUEZ. I love your optimism.

I have a question for Mr. Mastromarco. I am an original co-sponsor of H.R. 1873, the Self-Employed Health Care Affordability Act of 2003. This bill is designed to remedy only one of the many inequities in the tax code as described in Mr. Mastromarco's report that unfairly impact the self-employed and small businesses.

Although those solutions seem simple enough, my question is this. How did this inequity ever make its way into the tax code as well as many of the other provisions mentioned in your report?

Mr. MASTROMARCO. It is a good question, Congresswoman. My view is that they made it in there, and I do not want to answer this in a philosophical way, but it is important to understand, because in many cases in tax policy debates the interests of small business are just after thoughts, and that was the reason for my view and recommendation that the Committee really look to speak with Chairman Thomas and others about systemic solutions to the problem.

For example, go right into the Committee, that tax writing Committees and ask the Joint Tax Committee to analyze the disproportionate distribution of tax expenditures that exist.

For example, you will find that the R&E tax cut is taken by the nation's largest pharmaceuticals, although the light bulb, the six-axis robot arm, the large capacity computer, the personal computer, and just about any innovation that we cherish today was invented by small firms.

Ms. VELAZQUEZ. Thank you. My time is up.

Who is in charge?

Mr. BEAUPREZ. [Presiding] Mr. Akin.

Mr. AKIN. Thank you. I would just like to just thank the entire panel. We see a lot of panels of witnesses and I do not think that I have ever seen a big a one as you are and yet people being more specific and very helpful in your comments. I just wish that somehow I could wave a wand and let you go to work on the tax code and see what you could come up with. I think together you would come up with good stuff, and probably a lot of simplification.

Some of the bills you have made reference to, we have passed out of the House. We have some difficulty getting them through the whole process, but certainly the couple that you have mentioned we have gotten through the House. But thank you all for coming. Thank you.

Mr. BEAUPREZ. Thank you, Mr. Akin.

I am not really sure who I want to direct this question to, but I guess I will ask a general question, and see who has got an answer.

Does anybody among the panel have an estimate of the cost of—you have all talked about the complexity of the tax code. Anybody got an idea of what especially business pays to comply with tax?

Mr. MASTROMARCO. There are many estimates out there, and they range anywhere from $100 billion, from Joel Slemrod at the University of Michigan, all the way to $400 billion on the top end. If you take the estimate somewhere in the middle, it's going to about 250 billion or so, the median estimate for the entire compliance costs.

But it is important to understand, Mr. Chairman, that compliance costs are fixed costs. That is, when small businesses incur them, they cost more per employee in small firms, more than they do in large firms. So when you have an economy that contains many small firms, vertically integrated businesses have a great advantage because compliance costs cascade from one business to the next.

Mr. BEAUPREZ. Yes, I am somewhat familiar with that. I am actually one of the members of both Congress and this Committee that has run a small business before, so I am quite familiar with that.

Mr. MASTROMARCO. So you like my legislative idea?

Mr. BEAUPREZ. Well, I would perhaps go—it is attractive.

Mr. MASTROMARCO. You would increase it to 10 years.

Mr. BEAUPREZ. Let me follow that line of thinking so I do not spend the entire afternoon here.

How many businesses, roughly, out there in America that are burdened with this quarter of a trillion dollars?

Mr. MASTROMARCO. Well, depending on who you ask—and that is because there are establishments and others——.

Mr. BEAUPREZ. Sure. Wild guess.

Mr. MASTROMARCO. And Tom would probably answer that question better——

Mr. SULLIVAN. There are approximately 23 million——

Mr. MASTROMARCO [continuing]. But, about 23 million——.

Mr. SULLIVAN [continuing]. Small businesses.

Mr. BEAUPREZ. Okay, so we have got 23 and a half million small businesses expending somewhere around $250 billion a year to comply with the tax code that we wrote, and before I came to Con-

gress, frankly, still after I came to Congress, I consider that essentially tax. It is an expense imposed on businesses by the government, cost of compliance.

One question, and then I have got another one to follow up with you, why do we not maybe consider a deduction for that burden that we have imposed on them?

Mr. MASTROMARCO. I think that is a very good idea. If you look at some of the fundamental tax reform ideas, for example, the fair tax, national sales tax plan, that is exactly what they do.

Mr. BEAUPREZ. What is the fatal flaw? There is a couple, is there something that is unfair or inappropriate or?

Ms. POPPEN. Well, in terms of tax compliance at the individual level, the cost of tax compliance is subject to the two percent of adjusted gross income flow before it is deductible. And so that would hit the small entrepreneur.

However, as a business expense, it is 100 percent deductible, so in effect what you are charging them to comply they are deducting for the most part.

Mr. BEAUPREZ. Deducting the direct expense.

Ms. POPPEN. Direct expense from business income.

Mr. BEAUPREZ. But still there is a marginal—the marginal effect of that.

Ms. POPPEN. There could be a marginal effect when it is reported at the individual level.

Mr. BEAUPREZ. Right.

Ms. POPPEN. And the expenses taken there.

Mr. BEAUPREZ. Mr. Pitrone?

Mr. PITRONE. I think that that is not the whole picture. I for one, I deduct the cost of taking my taxes to an accountant for preparing, but I have, you know, probably close to 100 hours in the course of a year that I am doing other things that go into being able to deliver——.

Mr. BEAUPREZ. Yes, the last small business I ran, and my wife runs, a little community bank, we had a whole department that took care of stuff for the taxman; you know, a fairly significant expense. And another one that we have not even talked about is regulation, but we will do that another time.

Ms. OLSON. Sir, the——

Mr. BEAUPREZ. Go ahead.

Ms. OLSON [continuing]. Fatal flaw in that is that if you allow that for small businesses, as the taxpayer advocate I would say you would need to allow that for individuals when you look at the paperwork——.

Mr. BEAUPREZ. And that would be okay with me too.

Ms. OLSON. Okay. All right. You know, just figuring out whether a child is your dependent——

Mr. BEAUPREZ. You bet.

Ms. OLSON [continuing]. Or entitled to head of household deduction or whatever you——.

Mr. BEAUPREZ. Which leads me to the place I really want to go. You have all kind of talked around the complexity and I think we all accept that. It is nightmarish on this side of the tax code or that side of the tax code. I think we would all concur.

Other than Mr. Mastromarco, have I pronounced it right?

Mr. MASTROMARCO. That is correct.

Mr. BEAUPREZ. I did not hear anybody talk about kind of the mega tax reform. There is two proposals out there; the so-called fair tax, which is really a national sales tax and a flat tax. And since my red light is on, if you have got an opinion on that, I would be very curious as to what it might be, and why do we not just go from my left to right real quickly.

Ms. POPPEN. I am not familiar with the fair proposal, but the flat tax proposal still lacks some equity, and there would still be the requisite amount of recordkeeping necessary. So I do not see that it is a big savings, and perhaps some of the other benefits in the tax code such as home ownership and so forth would be—you know, the mortgage interest deduction, that kind of thing—yes, go around.

Mr. BEAUPREZ. Let us go real quickly if we could because I do not want to monopolize.

Mr. QUICK. Okay, on the flat tax or the fair tax, you have to be very careful of unintended consequences because our whole country's economic system is based on the current tax code. And if you start telling people they cannot deduct their charitable contributions, how is that going to affect not-for-profit agencies?

You still have the same amount of recordkeeping no matter what kind of tax you have.

Mr. PITRONE. National Small Business Association has formally endorsed the fair tax, and I personally endorse the fair tax, and have worked to get the Ohio Chamber of Commerce to endorse it.

Mr. BEAUPREZ. Okay.

Ms. BATTLE. Our members certainly support tax simplification, but if you poll them on the methodology of it, they are definitely split, so I think the jury is still out, but we support overall tax simplification.

Mr. BEAUPREZ. Okay. Mr. Mastromarco?

Mr. MASTROMARCO. You know, perhaps there could be another hearing at this Committee, and a good one, but there are many groups, including NSBA, state groups, American Farm Bureau and others that support the fair tax, but nothing really could be simpler than having small business pay zero tax and individuals file absolutely no returns and exempting purchases up to the poverty line, which makes it the fair tax.

So as a tax lawyer practicing for 15 years, I have come to the conclusion that the only way the system can be resurrected, and by the way, the economy is not based on the income tax, it is based on entrepreneurship and business, is to eliminate entirely the income tax from the face of this planet.

Mr. BEAUPREZ. You are so subtle.

[Laughter.]

Mr. BEAUPREZ. Ms. Olson.

Ms. OLSON. Well, I get to dodge this because I am very practical, and no matter what tax system you enact I will have a job solving taxpayer problems.

[Laughter.]

Mr. BEAUPREZ. What a nice dodge.

Mr. Sullivan.

Mr. SULLIVAN. Mr. Chairman, actually, the Office of Advocacy is unique in the federal government in that we serve as a channel for small business views up to the President and to Congress, and so when Ms. Battle puts it the jury is still out, we would try to work with the Committee and work with small business groups to get more of a definitive finding, and then we will pursue it aggressively.

Mr. BEAUPREZ. I would encourage you to continue to pursue it because it is at least my opinion that all of the suggestions that you have raised, which I think have merit, differing degrees of merit perhaps, but merit, kind of underscore how we got where we are. We nibble here, and we poke there, and the tax code continues to morph and create job security for some people, but tremendous expense, confusion, and complexity for others. And you said serious reform, that is where we are at.

Ms. Majette.

Ms. MAJETTE. Thank you, Mr. Chairman, and thank all of you for being here today.

I would certainly agree with you that it would be very helpful if we had more members of Congress who have been small business owners. I happen to be one of those, although I did not do it for five years, but at least for three, and my husband continues to be a small business owner, but it certainly has given me a very different perspective than the one I had before I had that experience.

And I would also agree with all of you that the tax code does need to be simplified, and certainly perhaps we will be able to have another hearing on that issue.

I do have a couple of questions, one for Mr. Quick. You talked about the increasing the amounts that small businesses can deduct for meals and expenses, entertainment expenses, and that whole issue does come up against some opposition.

Is there a way that you think that we can increase the percentage that businesses can deduct for those expenses but prevent the kind of fraud and abuse that sometimes is raised in the context of giving that kind of a deduction?

Mr. QUICK. Well, I feel that there is a lot of rhetoric on that subject, but people raised the objection of the three martini lunch talking about fraud.

To me, any small business owner that has a three-martini lunch will not have a small business for long.

[Laughter.]

Mr. QUICK. I personally feel that small businesses' marketing expenses over a meal are no different than a corporate dining room, and I am from St. Louis and Anheuser-Busch billboard along the highway.

Ms. MAJETTE. All right.

Mr. BEAUPREZ. We have got 15 minutes, so if you want to continue, go right ahead.

Ms. MAJETTE. All right. Thank you for that.

And on the issue of the expensing provision, I think it is a little bit frustrating that we did have some adjustments made but that that is not a permanent situation. I think that makes it difficult for businesses to plan.

What do you see as being a way that we can address that issue, and are there particular industries or companies or businesses that you think would gain the most from having a permanent increase in the expensing levels?

Mr. QUICK. All small business will benefit from the permanent increase in the expensing levels. What they need is the ability to plan so that they can have certainty when they hire people, create jobs, invest in equipment which in turn creates more jobs, I think, across the board. I do not think there is any specific industry. Your technology industries and your small manufacturers probably would benefit the most from it, but all small business buys equipment. Thank you.

Ms. MAJETTE. Thank you.

And with respect to the worker classification, Ms. Poppen, you had address that issue, what do you think—if we can get some of that done, some of that reclassification done, where do you think we could focus those efforts so that we maximize the benefit of that?

Ms. POPPEN. There was a bill that did not make it out of the Senate last year. It had a more objective standard to it. And I think the viewpoint is when small businesses pair up to do something, whether those are individual, sole proprietorships, or two partnerships or two S corporations to accomplish a contract, we end up in a position where we are trying to blend those two companies into one, one must employ the other, and this is a problem when it comes to the small, particularly technology businesses where they may have one or two employees in a particular thing pairing with another, technology business, and one of them has to become an employee, and this is not right because then we are dealing about benefit plans, and we are taking everything away from those two individual companies that they have developed, and forcing them into one hat, if you will.

So that is why we need to get some good objective definition so that these pairing arrangements can happen; that someone can work for me five days or three days, and someone else two days, that kind of thing. And it gets lost in the whole big business kind of concept, you know, where there have been abuses in the past.

Ms. MAJETTE. Thank you. I see my time is up. Thank you.

Mr. BEAUPREZ. Ms. Velazquez, do you want to recognize the group that just entered the room? I think you know them.

Ms. VELAZQUEZ. Sure. These are students from my district, lower Manhattan, and I want to thank them for being here today. They are asking for the administration not to eliminate resources for youth program, and that is the only way that we can keep crime down in our nation. So I want to thank them for being here.

[Applause.]

Mr. BEAUPREZ. I want to thank all the panelists. I think this too has been an exceptional panel, and you participated with us or cooperated with us in getting a good hearing in, in between our calls to vote. And you just heard what the Chairman refers to as the bells of tyranny go off, so we will be on our way.

I will declare this hearing adjourned. Thank you very much for you input.

[Whereupon, at 4:17 p.m., the Committee was adjourned.]

Opening Statement

Donald A. Manzullo, Chairman

Assisting Small Businesses Through the Tax Code— Recent Gains and What Remains to Be Done

Hearing before the U.S. House of Representative
Committee on Small Business

Wednesday, July 23, 2003, at 2:00 p.m.
2360 Rayburn House Office Building

Today, the Committee will consider proposals for assisting small businesses through the tax code. We will first briefly review recently enacted tax relief for small businesses, but the primary focus of the hearing is to consider additional proposals that can further aid America's ailing small businesses.

Last May, President Bush signed into law H.R. 2, the Jobs and Growth Reconciliation Act of 2003. This bill provides $320 billion in net tax relief to American taxpayers over the next 10 years. A considerable portion of this relief is directed toward small businesses.

Specifically, H.R. 2 assists small business owners by increasing the small business expensing provision from $25,000 to $100,000 and lowering marginal tax rates. Eighty-five percent of small businesses pay taxes at the individual rates and the acceleration in the reduction of individual income tax rates is very helpful to small businesses. In addition, the bill increases first year bonus depreciation from 30 to 50 percent—a provision many small business owners will find helpful.

During the 107th Congress, I introduced, together with the Committee's Ranking Member, Nydia Velázquez, H.R. 1037, the Small Employer Tax Relief Act of 2001. In preparing to revise that bill for reintroduction in the 108th Congress, it is important to solicit the very best ideas available for assisting small businesses through the tax code.

To that end, we have with us this afternoon seven distinguished witnesses—a panel comprised of both government witnesses and representatives of small business advocacy groups. We look forward to hearing your recommendations.

As is customary, the hearing record will remain open for two weeks and I would encourage all interested parties to submit their proposals for the record.

We look forward to the testimony of the witnesses this afternoon. On behalf of the Committee, I wish to thank them all for coming, especially those who have traveled far. I now yield for any opening statement by the gentle lady from New York, Ms. Velázquez.

Testimony of Thomas Pitrone,

The Integrity Group

On Behalf of
The National Small Business Association

House Small Business Committee Hearing
"Assisting Small Businesses Through the Tax Code – Recent Gains and What Remains to be Done"

July 23, 2003

1156 15th Street, N.W., Suite 1100
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Introduction

I would like to thank Chairman Manzullo, Ranking Member Velazquez and the other members of the Small Business Committee for the opportunity to testify before you today. My name is Thomas C. Pitrone and I am a principal of the Integrity Group, a financial planning practice I started with my father, Frank P. Pitrone. Since we started our business in 1983, we have worked to guide individuals through the complexities of the tax code while finding the most intelligent ways for our clients to plan for their future. Overall, I have been active in estate, succession and investment planning for small businesses for over twenty years.

I also come before the committee today as a representative of the National Small Business Association (NSBA). The National Small Business Association, formerly National Small Business United, is the nation's oldest bipartisan advocate for small business. NSBA represents over 65,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations across the country. The goal of our association is to protect and promote our members and all of our nation's small businesses before Congress and the Administration. We, at the NSBA, work toward this goal by working with Congress, the media, our direct members, affiliates and a national audience as a small-business advocacy organization.

Background

I have been a member of the National Small Business Association for 15 years and now chair our Tax Committee. For many years, NSBA cataloged small business owner's criticisms of the tax code. An overarching feature of the varied complaints was that the tax code frequently discriminated against small businesses. Without fully knowing what we would discover, NSBA commissioned the Prosperity Institute to conduct an exhaustive review of the U.S. tax code and document which provisions directly put small firms, and their owners, at a disadvantage.

As we released the report, titled *The Internal Revenue Code: Unequal Treatment Between Large and Small Firms*, during Small Business Week in 2002 even we were amazed by the wide-ranging disincentives for our nation's small business owners built into the tax code. While most of the offending regulations appear to unintentionally harm small business owners, some are blatantly discriminatory. All should be fixed.

Since the report was so wide-ranging, NSBA's members voted on three top priorities to focus on in the 108th Congress. We are encouraged by the progress we have made thus far on the issues that I will now summarize.

Pension Reform

Small-business success requires owners reinvest compensation derived from their trade back into the business. This is especially of concern when entrepreneurs begin to survey retirement plans for their families and their employees. In the past 20 years, Congress has amended and revised the tax laws governing pension plans about every ten months, adding new layers of complexity with every change. Starting with the Employee Retirement Income Security Act (ERISA), created in 1974, these changes have contributed significantly to a steep decline in small-business pension plans. The 2003 Employee Benefit Research Institute's *Small Employer Retirement Survey* highlighted small employers' failure to participate in pension plans stating that, "(J)ust 34% of full-time workers in small private establishments (99 or fewer workers) were covered by a retirement plan." Two provisions embedded in the tax code are important factors in this disturbing trend.

First, nondiscrimination rules, key-employee clauses and plan administration costs drive many small business owners away from popular defined contribution pension plans. Owners that do begin traditional 401(k) or other plans for their employees must deal with administrative burdens and fees designed with large corporations in mind. The cost of administering even a simple profit-sharing plan is around $1,500. A larger company easily absorbs this cost. However, it is often an overwhelming burden for a small

business. Strict nondiscrimination rules also disproportionately affect the smallest firms who lack the diverse employee pool characteristic of large firms.

Congress, in effect, has acknowledged that the regulatory environment surrounding popular pension plans is too onerous for small businesses by creating Savings Incentive Match Plans (SIMPLE). Created in the 104th Congress, SIMPLE plans allow small business owners and their employees access to tax benefits awarded to traditional qualified pension plans but with greatly reduced regulatory burden and cost. Unfortunately, this acknowledgement comes with a serious cost to participants. Current rules allow a traditional 401(k) participant to put away $12,000 in tax-advantaged dollars for retirement while a SIMPLE 401(k) participant may only save $8,000. It is stunning that Congress would penalize the small-business community's ability to save for retirement in the same legislation that acknowledges it is hard for them to do so.

It is important to note that President Bush has offered a genuine fix for the problems identified above in the Employer Retirement Savings Accounts (ERSA) proposed in January of this year. ERSAs would follow existing rules for 401(k) plans but with greatly simplified administrative burden, reduced testing requirements and no top-heavy rules. The President's actions show that the administration is clearly interested in helping to bring retirement security to those in our nation now most likely not to have it.

Section 125 "Cafeteria Plans"

Current law prohibits most entrepreneurs from taking advantage of benefits widely available to employees in the form of "Cafeteria Plans" or education assistance programs. Small business owners who are self-employed, partners in a partnership, Limited Liability Corporation members and more than two percent shareholders in an S Corporation are specifically banned from participation in these plans because they are not employees as required by Internal Revenue Code section 125(d). Cafeteria plans and their like can be used by participants to save in tax-advantaged accounts for health care, childcare, eldercare and education costs. Non-discrimination rules also bedevil those

small business owners who could participate if organized as a C Corporation but who are too small to satisfy non-discrimination testing.

NSBA believes that excluding small business owners from "Cafeteria Plan" benefits is both unfair to entrepreneurs and detrimental to plan adoption. An individual should not be deprived of widely available savings on health care and education costs because they took a risk and started their own business. This inequity is a clear example of a tax provision that penalizes entrepreneurship.

Self-employment Tax on Healthcare

As many members of this committee are very aware, we have recently crossed the finish line in a small-business victory that was a long time coming. Just this year, small business owners will be able to deduct the cost of their health care against their income taxes. A genuine thank you to all who helped fix this glaring error.

Many of you are also aware that our job is not finished. As the law stands now, self-employed individuals still pay for their health care with money that has been subject to the self-employment tax. All employed individuals pay the FICA tax on their income, of which 6.2% is allotted for Social Security and 1.45% goes to Medicare. Employers are required to match employee contributions with a 7.65% contribution of their own. Self-employed individuals are required to pay both sides of this tax resulting in a total 15.3% tax on income, commonly referred to as the "self-employment tax."

Contrary to rules for C Corporations, a provision of the Internal Revenue Code requires self-employed individuals to pay the additional 15.3% self-employment tax on the cost of their health care premiums. No other worker is required to pay FICA taxes on any portion of their employer-sponsored health benefits. With health care costs already sky-high, our members find it unbelievable that the federal government would slap an extra tax on those who have the hardest time securing coverage in the first place.

Chairman Manzullo and Ranking Member Velazquez are to be commended for recognizing this inequity and introducing H.R. 1873, the Self-employed Health Care

Affordability Act. Their bill, supported by many members of this committee, can immediately reduce the cost of health care for our nations self-employed by a substantial amount.

Conclusion

The three issues outlined above illustrate clear examples where individuals who decide to enter into business for themselves are penalized. As most any business owner will tell you, it takes a lot of courage to strike out on your own. Being unfairly discriminated against in the tax code does not have the effect of encouraging the American Dream.

I have to assume that Congress is not intentionally trying to disadvantage entrepreneurs' nest eggs, make it harder for them to pay for their loved ones elder care or pay for their own family's health care. I assume this because I always hear in speeches that small-business is the backbone of the economy. We hear that small businesses will pull us from recession, create new jobs and drive innovation. If all of this is true, then I hope we can continue to work together to fix the problems identified today.

We are making good progress thus far with the help of members on this committee through H.R. 1873 and the White House's desire to simplify and expand pension plan adoption. On behalf of NSBA, we look forward to continuing working with you to achieve equity in our nation's tax code.

Statement of the U.S. Chamber of Commerce

ON: **Assisting Small Businesses Through Changes In the Tax Code - Recent Gains and What Remains to be Done**

TO: **House Committee on Small Business**

DATE: **July 23, 2003**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

STATEMENT
on
Assisting Small Businesses Through Changes In the Tax Code
Recent Gains and What Remains to be Done
Before
The House Small Business Committee
by
Mr. Roy M. Quick, Jr., EA
Quick Tax and Accounting Service
Saint Louis, Missouri
On Behalf of
The U.S. Chamber of Commerce
July 23, 2003

Chairman Manzullo, Ranking Member Velazquez and members of the Committee, I am Roy Quick, Principal, Quick Tax and Accounting Service, a 20 year old private home-based business practice located in Saint Louis County, Missouri. The business focus is primarily on small business, startup and individuals tax matters. Previously, I have served as Chairman of the Small Business/Self-Employed Subgroup of the Internal Revenue Service Advisory Council (IRSAC). Currently I am Co-Tax Chair for Region VII of the White House Conference on Small Business and also serve on the Council on Small Business of the U.S. Chamber of Commerce, the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region.

Over ninety-six percent of the Chamber members are small businesses with fewer than 100 employees. Chairman Manzullo, we applaud your dedication and interest in reducing the tax burdens faced by the nation's 24 million small businesses.

The Need For Small Business Tax Reform

In recent years, the importance of small businesses to our economic growth and prosperity has been unparalleled. As economic statistics confirm, maintaining a healthy environment for small businesses to proliferate contributes greatly to our economic expansion and to raising our standard of living. Small enterprises and startups form the foundation for our future economic prosperity.

Furthermore, small businesses have traditionally accounted for most of our nation's job growth. According to statistics from the Small Business Administration's Office of Advocacy, small businesses represent ninety-nine percent of all employers and generate three-quarters of all net new jobs. It would make sense, then, that any efforts to stabilize and grow the economy by job creation through fiscal policy should have a strong small business component.

It is sound economic policy and in the best interest of our country that small businesses be encouraged and nurtured through the promotion of tax policies that allow them the opportunity to devote more of their limited resources to their growth and investment, rather than to the expansion of government. This can be manifested in a number of ways, several of which are presented as follows:

Eliminate the Payroll Tax on Health Care Premiums for the Self-Employed

In 2003 self-employed individuals and partners in a partnership will finally achieve 100% deductibility of health insurance costs for federal tax purposes. Unfortunately, those self-employed and partnerships still cannot deduct health care premiums for the purposes of calculating payroll taxes (Social Security and Medicare). An equivalent exclusion from wages subject to payroll taxes is already enjoyed by owners of subchapter S corporations and C corporations.

As a matter of taxpayer equity and fairness, the treatment of the cost of health insurance premiums for all business forms should be brought to parity by allowing them to be deductible from revenue to derive net income, basing payroll tax (Social Security and Medicare) calculation on this net income figure. At a time when health care costs are soaring, small business owners should not be penalized by an additional tax on their health care premiums for merely choosing one form of business over another.

Furthermore, this tax fairness measure will have the collateral effect of encouraging access for the 3 million self-employed individuals who currently do not have health insurance. Small business self-employed and partnerships, in general, are twice disadvantaged when it comes to purchasing healthcare, not only must they have the added burden of self-employment tax (15.3%) on their health insurance premiums, they must also pay higher premiums to insurance companies due to their small "pool" of workers.

As a matter of tax equity and fairness, *The Self-Employed Healthcare Affordability Act*, H.R. 1873, should be passed without delay. I applaud the Chairman and Ranking Member's leadership for introducing this important bill.

Increase the Allowable Deduction for Business Related Meals

Small businesses are also disadvantaged in the tax code when it comes to marketing and selling their products and services over a meal. In the *Omnibus Budget Reconciliation Act of 1993*, the allowable deduction for business expenses was reduced to 50 percent. Since then, many small businesses, whose business depends on networking contacts, travel or personal presentations at restaurants have been unfairly penalized. Research completed in 1998 by some members of the Travel Business Roundtable showed that one-fifth of business meal users were self-employed, with more than two-thirds of business meal users having incomes of less than $60,000, and 37 percent having incomes below $40,000.

Currently, many large companies have on-site facilities suitable for presentations, negotiations and meals which are fully deductible as an "ordinary and necessary" business expense. For a small business owner, however, the "kitchen table" is unsuitable for marketing services or negotiating contracts and the best alternative is usually meeting over a meal at a local restaurant.

Currently, they can deduct 50% of the meal cost. If more than one other person attends the meeting, they get less than 50% personal benefit. Tax fairness would dictate full deductibility. For me, there is no difference in utilizing the atmosphere of a restaurant to provide a presentation to a client and a in-house corporate dining facility for a larger business. At the very minimum, small business owners should have parity with the allowance for those workers covered by DOT regulations.

Furthermore, the restoration of full deductibility of restaurant meals as a business expense would encourage travel and tourism within the United States. The hospitality and travel industry, which is made up of mostly small businesses, has been particularly hard hit over the last two years. As such, to restore fairness to the tax code for small businesses by allowing full deductibility of meals, as well as providing relief to the beleaguered travel and tourism industry is just good public policy.

Accelerate the Cost Recovery of Business Assets and Make Permanent the Increase in the Small Business Equipment Expensing Allowance

Under the recently enacted *Jobs and Growth Tax Relief Reconciliation Act of 2003*, businesses can annually expense up to $100,000 of asset purchases. This is a marked

improvement from the allowance of $25,000 provided by former law. The quadrupling of that figure was complemented by a doubling of the phase-out threshold, and both are, for the first time, to be indexed for inflation. Furthermore, the Act provides that off-the-shelf computer software is now eligible for expensing.

The Act also increased first year "bonus depreciation" introduced by the *Job Creation and Worker Assistance Act of 2002*, from 30 percent to 50 percent of the investment in qualifying business assets. Unfortunately, the legislation did not go far enough. The Section 179 increases expire after 2005, reverting to the $25,000 cap provided in earlier law. Bonus depreciation is set to fully expire after 2004.

In general, businesses investing more than the annual expensing allowance must recover the cost of their expenditures through an elective first year bonus depreciation and through mandatory cost recovery of the remainder over several years through the depreciation system. Inflation, however, erodes the present value of future depreciation deductions taken in all but the initial year of business use.

This injustice can be remedied through the full expensing of business personal property, or, at the very least, reduced through extension or permanency of the bonus depreciation and Section 179 expensing provisions, coupled with further increases to the Section 179 cap. Such measures would spur additional investment in business assets and lead to increased productivity and more jobs. They would also simplify the tax code and reduce compliance burdens for small businesses by allowing cost recovery in the year of asset purchase.

One such measure that would provide for the permanency of the newly enhanced Section 179 provisions is H.R. 2638, the *Small Business Expensing Permanency Act of 2003*, recently introduced by Representative Wally Herger (R-CA). The U.S. Chamber strongly supports this legislation and asks that the Congress make its enacting a priority.

Another reform crucial to small businesses would be the expensing or expedited cost recovery of investments in leasehold improvements. Small business owners often invest large sums in improving their storefronts, building interiors, or shop floors to remain competitive. The tax code currently provides for recovery over 39 years. We feel it is an excessive and unreasonable span of time, and that it should be changed.

We also feel that cost recovery provisions should keep up with technological advances. While the *Jobs and Growth Tax Relief Reconciliation Act of 2003* allows for expensing of off-the-shelf software, legislation should be enacted to treat computers

and peripheral equipment in the same manner, thus ensuring cost recovery before this equipment becomes obsolete.

Currently, the "listed property" or "luxury car" rules apply to limit cost recovery on vehicles. The term "luxury car" is a misnomer, as the limitations are so modest that they restrict recovery of even modestly priced vehicles. These constraints are sorely in need of updating.

Repeal the Individual and Corporate Alternative Minimum Tax

Originally designed to ensure that all taxpayers pay a minimum amount of taxes, the Alternative Minimum Tax (AMT) unfairly penalizes businesses that invest heavily in plant, machinery, equipment and other assets.

The AMT significantly increases the cost of capital and discourages investment in productivity-enhancing assets by negating many of the capital formation incentives provided under the "regular" tax system, most notably accelerated depreciation. To make matters worse, many capital-intensive businesses have been perpetually trapped in the AMT system, unable to utilize their suspended AMT credits.

Furthermore, the AMT is extremely complex, burdensome, and expensive to comply with. Even businesses not subject to the AMT must go through the computations to determine whether or not they are liable for the tax. While the *Taxpayer Relief Act of 1997* (P.L. 105-34) exempted "small business corporations" from the AMT, larger corporations and individuals may not be exempt. Furthermore, the tax code does not provide for indexing this onerous tax for inflation, leaving more and more middle-income individuals – including business owners taxed as individuals – vulnerable to the AMT. In fact, a 2001 study by the Joint Economic Committee projected that the number of individuals subject to the AMT would balloon to 17 million in 2010. While the AMT was originally geared to target high-income taxpayers, the lack of indexing is causing many middle-income taxpayers to get caught in its ever-expanding web – an unfortunate result that was inadvertently not protected against in the tax code.

Repealing the AMT would spur capital investment within the business community, thereby creating more jobs. The AMT system needs to be repealed – and, until that time, made less complex and easier to comply with. Good steps in that direction would include the raising of exemption amounts coupled with indexing for inflation.

Simplify/Clarify the Worker Classification Rules (Employee vs. Independent Contractor)

The reclassification by the Internal Revenue Service of workers from independent contractors to employees can be devastating to small business owners. Such reclassification often subjects a business to back federal and state taxes, penalties and interest, as well as administrative laws. To satisfy their assessments, business owners must dip into their cash reserves, lay off workers, sell assets, or in the worst-case scenario, liquidate or declare bankruptcy. In addition, businesses that choose to dispute IRS reclassification may have to deplete their resources to defend their positions. The last White House Conference on Small Business ranked this problem as the number one issue facing small business

Existing worker-classification rules are too complicated, confusing and subjective. Clearer classification guidelines – either statutory or regulatory – should be carefully written and include improved resolution of classification disputes and better training for IRS examiners. Mr. Chairman, your bill the *Independent Contractor Determination Act of 2001*, H.R. 1783, introduced in the 107th Congress and the Senate companion bill S. 837 introduced by Senator Bond in the 107th Congress, contained objective criteria to determine who is not an employee. This legislation would be significantly clearer and easier to apply than the existing subjective 20-factor test and "Section 530" safe harbor rules. Also included in this bill, was anti-abuse language to avoid problems of wholesale reclassifications of legitimate employees as independent contractors.

It is our hope that similar legislation would be introduced and passed in the current Congress. The worker classification rules must be clarified and thoughtfully reformed to increase flexibility and reduce burden for America's small businesses.

Expand Individual Retirement Accounts and Other Forms of Retirement Saving, and Simplify Overly Complex Pension Rules

As the nation's "baby boom" generation moves towards retirement, there is a growing realization that many individuals have not sufficiently saved for their retirement years. When considered along with an increased life expectancy and concerns regarding the future viability of Social Security, the necessity for a strong and effective private retirement system is paramount. Throughout the 1980s and into the mid-1990s, Congress amended the tax code and the *Employee Retirement Income Security Act* (ERISA) almost annually. This has resulted in a system of rules and regulations so complex that establishment of a retirement plan is often not an affordable business option for employers. This is especially true for small employers; lower coverage rates in this sector bear this out.

Congressional initiative is needed to simplify the pension law and increase the incentives for businesses, especially small employers, to offer retirement plans to their workers. While it is imperative that our nation's employee benefit system remains voluntary – giving employers the flexibility they need to tailor benefits to their own workforce – it is, likewise, important to enact legislation that encourages employers to choose to participate in the private retirement system.

For example, one change that would help small employers is to allow an extension for IRA contributions similar to that for other retirement vehicles. Under current law, all IRA contributions that are to be deducted from any year's income are due by April 15th of the following year. As a matter of equity with other retirement vehicles, the due date for the contribution should be the same as the tax-filing date including extensions. Many times the sole proprietor does not have the cash to pay the balance due, the first quarter estimated tax payment and fund an IRA all at the same time. Since retirement saving is a priority recognized by the federal government, the IRA contribution deadline should include extensions to help small business owners balance their short-term capital needs.

Additionally, legislation is also needed to allow workers to save more in Individual Retirement Accounts and 401(k)-type pension plans, thus allowing workers to save more for their retirement.

Make the Marginal Tax Rates Reductions Permanent

Most small business owners choose to organize as flow-through tax entities in order to do business, such as subchapter S corporations, LLC's, partnerships and sole proprietorships. According to the IRS, about 31 million Americans include small business income when they file their individual federal tax returns. Thus, small business owners are closely tied to the individual marginal tax rates. These rates will determine the level of personal savings as well as the ability to accumulate personal equity, retire debt, or expand operations.

Indeed, other than infusions of outside venture capital by third parties and cash generated by debt, the personal investment of savings, loans from family members, and the plowing back into the business of its profits throttles the expansion of most small businesses. Lowering individual marginal rates will have a positive affect on the ability of many entrepreneurs to expand. Taxes matter. As individual tax rates go down, entrepreneurial enterprises grow at a faster rate, they buy more capital, and they are more likely to hire workers.

Currently, small business taxpayers face uncertainty because they do not know whether the current tax rate reductions that were implemented in the *Economic Growth and Tax Relief Reconciliation Act of 2001,* and accelerated recently in the *Jobs and Growth Tax Relief Reconciliation Act of 2003,* are going to be permanent. This uncertainty hinders business planning and makes it difficult to make long-term business decisions.

Making permanent the reduction in the individual marginal income tax rates, provides the broadest possible long-term tax implications for both potential and incumbent entrepreneurs. It fosters entry, stimulates growth and provides a generally more robust small business community.

Also, reducing the marginal tax rates, not only for income taxes, but for those on dividends and gains from the sale of capital assets will put more money in the hands of taxpayers, will increase purchases of goods and services, and the resulting increase in demand will help businesses to grow.

Additionally, a lower capital gains tax rate will spur capital formation, mobility, and investment activity, thus creating jobs and expanding the overall economy, benefiting individuals of all income levels.

Make Permanent the Repeal the Estate and Gift Tax

The current federal estate and gift tax system can deplete the estates of those who have saved their entire lives, force family businesses to liquidate and lay off workers, and motivate people to make financial decisions for estate tax purposes rather than for sound business or investment reasons.

Family-owned businesses should not be punished for being successful or for having their owners pass away. Fundamentally, the United States is the land of opportunity, encouraging free enterprise and rewarding entrepreneurs. Estate and gift taxes run contrary to this basic philosophy. They are burdensome taxes that heavily penalize saving and investment, especially in family-owned businesses.

The *Economic Growth and Tax Relief Reconciliation Act of 2001* offered some progress in alleviating these problems, providing for reductions in the gift tax and the phase-out and temporary repeal of the estate tax. However, the prospect for the estate tax arising again looms in the distance, as it is set to do in 2011, wreaking havoc with attempts to plan for an orderly transition of businesses to subsequent generations. These taxes should be permanently repealed.

Permanently Extend the Research and Experimentation Tax Credit

The Research and Experimentation (R&E) Tax Credit encourages technology-based companies to invest additional resources into the research, development and experimentation of various products and services, which promotes both job creation and economic expansion.

The R&E Tax Credit should be permanently extended and expanded. It provides an extra incentive for firms to invest more in the research and development of their goods and services.

A permanent extension of the R&E Tax Credit, rather than temporarily renewing it during the political bargaining process, would provide businesses with continuity and certainty. A permanent credit would allow business to make long-range planning decisions, which are important in many fields where it takes years of research before a product can be brought to the market.

Reform the S Corporation Rules

S Corporations operate in every business sector in every state and account for almost one-half of all corporations. There are over 2.5 million S corporations nationwide and the vast majority of them, as small businesses, are responsible for most new jobs created each year. S corporations serve as useful vehicles for the organization and operation of family-owned businesses, offering the benefits of operating in corporate form, with the attendant limited liability of shareholders, while sparing the businesses' earnings from being subjected to double taxation.

The tax laws that currently govern these entities remain too restrictive, complex and burdensome. The current rules – adopted in 1958 when S corporations were created, and subsequently amended – are out of sync with modern economic realities and impede the growth of small businesses and burden them with unnecessary administrative complexity.

Despite the various S corporation tax relief provisions enacted in 1996 and in previous years, other reforms are still needed. The current rules should be liberalized, simplified, and clarified to encourage the growth of small businesses.

Reform the Federal Unemployment Tax Act (FUTA)

The Federal Unemployment Tax Act (FUTA) came into existence in 1939 to guarantee financing for a national employment security system. The idea was for

employers to pay the costs of administering the unemployment compensation and national job placement system. In return, employers would receive assistance in recruiting new workers and the unemployed would be able to find jobs more quickly.

The current maximum tax imposed is at a rate of 6.2 percent – including the "temporary" surtax of 0.2 percent that was added to the tax rate in 1976, and extended through 2007 – on the first $7,000 paid annually by employers to each employee.

It is time to end the "temporary" FUTA surtax and stop all attempts to collect the FUTA tax on an accelerated payment schedule.

It is also time to take a closer look at the system to determine if it is working properly, whether the federal government is collecting an appropriate amount of money from employers, whether claimants are receiving adequate benefits, and whether the states are receiving a sufficient return of dollars to fund services promised to workers and employers.

Permanently Extend the Work Opportunity and Welfare-to-Work Tax Credits

The Work Opportunity Tax Credit and Welfare-to-Work Tax Credit encourage employers to hire individuals from several targeted groups. Eligible workers under the Work Opportunity Tax Credit include, among others, economically disadvantaged youths, Vietnam veterans and welfare recipients. Eligible workers under the Welfare-to-Work Tax Credit include long-term family assistance recipients. Without the Work Opportunity Tax Credit and Welfare-to-Work Tax Credit, employers may have less incentive to hire individuals from the targeted groups.

Both credits should be permanently extended. They provide employers with an added incentive to hire disadvantaged individuals, which in turn, benefit the local and national economies. Permanent extensions would provide continuity and certainty to the income tax system and maximize the beneficial aspects of the credit.

Conclusion

In order to encourage long-term stable growth within the American economy, providing continued small business tax reform must be a top congressional priority. While many small businesses has been investing in research, building plants, buying equipment, expanding their markets, creating jobs and developing the workforce, this has happened against the backdrop of a federal tax code that is becoming ever more complex and uncertain and still often penalizes savings and investment.

If business – small business in particular – is to continue to lead the economy, additional tax reforms are warranted and those already enacted must be made permanent to encourage jobs, savings, and investment. Implementation of the recommendations previously set forth will go a long way toward these ends.

Testimony before

House Small Business Committee

on

**"Assisting Small Businesses Through the Tax Code-
Recent Gains and What Remains to Be Done"**

July 23, 2003

Janet Poppen

**Member of
Women Impacting Public Policy**
www.WIPP.org

Mr. Chairman and Members of the Committee, my name is Janet Poppen, CEO of Poppen & Associates CPA's, P.C., located in St. Louis, Missouri. I am appearing today on behalf of Women Impacting Public Policy (WIPP), a national bi-partisan public policy organization, advocating in behalf of women in business and minorities, representing 450,000 members.

We would like to commend the Committee for devoting time to this topic because of its importance to the small business community. We have seen significant movement on the resolution of tax issues facing small businesses but we have a long way to go. I believe some of our witnesses will address what has been accomplished in the past, so I will focus on changes to the tax code that would be beneficial for our members.

First, we want to commend Chairman Manzullo and Representative Velasquez for their leadership in the introduction of HR 1873, which allows self employed individuals to deduct health insurance costs in determining the self-employment tax. This is long overdue.

Secondly, we support H.R. 1117, introduced by Representative Christopher Cox, the Health Care Freedom of Choice Act. This legislation would provide 100% tax deductibility for an individual's medical expenses. It will enable those employees who seek health insurance through someone other than their employer to receive the same deductibility of those expenses, as would an employer. As this Committee knows, affordable health care is at the top of everyone's list when it comes to critical issues and

we appreciate the cosponsorship of Mr.Graves, Mr. Akin, Mr. King, Ms. Musgrave and Mr. Franks on this legislation.

The score for H.R. 1117, according to the sponsor of the bill, Representative. Cox, would only be $870 million a year. MIT economist Jonathan Gruber and the Kaiser Family Foundation's Larry Levitt in an article in Health Affairs (Jan/Feb 2000) found that revenues to the government would actually increase for those previously employer-insured. It is estimated that tax revenue from higher wages (in lieu of health coverage) would outweigh the cost of more people claiming a greater tax deduction. That is less than .7% of the worth of the current tax exemption for employer-paid health insurance, estimated to be about $126 billion in 2000. (White House, Council of Economic Advisers, "Health Care Tax Credits," February 14, 2002, p. 4). It is .3% of what the U.S. spent on Medicare in 2002 and less than .07% of the total national health spending (public and private) which was $1,2999.5 billion in 2002. (Center for Medicare and Medicaid Services (CMS), 2001). We believe Congress should take into account every mechanism possible to increase the ability of our employees to afford health insurance.

Small businesses still suffer discrimination in the tax code and should be fixed. Here are few examples:

- Pension contributions to simplified plans are lower than contributions to larger complex plans. The SIMPLE 401(k) type plan allows a lesser contribution than the standard 401(k). The Simplified Employer Plan (SEP) does not provide for a vesting schedule or the ability to exclude employees working less than 1,000 hours that is the usual standard in other prototype plans.

- Professional Corporations are taxed at a flat tax rate as opposed to the graduated corporate tax rate available to other businesses;
- Fringe benefits treatment in the tax code should apply fairly across the board. S Corporations, LLC's. Partnerships and sole proprietors should all be allowed to deduct their benefits costs directly from business income. Currently, the form of the business affects deductibility, which adds unnecessary complexity to the law for small businesses.
- Meals and entertainment costs are really advertising costs to small businesses because small business growth tends to be relationship rather than brand oriented. Large businesses can deduct 100% of their advertising expenses. Meals and entertainment for small businesses should be treated as advertising and should be 100% deductible.
- Automobile expense is perhaps the most difficult deduction for small business. Using as a guideline, for small businesses with $10 million or less in revenues, we recommend that the regular MACRS depreciation rules apply, without eligibility for Section 179, if this makes the change more acceptable, and simplify the record keeping for sole proprietors, and other small businesses. The annual depreciation amounts keep changing which adds to confusion in trying to comply with tax reporting rules. The recent legislation allowing increased expensing in the initial year is a step in the right direction to more closely match expenditures with deductions.
- With regard to auto leasing, accounting for auto expense differs for small business owners. Small corporate business owners have special income inclusion

calculations, and some of these amounts exceed the actual lease payments. Then there are the 'lease inclusion' calculations for sole proprietors. There is unnecessary complexity in these rules, most of which impact small business owners more heavily than their large corporate counterparts.

Between the complexity of auto, meals and entertainment deductions, an IRS auditor can easily find an audit tax adjustment for a small business—because the rules, particularly with auto expense, are difficult for a small business to understand.

WIPP would like to propose a more comprehensive solution to the Committee for health and employee benefits. For purposes of discussion, we will call it the "Simplified Benefits Reimbursement Plan."

The Simplified Benefits Reimbursement Plan would be structured as an extension of an Health Reimbursement Account (HRA), focusing on businesses under 50 employees. Relatively few small businesses take advantage of all the opportunities within Section 125 plans because of the complexity and administrative costs. Our concept--the Simplified Benefits Reimbursement Plan-- would allow small businesses, and only small businesses, to provide a menu of dependent care/childcare, health, dental, life, long term care, offered under one umbrella through a salary tax deferral benefits plan without the complicated rules that require multiple benefits administrators. A critical component of this plan would be the ability of both employers and employees to contribute. Currently, only employers can contribute to HRAs. Employees could use the plan to reimburse expenses for all of the costs we have listed above.

Currently, the administration cost for an FSA is $5 per employee per month, an HRA is $5 per employee per month and for a dependent care is $5 or $6 per employee per

month. Under a simplified plan, costs savings and administrative costs would hopefully decrease as well as simplified administration for the small business.

Mr. Chairman, we need a vehicle such as this to recruit and retain our employees and the impact would be enormous. More than 1/3 of America's workforce is employed by businesses with 50 or fewer employees.

Along those same lines, we believe certain changes to Medical Savings Accounts (MSA)s, Health Reimbursement Accounts (HRAs) and Flexible Spending Accounts (FSA)s, would improve their value to employers and employees.

One of the flaws of FSAs, is that the lack of a carry over provision. The "use it or lose" provision requires an employee to spend all of the money in that year. We recommend a $500 carryover. The House Ways and Means Committee reported H.R. 2351, which fixes this problem and we urge passage by the full House on this legislation.

With regard to MSAs and HRAs, WIPP will continue to encourage Congress to allow greater contributions by both employers and employees so that they can encourage wise use of the savings and increase employer/employee contributions whenever possible.

Mr. Chairman, thank you for inviting us to address these issues. If there are questions, I would be happy to answer them.

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Testimony of
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U.S. Small Business Administration

U.S. House of Representatives
Committee on Small Business

Date:	July 23, 2003
Time:	2:00 P.M.
Location:	Room 2360 Rayburn House Office Building Washington, D.C.
Topic:	Assisting Small Business through the Tax Code— Recent Gains and What Remains to be Done

Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit ***http://www.sba.gov/advo****, or call (202) 205-6533.*

Chairman Manzullo, Representative Velazquez and Members of the Committee:

Thank you for this opportunity to testify today. My name is Thomas M. Sullivan and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). Congress established the Office of Advocacy to represent the views of small entities before Federal agencies and Congress. The Office of Advocacy is an independent office within the SBA so the views expressed in this statement do not necessarily reflect the views of the Administration or the SBA. My statement was not circulated within the Administration for comment or clearance.

You have asked that I testify regarding the tax relief granted to small businesses as a result of the recent enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the Jobs and Growth Act). In addition, you have asked for suggestions about what else needs to be done. The Office of Advocacy takes its direction from small business. With their help our team of economists and regulatory experts seek to fulfill our statutory responsibility to:

> determine the impact of the tax structure on small businesses and make legislative and other proposals for altering the tax structure to enable all small businesses to realize their potential for contributing to the improvement of the Nation's economic well-being... [1]

We welcome this opportunity to share small business' views on the President's tax relief package of 2003 and additional areas for improvement.

The Impact on Small Business of the Jobs and Growth Tax Relief Reconciliation Act of 2003

Advocacy promoted a number of the provisions in the President's Jobs and Growth package and we were pleased with the bill's emphasis on small business. Many of the provisions in the law received widespread support from small business during

[1] 15 USC §634b(4).

Congressional consideration. These provisions will have a significant positive impact on small businesses.

First and foremost, the Jobs and Growth Act provided useful changes in section 179 expensing that had been long sought by Advocacy and the small business community. The new law increased the amount of equipment purchases a small business can expense directly, rather than depreciate over time, from $25,000 to $100,000. In addition, the threshold for phasing out expensing was doubled to $400,000. Each of these numbers will be indexed to inflation beginning in 2004.

The Treasury Department had estimated that at least half a million businesses would directly benefit from expensing provision changes that were similar (though not as generous) to those enacted.

Section 179 has been very useful for small businesses. Using 1999 tax data, 69 percent of the businesses that elected to "expense" their purchases were sole proprietors and individual farmers (2.9 million businesses). Expensing simplifies capital purchases and has the effect of reducing the cost of purchasing capital goods. The increase in the amount of purchases covered by section 179 should provide an economic boost as businesses buy new equipment they would otherwise forego.

Additionally, first year "bonus" depreciation was increased from 30 to 50 percent for investments acquired and placed in service through 2004 and in some cases through 2005. When combined with section 179, this creates a substantial additional incentive for small businesses to make their capital equipment purchases quickly. Likewise, equipment dealers and manufacturers benefit from the sale of new, more productive equipment to these businesses.

The Jobs and Growth Act accelerated most of the tax cuts enacted in 2001 to take effect this year. The top tax rate for individuals, for example, was reduced from 38.6 percent to 35 percent. The impact of individual income tax rate cuts is widely felt in the

small business community since over 90 percent of all businesses are taxed at the individual, not corporate, level. For example, in 1998 there were 17.1 million sole proprietorships; 2.1 million farm proprietorships, 1.9 million partnerships and 2.6 million S corporations all of which pay taxes on the individual owners' return. The Treasury Department estimated that 23 million U.S. small business owners would benefit under the Jobs and Growth Act and that 79 percent of the $12.4 billion in tax relief from reducing the top tax rate goes to small business owners.

In addition, the maximum tax on capital gains and dividends will each fall to 15 percent under the Jobs and Growth Act. For taxpayers in the 10 to 15 percent tax brackets, the rate for both will be five percent until 2007 and zero percent in 2008. The capital gains tax reduction applies to gains realized on or after March 6, 2003, and to dividends received in 2003 or after. Capital gains tax reductions and dividend tax reductions, which free up capital otherwise held for tax reasons, increase the pool of funds available for investment in small businesses.

Earlier this month, employees received an increase in their take-home pay reflecting the immediate implementation of the lower tax rates in the Jobs and Growth Act. And, beginning this week, the Treasury Department will mail advance payment checks reflecting the increased child tax credit to approximately 25 million eligible families. These provisions will increase consumption and spur purchases from small businesses.

What still needs to be done?

Mr. Chairman, your panel today is full of talented specialists. Our office has worked with each of them regularly over the years.

Being tax experts they can dissect the minute details of needed changes. If I had to summarize in one point what needs to be done to help small business, based on our research, it would be this: Simplify taxes for small businesses as much as possible. We

should work to limit the rollercoaster ride of changes and confusion that exist in the Tax Code and make permanent key small business benefits.

Simplicity is the Key - It was reported a couple weeks ago that the number of regulations that have an impact on small businesses was down by ten percent.[2] While I find that statistic gratifying and I hope our office played some part in that decline, I continue to have concerns about the burden of tax regulations and tax compliance on small employers.

Tax compliance is a serious and costly problem for small businesses. Most businesses are very small. Over 90% of all businesses have fewer than five employees. The majority have no employees; they are simply run by the family. We know from our research that it costs businesses billions of dollars each year to comply with tax laws and regulations. The Tax Foundation found that it costs small businesses more to collect and keep tax records than they pay in taxes.[3] A huge chunk of that cost is the time and effort required for the owner to wade through and decipher volumes of new tax laws and regulations. Many businesses find it necessary to hire a tax expert to guide them through the tax maze, dig out the required information and make the correct computations and judgment calls.

Our study on the federal regulatory burden in 2001 showed that tax compliance costs for firms with fewer than 20 employees was twice as much, per employee, as large firms with more than 500 employees. Tax compliance cost $1200 per employee for the very small firms versus $562 for large firms.[4] That is a significant handicap for a small business. Anything Congress can do to simplify tax compliance would provide relief to small businesses from the burden of this disadvantage.

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[2] Clyde Wayne Crews, Jr., Ten Thousand Commandments – An Annual Snapshot of the Federal Regulatory State, CATO Institute, (2003).

[3] J. Scott Moody, *The Cost of Complying with the U.S. Federal Income Tax*. Tax Foundation, November 2000.

[4] See *The Impact of Regulatory Costs on Small Firms*, an Advocacy-funded study by W. Mark Crain and Thomas D. Hopkins (October 2001).

The "penalty" placed on small business by complex tax laws and the groundbreaking study done by Dan Mastromarco for the National Small Business Association, which revealed tax laws that exclude small businesses, inspired the Office of Advocacy to commission a study, not yet completed, of the most commonly used business deductions. We want to determine how much of each tax break goes to small businesses compared to large businesses. From this data, we hope to learn what can be done to make these deductions more useful to small businesses.

Too Much Change - Advocacy research shows that stable and predictable tax policies promote economic growth and that frequent tampering with tax policy has distortional effects on the economy. Taxpayers will adjust and shift the bulk of their expenditures to the period in which there is a tax benefit and away from future periods when the tax benefits disappear. Dr. Radwan Saade of our economic team recently presented a working paper that demonstrated that constantly changing tax laws can create problems for small businesses.[5] The paper said:

> Small business associations identify taxes as the single most important issue facing small businesses. Unexpected shifts in the tax rate and structure only exacerbate the already difficult circumstances involved in running a small business. Now in addition to the uncertainties inherent in operating a small business, business owners must make allowances for unknown changes in the tax code while making plans that extend beyond the next presidential election cycle.[6]

Dr. Saade found that permanence in the tax structure had desirable effects. Less predictability in the Tax Code meant less economic predictability. Less economic predictability means less economic growth. Sunset provisions, phase-outs, and threshold levels introduce a higher level of variability in small business expectations. Providing

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[5] Dr. Radwan Saade's working paper entitled "Rules Versus Discretion in Tax Policy" can be viewed on Advocacy's website at http://www.sba.gov/advo/stats/wkpaper.html.

[6] Dr. Radwan Saade's working paper entitled "Rules Versus Discretion in Tax Policy" can be viewed on Advocacy's website at http://www.sba.gov/advo/stats/wkpaper.html see the Abstract, p.1.

certainty in the Tax Code gives small businesses the confidence to make decisions for their long term viability and growth. Giving small business the ability to invest with confidence in their future is good for the businesses and good for our economy.

Specific Recommendations

Make Increased Expensing Permanent - As mentioned earlier, the increase in expensing was a significant achievement of the Jobs and Growth Act. It is simple and efficient. It reflects the actual cash outlay of the small business and it ultimately reduces the cost of the capital acquisition that small businesses can then apply to another need. The expensing increase which is scheduled to end in 2005 should be made permanent so that businesses can plan future capital equipment purchases based on sound business decisions.

Make Estate Tax Relief Permanent - Under the current estate tax law, businesses cannot adequately plan for the death of an owner because of the annual changes and the final sunset of the estate tax repeal. Eliminating the estate tax was a top priority of the White House Conference on Small Business and has retained the strong support of the small business community since that time. The existing repeal of the "death tax" should be made permanent.

Repeal the Alternative Minimum Tax - For individual taxpayers who must perform Alternative Minimum Tax (AMT) calculations, the AMT has been steadily and relentlessly increasing its grip and is expected to apply to 33 million taxpayers by 2010. This is a far cry from the 156 "high income" non-taxpayers cited as one reason for creating the AMT. The AMT increases the marginal rate of those who must pay by denying them preferences granted by Congress.

For sole proprietors, partners, and S corporations shareholders, the individual AMT increases their liability on their business earnings by limiting use of depreciation and depletion deductions, net operating loss write-offs, deductibility of state and local

taxes, and expensing of research and experimentation costs. Also, individuals who invest in Internal Revenue Code section 1202 Special Small Business Corporations are denied the tax incentive for the investment. The year-end AMT calculation distorts the tax considerations on which earlier business decisions were based to the detriment of small business owners. Even in cases where the AMT does not apply, the small business taxpayer will still have had to perform (or more likely pay to have performed) a calculation that the IRS acknowledges is one of the most difficult and complicated in the Tax Code. For this reason, the small business community has consistently supported repeal or a thorough reform of the AMT.

Conclusion

In conclusion, the Jobs and Growth Act contained provisions which we believe are beneficial to small businesses and, through them, beneficial for the economy and job creation. As this Committee and the Congress move forward to consider other provisions to help small business, simplicity and predictability (permanence) are of critical importance so that small businesses can plan for certain tax consequences. I thank you for this opportunity to testify on this important issue. We look forward to working with the Committee to promote these and other tax reforms benefiting small business.

Statement of Nina E. Olson

National Taxpayer Advocate
Internal Revenue Service

Before the House Committee
On Small Business

23 July 2003

Mr. Chairman and Distinguished Members of the Committee, thank you for inviting me to speak today on important tax issues facing small businesses, including proposals to assist small businesses through the tax code.

The Office of the Taxpayer Advocate

Congress greatly expanded the authority of the Office of the Taxpayer Advocate and the National Taxpayer Advocate in the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).[1] By statute, the Office of the Taxpayer Advocate assists taxpayers in resolving their problems with the IRS and identifies both administrative and legislative proposals that might mitigate those problems.[2] The mission of the Taxpayer Advocate Service (TAS) states this clearly: "As an independent organization within the IRS, we help taxpayers resolve problems with the IRS and recommend changes that will prevent problems."

This dual mission is supported by two organizational components within TAS. The first component is case advocacy, which deals with problems faced by specific individual and business taxpayers. Congress has mandated that there be at least one Local Taxpayer Advocate in each state. Local Taxpayer Advocates are assisted by Case Advocates in resolving specific taxpayer problems ranging from simple IRS processing errors or delays to complex examinations and appeals.

The other component of TAS is Systemic Advocacy. The Office of Systemic Advocacy plays a vital role in the identification, analysis and resolution of broad-based taxpayer problems. Projects emanate from several venues, including TAS and other IRS field offices as well as external stakeholders. The National Taxpayer Advocate is required by statute to provide two annual reports directly to Congress, without any prior review by the Commissioner, the Department of the Treasury, the Office of Management and Budget, or the IRS Oversight Board.[3] The December 31st report comprises three major sections that:

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[1] Pub. L. No. 105-206 (1998).

[2] I.R.C. § 7803(c)(2)(A).

[3] I.R.C. § 7803(c)(2)(B).

- Identify the twenty most serious problems facing individual and business taxpayers.
- Recommend key legislative proposals to resolve significant taxpayer problems, address inequities in the law, or simplify the administration of the tax laws.
- Discuss the ten most litigated tax issues, analyze trends, and identify approaches that might prevent the need for litigation.

Tax Problems of Small Business

For fiscal year 2002, small business cases accounted for 35 percent (or 79,509) of TAS's total case closures. Of these cases, 89 percent came into TAS because of systemic problems, most notably delays, rather than economic hardships. Table 1 shows the top 10 issues, identified in TAS cases, encountered by small business and self-employed (SB/SE) taxpayers in fiscal year 2002 and the percentage of those cases in which TAS was able to provide relief:[4]

[4] This fiscal year, TAS is piloting several marketing initiatives targeted to a few of the segments of the TAS underserved population. We are designing a specific marketing strategy and set of messages to small business owners that cut across each of those segments. We have identified several key messages that we want to get across to small business owners:

- We are available, as an expert resource, to help small businesses with their unresolved federal tax problems.
- Payroll tax issues, among the most common for small businesses, are particularly challenging because of the potential for stiff penalties. Small business owners should not wait too long to seek help on these issues.
- We recognize the hardship that tax problems impose on small businesses. Once a small business taxpayer qualifies for TAS assistance, the taxpayer will receive personal service until the problem is resolved. The taxpayer will be assigned an impartial advocate whose job is to listen and work with the taxpayer.

MAJOR ISSUE DESCRIPTION	Volume	% of Total SB/SE Cases	Relief Provided
Penalties	11,820	14.9%	78%
Processing Claims/Amended Returns	9,268	11.7%	80%
Lost/Misapplied Payment Issues	5,048	6.3%	84%
Refund Inquiry/Request	4,882	6.1%	75%
Processing Individual Returns	4,199	5.3%	84%
Revenue Protection Strategy	3,915	4.9%	51%
Levy Issues	2,781	3.5%	62%
Other Entity Changes	2,331	2.9%	80%
Underreporter Process	2,295	2.9%	74%
Processing Business Returns	2,193	2.8%	87%

In the National Taxpayer Advocate's 2002 Annual Report to Congress,[5] I identified a number of issues affecting small businesses. Many of these issues are reflected in TAS's case inventory. Some of the problems noted were:

- Navigating the IRS – This was identified as a serious problem for all taxpayers, especially business taxpayers, who have to deal with the IRS more frequently than individuals. Unlike most individuals, business taxpayers not only file income tax returns, but employment and excise tax returns as well. They also are required to make employment tax deposits and file Forms W-2 and 1099. Finding the right IRS employee to address a particular problem or finding the program "owner" to point out program failure and discuss improvements is often a difficult task.

- Processing of Offer-in-Compromise Cases – This program continues to be plagued by delays and processing problems.[6] If the problems are resolved, the offer-in-compromise option can be helpful to small business taxpayers who fall behind on their income, payroll or self-employment tax payments or who experience inequities in application of the federal tax law.

- Collection Due Process (CDP) – This process is relatively new to the IRS, but a backlog of cases has nevertheless grown very quickly.[7] Established by RRA 98, it allows taxpayers an opportunity to have a hearing before an independent Appeals Officer to appeal collection enforcement decisions and explore collection

[5] National Taxpayer Advocate, FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12/2002).

[6] Appeals had 10,732 offer-in-compromise cases in inventory on May 31, 2003, with 42 percent in process for over 6 months. Appeals Inventory Report (AIR) for period ending May 31, 2003.

[7] Appeals had 15,813 Collection Due Process cases in inventory on May 31, 2003, with 27 percent in process for over 6 months. Appeals Inventory Report (AIR) for period ending May 31, 2003.

alternatives other than what the IRS is proposing, including the filing of a notice of federal tax lien. The effective implementation of this program in accordance with the intent of RRA 98 remains a concern to me – and my office will continue to monitor CDP case timeliness, processes and procedures to ensure that taxpayer rights are protected.

- Federal Tax Deposits – The Service assesses a large number of penalties for late employment tax deposits,[8] but the rules are complicated and may change during the life of a business. These penalties can be very severe on small businesses and can potentially impact their ability to continue operations.

- Obtaining an Employer Identification Number (EIN) – Getting an EIN is a crucial first step for new businesses. In our last two reports to Congress, we identified the delays encountered by taxpayers in obtaining an EIN as a serious problem. In response to our identification of the problem, the IRS has recently announced that businesses can now obtain identification numbers directly from its website.[9] The taxpayer completes an application form online and the system issues an EIN immediately. This is a significant improvement that will benefit business taxpayers. We commend the IRS for developing this long-needed application.

- Misapplied/Lost Payments – Payments lost or misplaced by the IRS impose additional burdens on business and individual taxpayers, requiring them to substantiate their initial payments. In fiscal year 2002, TAS closed 8,613 cases involving problems with payments/credits. A sampling of TAS cases revealed that misapplied payments were due to both IRS and taxpayer error.

Legislative Recommendations Affecting Small Business

In the two annual reports I have submitted since becoming National Taxpayer Advocate in 2001, I have made several legislative recommendations that would, if enacted, assist small businesses.

Married Couples as Business Co-owners[10]
An unincorporated business jointly owned by a married couple is classified as a partnership for federal income tax purposes.[11] As such, the business is subject to

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[8] The IRS assessed 3,499,865 Employment Tax Federal Tax Deposits Penalties involving $5,042,688,000. The IRS abated 799,058 Employment Tax Federal Deposit Penalties involving $3,201,483,000 in fiscal year 2002. IRS Data Book 2002, Table 26 - Civil Penalties Assessed and Abated by Type of Penalty and Type of Tax, at 5.

[9] I.R.S. News Release IR-2003-77 (June 13, 2003).

[10] *See* National Taxpayer Advocate, Fiscal Year 2002 Annual Report to Congress, Pub. 2104 (rev. 12/2002) at 172-184.

[11] I.R.C. § 761(a).

complex record-keeping requirements and must file a partnership income tax return (Form 1065, U.S. Return of Partnership Income).

In practice, most couples merely report their business income on one spouse's sole proprietorship return. As a result, that spouse alone receives credit for purposes of Social Security and Medicare. The spouse for whom no earned income is reported (the "ineligible spouse") does not receive credit for paying Social Security or Medicare tax. In the event of disability, the ineligible spouse would not qualify for Social Security disability or Medicare benefits. In the event of the death of the ineligible spouse, the surviving spouse and children would not qualify for Social Security benefits.

To address these problems, we recommend that IRC § 761(a) be amended to allow a married couple operating a business as co-owners to elect out of subchapter K[12] of the Code and to file one Schedule C (Profit or Loss from Business (Sole Proprietorship)), or one Schedule F (Profit or Loss From Farming) in the case of a farming business, and two Schedules SE (Self-Employment Tax) if:

- All of the capital and profits interests in the partnership are owned by two individuals who are married to each other;
- The couple makes an election; and
- The couple files a joint return for all taxable years that includes the items of the partnership, provided that the couple maintains adequate records to substantiate their respective interests.

We also recommend that IRC § 6017 be amended to provide that each spouse who operates an unincorporated business solely with his or her spouse as co-owner would file a separate schedule SE if the couple makes the election described above. Because approximately 97 percent of all sole proprietorship and farm schedules report income below the Social Security wage cap[13] and because we propose to make this provision elective, no couple would experience a tax increase as a result of this recommendation, yet many would benefit from Social Security and Medicare eligibility.[14]

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[12] Subchapter K is a portion of the Internal Revenue Code that contains rules and regulations governing the taxation of partnerships.

[13] *See* Tax year 2000, Compliance Research Information System (CRIS), Model IMF 2002. The Social Security wage base limitation is $87,000 in 2003.

[14] Social Security Survivors Benefits, Publication No. 05-10084, August 2000; Social Security = Understanding the Benefits, Publication No.05-10024, February 2002; Social Security Administration: What Every Woman Should Know, Publication No. 05-10127, March 2002.

Election to be Treated as an S Corporation[15]

Subchapter S of the Internal Revenue Code provides for the taxation of closely held incorporated businesses, including the pass-through reporting of certain items to shareholders. To be treated as an S corporation, an incorporated business otherwise meeting the eligibility criteria must make an election on the prescribed form on or before the 15th day of the 3rd month of its tax year. If this election is not made by the statutory date, it is deemed made solely for the succeeding years unless the Secretary determines that there was reasonable cause for the failure to make a timely election.[16]

We believe that the due date for filing an S election is counterintuitive and therefore leads to taxpayer confusion and missed deadlines. It does not coincide with any other tax filing due date. Thus, when a small business corporation files a Form 1120S (U.S. Income Tax Return for an S Corporation) for its first year without having made a timely election, the IRS treats the corporation return as that of a regular corporation and assesses tax against the corporation on that basis.

After processing the return as a regular corporate tax return, the IRS provides the corporation with the opportunity to prove that it had timely filed an S election. If the corporation did not file a timely election, the corporation may submit a private letter ruling (PLR) request to the IRS Office of Chief Counsel seeking a reasonable cause determination for its late filing of the election.

To address the above situation, we recommend that IRC § 1362(b)(1)(B) be amended to allow a small business corporation to elect to be treated as an S corporation in conjunction with the filing of its first Form 1120S return. This recommendation would reduce taxpayer burden and controversy. It would align the act of making the election with the significant due date of filing the first corporate income tax return.

De Minimis Exception to Passive Loss and Credit Limitations[17]

Losses from passive trade or business activities can only offset income from passive activities (*i.e.*, passive losses cannot offset non-passive income such as wages, portfolio income or income from an active trade or business). Credits from passive activities generally can only offset the tax attributable to income from passive activities. Passive losses and credits that are disallowed are carried forward and, to the extent not used in subsequent years, are allowed in full when the taxpayer disposes of his/her interest in the passive activity. Even taxpayers with relatively small amounts of passive losses and credits must complete a complex calculation on Form 8582 (Passive Activity

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[15] *See* National Taxpayer Advocate, Fiscal Year 2002 Annual Report to Congress, Pub. 2104 (rev. 12/2002) at 246.

[16] I.R.C. § 1362 (b)(1)(B).

[17] *See* National Taxpayer Advocate, Fiscal Year 2002 Annual Report to Congress, Pub. 2104 (rev. 12/2002) at 245.

Loss Limitations) to determine and claim their allowable losses and credits from passive activities.[18]

We recommend that IRC § 469(a) be amended to provide that the passive loss limitations shall not apply if the sum of the taxpayer's passive activity losses and three times his/her passive activity credits is less than $1,000, indexed for inflation. This de minimis threshold will eliminate the paperwork burden for small investors to comply with the complexities of the passive activity regime without undermining its essential rationale.

Health Insurance Deductions for Self-Employed Individuals[19]

Internal Revenue Code § 162(l)(4) disallows a deduction for the cost of health insurance in computing the net earnings of a sole proprietor for self-employment tax purposes. Under present law, self-employed individuals do not enjoy the same tax advantages for health insurance as wage earners. While many wage earners can participate in benefit plans that allow them to pay for their health insurance with pre-tax dollars, self-employed individuals cannot. Self-employed individuals can only reduce their taxable income by the cost of their health insurance and must pay self-employment tax at the rate of 15.3 percent on this amount.[20] Wage earners who participate in pre-tax plans do not pay Social Security tax on their health insurance payments.

In order to help the self-employed taxpayer, we recommended that IRC § 162(l)(4) be repealed to allow self-employed individuals to deduct the cost of health insurance in computing the net earnings of a sole proprietor from self-employment.

Regulation of Unenrolled Return Preparers[21]

Many taxpayers (including businesses) pay a third party to prepare their income tax returns.[22] Of these paid preparers, only attorneys, certified public accountants, and enrolled agents generally are subject to some form of regulation or oversight by the Internal Revenue Service or state licensing agencies.[23] Unlike the aforementioned (collectively known as "practitioners" because they are able to "practice" before the

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[18] The IRS estimates that record keeping, learning, preparing and filing Form 8582 requires five hours. *See* 2002 instructions for Form 8582.

[19] *See* National Taxpayer Advocate, Fiscal Year 2001 Annual Report to Congress, Pub. 2104 (rev. 12/2001) at 223.

[20] I.R.C. § 1401.

[21] *See* National Taxpayer Advocate, Fiscal Year 2002 Annual Report to Congress, Pub. 2104 (rev. 12/2002) at 216-230.

[22] There were 130.1 million individual federal income tax returns filed in tax year 2000. Of those returns, 70.7 million (or 54 percent) were submitted by a tax return preparer. Statistics of Income Spring Bulletin, 2002.

[23] 31 C.F.R. part 10.

IRS[24]), unenrolled return preparers are not required to demonstrate a minimum competency in the field of tax law, nor must they satisfy any continuing education requirements in order to prepare federal tax returns. Many pursue continuing education and are very competent, but some either do not have the required knowledge or fail to maintain it. Since the tax return represents a taxpayer's entry point into the federal tax system, errors on the return, however inadvertent or unintentional, can have serious consequences for taxpayers and the IRS in terms of money owed, time spent resolving the problems, and related adjustments in future years.

To illustrate the risks, let us suppose that a small business purchases $100,000 worth of tangible personal property that qualifies for the IRC § 179 immediate-expensing deduction. If the small business engages an unenrolled return preparer who has not taken any continuing education on the new tax law, the preparer may not know how to elect the IRC § 179 deduction to which the taxpayer is entitled. The taxpayer would end up paying additional tax that could have been used instead to help grow the small business and hire additional employees.

To address this problem, we recommend that preparers who are not attorneys, certified public accountants, or enrolled agents and who prepare more than five returns per year for a fee be required to register with the IRS and take an initial examination to demonstrate their competency to prepare either an individual or a business tax return. They should also be required to take an annual refresher examination and display a current certification card indicating their certified status.

Some may say such a certification requirement would be costly, and I acknowledge that there would be certain start-up and other costs. However, our recommendation will not require a significant investment in enforcement personnel. We envision a consumer education campaign that utilizes paid advertising, outreach, and partnering with other organizations to deliver two simple messages to tax consumers, who will enforce the program through their market behavior:

- If you pay for tax preparation, ask to see the preparer's certification.
- If you pay for tax preparation, don't pay until you see the preparer's name, address, and certification on your tax return and on your copy.

We believe our recommendation is administratively practical and efficient. Ultimately, more accurately prepared returns will benefit small businesses and other taxpayers, and

[24] Circular 230 defines "practice" before the IRS as comprehending all matter connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a client's rights, privileges or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include preparing and filing necessary documents, corresponding and communicating with the IRS, and representing a client at conferences, hearings and meetings.

reduce the resources the IRS must devote to examining incorrect returns and collecting tax.

In recent years, we have made several other legislative recommendations that would benefit small businesses, including the following:

- First-time Penalty Waiver (the so-called "one time stupid act" proposal).[25] This proposal would authorize the Secretary to grant a one-time abatement of the failure-to-file and failure-to-pay penalties for first-time filers and taxpayers who have a history of compliance.

- Interest Rate and Failure to Pay (FTP) Penalty.[26] We recommend that the FTP penalty be repealed and that taxpayers be charged an interest rate equivalent to a market rate of interest on unsecured loans. Elimination of the FTP penalty would reduce the number of reasonable cause abatements and ease the burden on both the IRS and taxpayers. This proposal would also put the government on an equal footing with commercial lending institutions and encourage taxpayers to borrow from other lenders.

- Federal Tax Deposit (FTD) Avoidance Penalty.[27] This proposal would reduce from ten percent to two percent the penalty rate for failure to make a deposit in the prescribed manner. Under current law, taxpayers who timely pay the correct amount of tax due but who use the wrong deposit method (*e.g.*, paying in person rather than paying electronically) are penalized at the same rate as taxpayers who do not pay the correct amount or who do not make timely payment of federal tax deposits.

- Income Averaging for Commercial Fishermen.[28] This proposal would extend the benefits of income averaging over a period of three years to commercial fishermen. Income averaging is currently available to commercial farmers.[29] It provides a cushion against the economic misfortunes and booms fishermen regularly experience due to weather, changing markets and prices, and environmental disasters.

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[25] *See* National Taxpayer Advocate, Fiscal Year 2001 Annual Report to Congress, Pub. 2104 (rev. 12/2001) at 188-192.

[26] *See* National Taxpayer Advocate, Fiscal Year 2001 Annual Report to Congress, Pub. 2104 (rev. 12/2001) at 179-182.

[27] *See* National Taxpayer Advocate, Fiscal Year 2001 Annual Report to Congress, Pub. 2104 (rev. 12/2001) at 222.

[28] *See* National Taxpayer Advocate, Fiscal Year 2001 Annual Report to Congress, Pub. 2104 (rev. 12/2001) at 226.

[29] I.R.C. § 1301(a)(2).

- Alternative Minimum Tax (AMT) for Individuals.[30] We recommend that the AMT be repealed or that significant revisions be enacted to eliminate or reduce the burden taxpayers experience when completing two different tax computations and maintaining the related books and records, including information about AMT credit carryforwards.

Several of the above recommendations are included in H.R. 1528 (The Taxpayer Protection and IRS Accountability Act of 2003), passed by the House of Representatives on June 19, 2003. In Appendix A, we have provided a status report showing Congressional action during the current Congress on legislative recommendations submitted by the National Taxpayer Advocate in her fiscal year 2001 and 2002 reports.

Current Advocacy Issues

The Office of the Taxpayer Advocate welcomes suggestions and recommendations for administrative and legislative changes. Many of the proposals discussed above originated from taxpayers, practitioners or IRS employees. To enhance our ability to identify taxpayer problems, our Office of Systemic Advocacy this past year designed and implemented the Systemic Advocacy Management System (SAMS). SAMS is a project identification and workload delivery mechanism that provides both internal and external stakeholders with a voice in the identification of issues. It is a new, national, web-based system intended to receive and resolve advocacy issues affecting individual taxpayers, small and large businesses, large corporations and the overall tax system.

Since its inception in 2002, SAMS has received 183 suggestions pertaining to small business issues. The Office of Systemic Advocacy has developed 53 small business advocacy projects that help identify the most serious problems and highlight legislative proposals that could potentially be included in the National Taxpayer Advocate's December 31st Annual Report to Congress.

The Office of the Taxpayer Advocate is currently studying a number of issues impacting small businesses, including:

- Appeals mediation processes, including the independence of mediators and confidentiality of communications with them;
- The impact on businesses of theft of their employment tax deposits by payroll processing firms; and
- Establishing a withholding mechanism for certain types of workers, regardless of whether an employer treats those workers as employees or independent contractors.

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[30] *See* National Taxpayer Advocate, FY 2001 Annual Report to Congress, Pub. 2104 (rev. 12/2001) at 166-177.

Taxpayer Advocacy Panel (TAP)

The Taxpayer Advocacy Panel (TAP) provides another opportunity for citizen participation, including small business participation, in improving tax administration. Established under the Federal Advisory Committee Act (FACA), the TAP serves as a two-way conduit between the IRS and taxpayers. TAP members participate in IRS focus groups and issue committees, providing input on strategic initiatives. TAP members also hold public meetings that serve as a venue for collecting and addressing issues identified by citizens. The following three national issue committees are dedicated to small business and self-employed taxpayers:

- Increased Use of E-filing Among Taxpayers and Tax Professionals. This committee is helping the IRS address the slow adoption of e-filing by businesses. It is focusing on improving IRS service to customers through education, marketing, outreach activities, and better delivery of services. For example, the committee prepared a marketing strategy, to be tested in September 2003, targeted to tax professionals who use software to prepare returns but then file paper returns. The committee also is developing a web-based tutorial, E-File Made Easy, for small business owners and practitioners to educate users on the e-file process. The tutorial will include links to appropriate forms and other e-file tools.

- Compliance Issues – Schedule C (Sole Proprietorship) Non-Filers. The Schedule C non-filer committee is working with taxpayers and the IRS to identify strategies for improving the level of filing compliance among Schedule C taxpayers without increasing taxpayer burden. One of its projects is to reduce the complexity and simplify the computation of estimated tax payments. The committee is also developing outreach programs for Schedule C non-filers to provide them with much needed education and encourage them to become compliant.

- Payroll Taxes. The payroll tax committee focuses on simplifying the employment tax process and reducing the burden on employers. It places special emphasis on small employers who do not have in-house payroll support or who cannot afford to use payroll tax services or other tax service professionals. The committee has developed a questionnaire to be distributed among small business organizations. It will use the responses from small business organizations to develop a recommendation to the IRS about how to simplify the employment tax process and reduce the burden on employers.

In addition to these activities, the TAP is working closely with IRS to develop and highlight national issues that incorporate concerns identified by small business owners through public meetings, toll-free calls, and the TAP website (www.improveirs.org). These include payment-posting issues with the Electronic Federal Tax Payment System (EFTPS), and equity and education issues involving the 9/11 grants in New York City.

Conclusion

The role of the Taxpayer Advocate Service is the same for businesses as it is for individuals. We help resolve taxpayer problems and propose administrative and legislative recommendations to reduce or eliminate those problems. As an independent advocate within the IRS, TAS is aware of issues that are creating problems, procedures that are being considered, processes that are changing, and guidance that is being drafted. We are also able to speak with an independent and impartial voice to ensure that taxpayer rights are respected and considered and that taxpayer burden is minimized. We take these responsibilities seriously.

Further, with the increasing numbers of taxpayers participating in abusive schemes, tax shelters and offshore activities, the IRS is redirecting its resources to these problem areas. We must ensure that as the IRS strengthens its enforcement regime, taxpayer rights are not compromised.

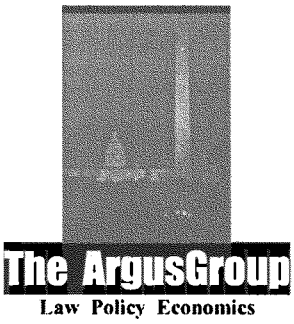
Thank you for the opportunity to speak to you today about my office and our efforts to assist small business. I have been and remain committed to expanding and improving our outreach and services to the small business and self-employed taxpayer. I welcome any questions or comments that you may have.

APPENDIX A:
Status of 2002 Legislative Recommendations with Congressional Action

Recommendation	Bill No.	Sponsor	Date	Current Status
Family Issues				
Uniform Definition of a Qualifying Child	HR 22	Houghton	1/3/2003	referred to the Ways & Means Committee
	S 755	Baucus	4/1/2003	referred to the Senate Finance Committee
	HR 2718	S. Brown	7/14/2003	referred to the Ways & Means Committee
Means Tested Public Assistance Benefits	HR 22	Houghton	1/3/2003	referred to the Ways & Means Committee
Alternative Minimum Tax				
Repeal	HR 43	Collins	1/7/2003	referred to the Ways & Means Committee
	HR 1233	English	3/12/2003	referred to the Ways & Means Committee
	S 1040	Shelby	5/12/2003	referred to the Senate Finance Committee
Index AMT exemption	HR 22	Houghton	1/3/2003	referred to the Ways & Means Committee
Tax Preparation				
Matching Grants for LITC for Return Preparation	S 476	Grassley	2/27/2003	referred to the Senate Finance Committee
	S 685	Bingaman	3/21/2003	referred to the Senate Finance Committee
	S 882	Baucus	4/10/2003	referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Regulation of Income Tax Return Preparers	S685	Bingaman	3/21/2003	referred to the Senate Finance Committee
Low Income Taxpayer Clinics -- funding & promotion	HR 1528	Portman	6/20/2003	referred to the Senate
	S 882	Baucus	4/10/2003	referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Small Business Issues				
Married Couples as Business Co-owners	HR 1528	Portman	6/20/2003	referred to the Senate
	S 842	Kerry	4/9/2003	referred to the Senate Finance Committee
	HR 1640	Udall	4/3/2001	referred to the Ways & Means Committee
	HR 1558	Doggett	4/2/2003	referred to the Ways & Means Committee
Health Insurance Deduction/Self-Employed Individuals	HR 741	Sanchez	2/12/2003	referred to the Ways & Means Committee
	HR 1873	Manzullo Velazquez	4/30/2003	referred to the Ways & Means Committee
Income Averaging for Commercial Fishermen	S 665	Grassley	3/19/2003	referred to the Senate Finance Committee
	S 842	Kerry	4/29/2003	referred to the Senate Finance Committee

APPENDIX A:
Status of 2002 Legislative Recommendations with Congressional Action

Recommendation	*Bill No.*	*Sponsor*	*Date*	*Current Status*
Office of the National Taxpayer Advocate				
Confidentiality of Taxpayer Communications	HR 1528	Portman	6/20/2003	referred to the Senate
Access to Independent Legal Counsel	HR 1528	Portman	6/20/2003	referred to the Senate
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
IRS Collection Procedures				
Return of Levy or Sale Proceeds	HR 1528	Portman	6/20/2003	referred to the Senate
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Reinstatement of Retirement Accounts	HR 1528	Portman	6/20/2003	referred to the Senate
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Partial Payment Installment Agreements	HR 1528	Portman	6/20/2003	referred to the Senate
	S 882	Baucus	4/10/2003	referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
	S 289	Grassley	2/4/2003	referred to the Senate Finance Committee
Penalties & Interest				
Interest Abatement on Erroneous Refunds	HR 1528	Portman	6/20/2003	referred to the Senate
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
First Time Penalty Waiver	HR 1528	Portman	6/20/2003	referred to the Senate
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Federal Tax Deposit (FTD) Avoidance Penalty	HR 1528	Portman	6/20/2003	referred to the Senate
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Other Issues				
Disclosure Regarding Suicide Threats	HR 1528	Portman	6/20/2003	referred to the Senate
	S 882	Baucus	4/10/2003	referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee
Tolling the Statute of Limitations 7811(d)	HR 1528	Portman	6/20/2003	referred to the Senate
	S 882	Baucus	4/10/2003	referred to the Senate Finance Committee
	HR 1661	Rangel	4/8/2003	referred to the Ways & Means Committee



Testimony of Dan R. Mastromarco
Before the Committee on Small Business
U.S. House of Representatives
On Assisting Small Businesses Through the Tax Code:
Recent Gains and What Remains to Be Done
July 23, 2003

Mr. Chairman and Members of the Committee on Small Business:

Thank you for the opportunity to testify today. Let me begin by complimenting you, Congresswoman Valázquez, and your talented staff, for focusing this hearing on the treatment of small firms under the Internal Revenue Code (Code). I appear at the invitation of the Committee in my personal capacity, and do not speak on behalf of any organization.

The Committee has available to it a study which I co-authored with David R. Burton, on behalf of the Prosperity Institute. Our study, entitled "America's Tax Regime: Exploring Unequal Treatment between Large and Small Firms," was commissioned by the National Small Business Association to examine whether or not our tax regime --in a qualitative sense – disadvantages small firms compared with large firms. What we show is that the Code – in addition to its many faults – does disadvantage small firms in several respects, belying the common misperception that small firms are advantaged over larger firms.

I make myself available to discuss this study and how this Committee can help achieve sound tax policy objectives for small firms. Our study is the seminal attempt to list the most notorious inequities. This study may lead to a better understanding of how key tax laws have sometimes been crafted to exclude small firms, often to the frustration of their underlying policy objective. Beyond this, we make specific recommendations to rectify each disparity.

I. Introduction: The Proper Role of Taxation

Allow me to make an initial point that helps place my later comments in context. If I had my druthers, the name of this hearing "Assisting Small Businesses Through the Tax Code" would be changed to "Removing Penalties Against Small Firms That are in the Tax Code." I say this for two reasons. Discussing small business relief in terms of removing penalties helps to dispense with the notion – with which too many identify -- that it is possible to really "assist" small firms through the tax Code. Also, it helps dispense with the notion that the Congress should attempt to do so.

This seems like a nitpicking change, but within it lays an ocean of philosophical difference with the current law on the proper role of the tax system. It is my view that tinkering with the tax system to redistribute income, or engineer social change or even make business more competitive that has caused the problems we face today. The subtle contrast between assisting and removing impediments is really at the heart of fundamental tax policy debates.

If one were to review the policy papers, the legislative iterations, and the public and private debates of each of the Code sections, one would find that most had persuasive justification at the time they were enacted. All were hailed as a victories by their sponsors, and in the abstract had value -- if merely political value. Ninety years hence, the compound result of this "assistance" has been layer-upon-layer of complexity and distortions. Once planted in the Code, tax breaks proved resilient as new constituencies developed new arguments for their perpetuation and enlargement.

At the dawning of the 20th century, U.S. federal taxes accounted for just 3 percent of our Nation's gross domestic product (GDP). President Theodore Roosevelt's return was two pages long; the Code, twelve pages long. But prescient Members of Congress forewarned in 1913

that what was planted in the fertile political soil of the U.S. that year was a bad seed — a seed that would be nurtured by a productive partnership between tax-writers and lobbyists and ultimately grow into the abomination we know today. Over the years, tax writers and tax lobbyists jointly set out to "assist" all manner of causes, to define what taxable income is, what would qualify for deductions, expensing, credits or deferral. The tax policymaking process emerged as the cherished legislative tool for granting economic favors – the new Tamany Hall -- far more versatile than the more direct, visible, and accountable method of allocating specific taxpayer benefits through appropriations – in a word "assisting" taxpayers.

Through the annual accretion of new proposals – bills to raise revenue, bills to cut taxes, simplification bills, base broadening bills, stimulus bills, and bills for fairness sake – the U.S. tax system grew into the dense, intertwined thicket we now know affectionately know as the Code. Today federal taxes account for 21 percent of the GDP, and the federal tax rules span 45,662 pages. The regulations consist of interminable sentences of very small type that, when strung together, occupy five volumes of translucently thin paper that requires a lawyer with an exceptionally high tolerance for boredom to read. The IRS now employs more than 100,000 personnel, and Americans spend more than $200 billion complying with the law.

When Oliver Wendell Holmes penned "taxes are what we pay for a civilized society" -- now the marquis at the front doors of the imposing IRS structure at 10th and Constitution Avenues -- he was right. We must impose a certain level of taxes; although we are free to argue what is meant by a civilized tax system or a proper level of government. However, most free market economists would assert that when we impose those taxes on businesses and on individuals, the government's primary directive should be to try to do so by inflicting upon them the least amount of harm. We should seek to impose a system of taxation that does not interfere with the free marketplace and does not create distortions in the economy any more than the imposition of taxes already do. We should strive for the greatest level of neutrality, and let the marketplace, not lobbyists, dictate optimal allocation of resources. Under a penalty-free Code, all income would be taxed only once, and with the lowest marginal rates possible.

II. Recent Past Successes

The scope of your hearing -- recent gains and what remains to be done -- covers a lot of territory: there have been recent gains and there is a lot left to do. I will not dwell on the recent gains, except to say that a free market economist would find much to like about H.R. 2, the Jobs and Growth Act, because it goes in the right direction by removing penalties. By reducing the capital gains rate from 20 to 15 percent, the Act reduces penalties for investing. As economists know, a capital gains tax of even 1 percent constitutes double taxation. Capital gains represent the buyer's best estimate of the present discounted value of the future income stream from that asset. When both the capital gain and the income stream are taxed, we tax the investment twice.

Ironically, if one follows the heated rhetoric about capital gains debates, one understands that the capital gains tax is intended to achieve fairness, but how can a penalty on investment accomplish that result for small firms? In reality, double taxation penalizes the form of long term investment small firms need in order to favor current consumption – and at a time when savings rates are at depression levels. Lowering capital gains rates, therefore, by reducing the

penalty on investment, encourages those with the capital to invest to provide it to those with the greatest need for that capital. Most small firms neither have access to the stock exchange, nor to the more than $7 trillion in pension funds.

By permitting expensing of up to $100,000 and raising the phase out limit to $400,000, the Act brings the tax system closer to a consumption tax, which again economists see as removing the penalty on work, saving and investing. The economic equivalent of full expensing of capital is a hallmark of any consumption tax; be it a national sales tax, a subtraction method value added tax, a business transfer tax or a consumed income tax. Expensing is necessary to prevent businesses from having to purchase capital stock with after tax profits, capital stock that is the seed corn for job creation.

By accelerating most of the tax cuts enacted in 2001 -- reducing from 38.6 percent to 35 percent – small firms were further advantaged because the vast majority function as sole proprietorships, partnerships, LLCs, LLPs or S corporations, all of which pay taxes on the individual owners' return. Reduction in marginal rates reduces the penalty for work. Likewise, by reducing the tax on dividends to the same degree as capital gains, the Act partially removes the penalty which favors bond financing over equity financing (since interest but not dividends are deductible against corporate income tax), and reduces double taxation of corporate earnings.

In each of these cases, the Congress assisted small business, but did so by removing from them the shackles of uninformed policy and marginal disincentives to invest.

III. The Road Ahead: Eliminating Discrimination Against Small Firms

While many problems caused by the growth, complexity and size of our tax regime are worth discussing, one of the worst is the distortions it has caused. Distortions exist across industries (the pharmaceutical industry, for example, enjoys most of the Research and Experimentation tax credit); by one's choice of the form of entity though which to conduct business (partnerships versus corporations); and by the choice to operate a business as a tax-exempt or taxpaying firm (e.g., tax-exempt alumni groups versus for-profit tour operators). Finally, there are distortions caused simply by the size of firm.

For small firms, there inequities in U.S. tax laws pose greater problems than many government rules. No small business owner can avoid taxes which cut across the entire economy. When tax laws are inequitable, they stand as a monolithic economic barrier to all small firms, and ultimately reduce the benefits they can provide to the economy at large – entrepreneurs, workers and consumers.

When we began our study, we thought we would highlight a few, mostly well known distortions, such as the seemingly interminable distinction between the deductibility of health insurance premiums by the self-employed versus C corporations. What we found was that the Code is replete with provisions that either expressly discriminate or have the economic effect of discriminating. This discrimination against small firms is of several basic origins.

Distributional Concerns that Discriminate

Layers of requirements intended to ensure tax-leveraged employee benefits are equitably distributed within firms constitute one such distortion. There are many examples of the types of tax-leveraged plans affected by these requirements. The ones cited in my report include: qualified pension, profit-sharing and stock bonus plans; group life insurance plans; exclusions for amounts received under health plans and self-insured health plans, "cafeteria plans" (also referred to as a "flexible benefit plan where employees may choose their own "menu" of benefits), educational assistance programs; employee stock options; dependent Care Assistance Programs; adoption assistance programs; employee achievement awards; stock redemptions in family businesses – all of which impose various "non-discrimination" requirements.

Consider qualified defined benefit plans. Small business owners are often unable to fund their retirement as an exit strategy; rather, they reinvest proceeds of growth in operating expenses and in developing the capital asset. During the early building period they can contribute only modest amounts towards retirement. For small business owners to recapture some of savings opportunities diverted to investment, they would be better off with a plan that benchmarks benefit based on years of service, rather than on contribution that are capped. If it works, a defined benefit plan serves a catch-up purpose. An employer gets an immediate deduction for contributions under the plan. Earnings of funds held in the plan are exempt from taxation. The employee isn't taxed until fund amounts are distributed (usually after retirement). In a sense, the employees, who are the future beneficiaries of the efforts of the founders, can help fund the retirement of the founder.

However, a defined benefit plan isn't qualified unless it benefits at least the lesser of (a) 50 employees of the employer, or (b) the greatest of 40 percent of employees or 2 employees (or 1 employee if there is only 1 employee plus the owner). What all these rules mean is that large firms need not provide as widely or evenly distributed coverage as a small firm. For example, when a firm has more than 125 employees, they need to cover only 50 employees (40 percent of 125). According to the rules, this is the same for a firm with twice that number of employees or four times that number and so on. A firm with 500 employees that covers only 50 employees has a coverage rate of 10 percent. However, if a firm has only two employees, it must cover them both. Full coverage of all employees or a larger percentage means that a defined benefit based on the average work pool compensation will yield a lower benefit to managers and owners. For instance, if a 500-person firm can skew its benefit toward the higher compensation levels of the 10 percent of employees, they will enjoy a relative advantage.

These rules have minimal impact on large firms, but a major impact on small firms. A common problem is that these rules are so complex that small firms face considerably higher compliance costs per employee than large firms face when seeking to exploit these benefits. Such costs are generally fixed; larger firms enjoy greater economies of scale than small firms; and, larger firms have an easier time passing these costs along to consumers. Second, these distributional rules present a gauntlet so treacherous that small employers who wish to offer tax-leveraged plans expose themselves to considerable legal and financial risks. Third, the nondiscrimination rules make the benefits of such plans worth less to the owners of a small company since the provisions sometimes prevent owners or top managers from enjoying the benefits they are being encouraged to extend to others. Therefore, they frustrate tax policy objectives by discouraging promotion of employer-sponsored plans. Instead of equitably

distributing tax benefits, these rules have fostered inequities between the treatment of small employers and employees and that of large firm employers and employees.

If one doubts the real world effects, the data may convince them. A recent CRS study, "Pension Coverage: Recent Trends and Current Policy Issues," showed small business lagging in many areas of coverage. The report found 83.3 percent of employees in firms with 100 or more employees had employers who sponsor a pension or retirement savings plan. This is contrasted to 58.1 percent of employees in companies with 25 to 99 employees have employers who sponsor such a plan. Worse, only 30.3 percent of employees in firms with fewer than 25 employees have employers who sponsor such a plan. It is clear that the size of the company impacts retirement plan sponsorship.

Another example of the dysfunctional operation of the "non-discrimination" requirements is group life insurance plans. Code § 79 provides that up to $50,000 of group life insurance purchased by employers may be excluded from an employee's taxable income. Mathematically, if such a policy were in effect over the course of an employee's life, since the policy amount paid is the present discounted value of the future income stream (plus intermediation costs and risk adjusted) the value is the employee's tax rate times at least $50,000. Again, however, "non-discrimination" penalties discourage small employers from offering such plan, because § 79 requires that at least 85 percent of plan participants be other than "key employees" within the meaning of Code § 416(i)(1)(A). A "key employee" under § 416(i)(1)(A) includes an employee who owns at least "5 percent ... of the employer."

Consider a business with two owners. With two owners, it would be impossible for the business to provide tax-free life insurance for its owners or its employees unless it had at least 14 employees. With one owner, 9 employees would suffice. Section 79 could just as easily, and possible a lot more clearly stated "small firms are severely discouraged from providing life insurance to their employees until they have at least 9 employees."

The effect of this provision on highly paid large firm employees is softened, exacerbating the inequity. Section 416(i)(I)(A)(i) provides that the term "key employee" is an "officer having an annual compensation greater than 50 percent of the amount in effect under § 415(b)(1)(A)" (around $150,000) but that no "more than 50 employees" or if lesser, "the greater of 3 or 10 percent of the employees" shall be treated as officers. The economic effect of this provision is to discourage owners of small firms to extend life insurance to their employees and to themselves. The problem, of course, is that life insurance is often what is needed to prevent the liquidation of the firm upon the death of a significant owner. Larger firm managers, with less of a need, can skew benefits towards themselves.

One final example, direct from recent headlines, are employee stock options. Through stock options an employer has an alternative and often more favorable means of compensating employees for services. Under Incentive Stock Option (ISO) plan, for instance, there are no regular income tax consequences when an ISO is granted or exercised; the employee has capital gain when the stock is sold at a gain. Companies are not required to collect payroll and withholding taxes. So, in addition to the treatment of the assets as a long term capital asset – the payroll taxes on what is effectively compensation is forgiven. Of course, "stock options"

are available only to corporations. However, they are also generally not available to employees who own 10 percent of the total combined voting power of all classes of the stock of the employer even if the entity is a corporation. Hence, they are not available as an additional incentive to many existing shareholder-employees of small corporations.

Laws that disproportionately injure small firms in an attempt to enforce equitable distribution of benefits make some initial policy sense because they seek efficiency in the use of the tax expenditure, but the fundamental premise that equity ownership is somehow a disqualifier rests on a dubious foundation. Denying small business owners the ability to participate in benefit schemes or increasing their cost to do so does not encourage the extension of such benefits to workers.

"Highly compensated" is not what the name implies. The restriction has less to do with compensation than with the choice of a person to assume entrepreneurial risk. Those denied the advantages in small firms need not be earning any more than those with greater managerial responsibilities (and power to influence business decision-making) in larger firms who can take full advantage of the tax-leveraged benefits. Consider that small firm employers denied the advantages of participating in tax leveraged benefits are probably earning less than large firm executives with similar managerial responsibilities (and demonstrable power to influence business decision-making (think, Enron Corp.)). In truth, many small firms exist more as a sort of extended family where owners and employees benefit alike from collaborative efforts. Is it not true, for example, that executives of large employers often can negotiate large stock option agreements because of their bargaining position and a friendly relationship with the board, yet the large capitalization of the company makes it unlikely they will own 10 percent or more of the outstanding shares?

The real losers are the employees of small firms who are much less likely to be provided benefits because of laws ostensibly meant to protect them and policymakers who wanted to achieve that result. In a nutshell, concern over intracompany inequity has eclipsed the view that the efforts to ameliorate that effect often create a greater inequity. Excluding owners of small firms from the benefits they share with their workers is one more disincentive for the expanded use of these benefits.

Favoring Corporations – An Entity Favored by Large Firms

As the study points out, inequities also result from provisions favoring the corporate form of entity -- the most common choice of large firms and least common of small firms. For example, the Treasury has imposed a sort of "souped-up" payroll tax regime on the self-employed by eliminating distinctions between payroll and earnings from capital for the owners and operators of these firms. Whether or not a taxpayer should be subjected to Self-Employment Contribution Act taxes (SECA taxes) on their net earnings from self-employment should really depend upon whether or not the taxpayer's remuneration was in nature of compensation for services or investment returns from a capital asset. However, a corporate manager is free to determine his compensation partly as returns on capital, and therefore reduce his tax rate by at least 2.9 percent.

And before the champagne is uncorked for finally ending the disparity in the treatment of deductibility of health insurance costs remedied this year, consider this "victory" muted by the fact that Code § 162(l)(4) provides "the deduction ... shall not be taken into account in determining an individual's net earnings from self-employment...." This means the health insurance deduction of a corporation will be allowed for purposes of the employee or employer share of FICA or Medicare tax (jointly known as the payroll taxes). However, the self-employed person is not eligible to deduct this amount against the net earnings from self-employment. Assume a corporate employer pays the $6,000 of health insurance in a year for an employee, who is also an owner. The corporation gets a deduction of $6,000. But if the owner were self-employed, the owner would have to earn effectively $7,084 in order to make a payment of $6,000 for self-employed health insurance costs after payroll taxes. This is on top of the already disproportionately high and rising health insurance costs for the self-employed, where the working uninsured are more likely to be found.

Not So Fringe, Fringe Benefit Discrimination

The Congress has also showered large companies with fringe benefits that are effectively unavailable to small firms. Take the example of an employee who uses an employer's vehicle for *bona fide* but "noncompensatory" reasons, *i.e.* commuting. Under regulations, the value of an employee's use of a vehicle is deemed to be $1.50 per one way commute for each employee. This means that the employee need only include $1.50 per one-way commute as the value of the compensation he or she receives for the use of the vehicle. However, this method of evaluating the benefit received is not available to "control employees" defined by the regulations to be an elected officer with compensation greater than $50,000, or who owns a one percent or greater equity, capital or profits interest. In other words, a small business owner.

You Can Take It, If You're Big Enough

Other provisions benefit firms large enough to justify the capital outlays to which they relate. For instance, if a small employer were to pick up an employee's lunch tab every day of the year, that amount would be taxable to the employee as compensation. However, employees are entitled to exclude an amount that equals the value of the meal when eaten at an employer's cafeteria. If General Motors has their own executive cafeteria, for example, it would be able to deduct the cost of food service to employees, their spouse and their children, and the employees would be able to exclude that benefit from their compensation no matter how often received. If however, a worker of the Tiny Manufacturing Shop down the road, without a cafeteria, were to take his paycheck and go to Bill's Deli, the meal would not be deductible (and the income used to buy the meal would have been taxed as compensation). When small firm restaurants and eating facilities have to compete against tax-subsidized facilities, they are unlikely to form. After all, the combined economic cost is clearly significant. The combined cost to the employer and employee of $10.00 of meals eaten on premises is $10.00. If the worker were to buy $10.00 of food off-premises, he would have to earn as much as $17.60.

Compliance Costs

Finally, no study on the disproportionate impact of tax laws would be complete without a discussion of what is perhaps the largest inequity – disproportionate compliance costs. A Tax Foundation study estimates that it costs individuals and businesses in the U.S. approximately

$125 billion each year just to read the rules and fill out the forms necessary to comply with federal income tax laws. The costs of the IRS and disputes were excluded.

In 1991, for example, the last year the cost of the system was examined in depth, businesses spent three-fourths as much to comply with the tax laws as they paid in actual tax. The compliance burden is especially heavy on small corporations. Corporations with assets of $1 million or less (more than 90 percent of all corporations) paid a minimum of $382 in compliance costs for every $100 they paid in income taxes ($14 billion in compliance costs for $3.7 billion in income taxes). That represents about 90 percent of compliance costs for all corporations and about 4 percent of all corporate income taxes. Corporations with $250 million or more in assets paid about $3 in compliance costs for each $100 they paid in income taxes.

Many economists believe that small employers have greater difficulty passing these costs along, and therefore actually bear the costs applied to them. Larger employees can "push forward" these costs in the product prices, and therefore pass these costs forward on their small business and consumer customers. But one thing is certain: compliance costs are more or less fixed so the per employee burden is much higher for small firms.

IV. Overall Recommendations

As this Committee considers what it can do about these disparities, I offer several suggestions. First and foremost, we invite you to review the report, which is on the web site of National Small Business Association (www.nsba.org) since specific recommendations for each statutory problem are noted there.

A common problem with employee benefit plan law is overly broad application of the nondiscrimination rules in their various iterations. More particularly, in applying "highly compensated" rules, "key employee" rules, or "control employee" rules, we err by setting up classifications of individuals based on ownership percentages, and then gauge the proper distribution of benefits under arbitrary rules applied to these classifications. The percentage of stock ownership in a firm, or the combination of stock ownership and absolute or relative level of earnings, may all be indications that an individual has the managerial power to decide upon distribution of benefits, but the evil sought to be addressed is the exercise of this power in a disproportionate manner, not the ability to exercise that power.

References to "key employees" should be eliminated, as all references that distinguish between owners and employees. The ownership of an individual in a firm should be irrelevant for purposes of determining the equitable distribution of benefits. Furthermore, all rules relating to distributional requirements should be harmonized, so that the same rules or variations of rules apply to each section of the Code where distribution is a concern. For instance, the Code might specify a number of safe harbors. Benefits or contributions might be acceptable if they are within a range of compensation, or if they are based on years of service to the company and compensation. What the regulations might do is to effectively publish as safe harbors a number of plans that meet the requirements of the nondiscrimination rules.

Second, we ask you not only to consider rectifying past harms through promotion of a Small Business Penalty Relief Act, but look to a systemic solution that may be useful in defeating existing disparities and preventing future inequities. In a longer term sense, policymakers should look at the processes by which these inequities become law and how future disparities can be avoided before they are engrafted into the thicket of America's tax laws. .

In particular, we recommend that, before major changes are made to the Internal Revenue Code, the Joint Committee on Taxation staff prepare as part of their analysis an equity assessment. Under such an equity assessment, the staff would – in addition to providing a revenue estimate and a description of the legislation – show the distribution of the tax expenditure by employee by size of firm and assess whether there would be a disparate impact on businesses by size. The disparities in the Code were often spawned by the need of Congressional staff to increase administrative efficiency, to bolster compliance or to reduce revenue costs. To these ostensibly good reasons, might we not add fundamental fairness and inter-firm distributional equity.

We are pleased that the Office of Advocacy has undertaken to study inequities in the distribution of tax benefits by employee. This is exactly the type of research that can provide tax policymakers with a good barometer of fairness. We would predict with a high degree of certainty that virtually all of the provisions we sited in this report (those benefits which small firms can avail themselves of), are actually skewed in favor of larger companies that is the tax expenditure for these provisions per employee is far less in small firms relative to large firms.

There is one other problem that the Congress needs to confront, and that is the problem of institutional biases that exist in the revenue and distributional estimating processes. While this subject is well beyond the hearing today and resides more properly within the jurisdiction of the tax-writing committees, I will give you an example of how this institutional bias perpetuates tax penalties.

Some will remember Treasury Secretary Paul O'Neill's bold confirmation testimony several years ago that he wanted to eliminate the corporate tax. Believe it or not, that was a rather good idea because it removes double taxation. Corporations don't really pay tax anyway. Taxing corporations is just a convenient way to disguise the true tax burden we all pay when corporations pass those taxes forward in the cost of higher priced goods or back in lower wages to workers, or reduced returns to shareholders (read reduced pension).

But exposing naked truth is not enough to succeed because the government economic assumption is that shareholders pay corporate taxes, not consumers and not wagearners. The result: repeal of the fictional corporate taxes will help wealthy investors. If we were to consider corporate taxes to be paid by consumers or wagearners (a valid assumption since nobody knows), corporate tax repeal would really be relief for the poor. Too often dismissed as mere technicalities by policymakers, assumptions economists choose (such as this one on tax incidence) determine the cost of reforms and the tone of partisan rhetoric. These and many other economic assumptions are stacked against decreasing tax on savings and investment or lowering marginal rates. What makes this troublesome is that the assumptions reflect as much political judgment as objective analyses, yet are cloaked in scientific certitude.

Additionally, the Congress might look to impose the Regulatory Flexibility Act (RFA) on itself. While this Committee knows first hand the difficulty of getting the Department of Treasury to comply with the law, consider leading by example. Many of the inequities that were the subject of my report were legislative. If the RFA require Federal agencies to consider costs rulemakings impose on small firms, could the tax-writing committees abide by the same strictures?

One final suggestion. The Committee should study comprehensive tax reform alternatives, which point the way to a proper tax system. Under a national sales tax, for example, income is not taxed at all, so business tax returns would be vastly simpler. Instead of the complex morass that is the current tax system, a NST asks just one question. How much did retailers sell to consumers? Compliance costs which fall on small firms disproportionately could be reduced by more than 90 percent -- one good year of economic growth. The nation would experience much higher economic growth and it would no longer impose punitive tax rates on work, savings, investment and education. Capital will be attracted from throughout the world to the U.S.' zero rate of tax on business. More investment will increase productivity and real wages. Most of the fundamental tax reform plans all the current penalties will be removed, letting the marketplace and not lobbyists decide what resource gets subsidized. It is for this reason many small firms support a national sales tax, including the National Small Business United.

V. Conclusion

There is a special irony to the development of tax inequities as a form of penalty against small firms. Few elected officials pass up the opportunity to criticize the Internal Revenue Code, or rather, I should say, the Internal Revenue Service –although the latter is merely a necessary bureaucracy to enforce the laws that Congress itself passed. They lament the unfairness of the laws. Treasury Secretary Paul O'Neill called the system an "abomination." In 1976, President-to-be Jimmy Carter called for a "complete overhaul of our income tax system," declaring it, "a disgrace to the human race." Albert Einstein said that [preparing his tax return] was "too difficult for a mathematician. It takes a philosopher."

Even fewer miss the opportunity to sing the praises of small firms. "Small firms are the engine of the economy," "They symbolize the American spirit." These are common soap-box expressions. Yet the penalties in the Code continue to exist.

Introducing a "Small Business Penalty Relief Act," would be a good method of pointing the way to sound tax policy changes that will remove these penalties.

Testimony before the United States Congress on behalf of the

Testimony of

Dena Battle

before the

Committee on Small Business

on the date of

July 23, 2003

on the subject of

Assisting Small Business Through the Tax Code-Recent Gains and What Remains to Be Done.

Thank you Mr. Chairman and distinguished members of the Committee. My name is Dena Battle and I am testifying on behalf of the nation's largest small-business group, the National Federation of Independent Business (NFIB). NFIB has 600,000 members, and is represented in each of the fifty states. NFIB represents small employers who typically have about five employees and report gross sales of around $350,000 per year. Our average member nets $40,000 to $50,000 annually.

It is important to distinguish the type and size of businesses NFIB represents. Too often, federal policy makers view the business community as a monolithic enterprise that is capable of passing taxes and regulatory costs onto consumers, without suffering negative consequences. For small business, this is not the case. NFIB members are not publicly traded corporations; they are independently owned and operated. They do not have payroll departments, tax departments or attorneys on staff.

Being a small business owner means, more times than not, you are responsible for everything—taking out the garbage, ordering inventory, hiring employees, and dealing with the mandates imposed upon your business by the federal, state and local governments. That is why simple government regulations, particularly when it comes to the paperwork they generate, are so important. The less time our members spend with "government overhead," the more they can spend growing their business and employing more people.

Growing businesses lead to job creation, which is one of the major roles small business plays in our national economy. Small business is the leader in job creation. Small firms with fewer than 500 employees employ 52 percent of the non-farm private sector work force as of 1998, and are responsible for 51 percent of the private sector business share of the nation's gross domestic product.

From 1994 to 1998, about 11.1 million new jobs were added to the economy. Small businesses with 1-4 employees generated 60.2 percent of the net new jobs over this period and firms with 5-19 employees created another 18.3 percent. It is because small

businesses have such deep impact on employment and the national economy that it is so critical that the policies you shape account for the impact the law will have on small business.

The changes to the tax code that were recently signed into law will go a long way to benefit small business owners. Increasing limits on Section 179 expensing and accelerating individual rate cuts will have a significant impact on our membership and the economy as a whole. However there are still changes that can and need to be made to the tax code.

While there are many changes that NFIB would like to see made to the tax code, as illustrated in the appendix, there are three major changes that I'd like to highlight that would have a significant impact on NFIB members and their businesses. The first is finishing the job of providing full deductibility of health care costs for the self-employed.

Making health care costs for the self-employed fully deductible was a major step in providing tax parity for small business owners. Unfortunately the system still remains unequal. The code still prevents entrepreneurs from deducting these costs from the wage base for self-employment taxes, which is the tax for Social Security and Medicare.

H.R. 1873, The Self-Employed Health Care Affordability Act, sponsored by Chairman Manzullo, would eliminate this inequality. Current law allows employees to deduct 100 percent of the costs of employer provided health care from their income and FICA taxes, but those who pay self-employment taxes do not get this deduction. This means that small business owners pay higher taxes simply because they work for themselves and not for large corporations that offer health care.

Small business owners already face a difficult task in obtaining individual health insurance policies at a reasonable rate. Adding an additional tax to these premiums makes it even more difficult for small business owners to purchase insurance. By making

this simple change, Congress would be restoring parity to the tax code and helping small business owners provide health insurance for themselves and their families.

The second change to the tax code that Congress should make is establishing a standard home office deduction. Business location currently complicates common tax deductions. Home-based businesses incur expenses that would be easily deductible if the businesses were not located in the home. For example, if a small business owner rents his or her facilities or office outside of the home, then he or she would simply deduct the rent and associated costs, such as utilities. However, if the small business owner owns the physical structure, the process is much more complicated. In the case of a home-based office, the small business owner has to depreciate the actual room in their home. Because of the complicated process, many business owners never take these legitimate deductions. The complicated record keeping required by the IRS to qualify for a home-office deduction is a barrier to many who would qualify but don't have the time and staff to do the paperwork. That barrier would be removed if a "standard deduction" for home-based businesses were allowed.

We believe the standard home office deduction should be $2500 and adjusted to inflation. According to data from the Statistics Of Income at the Treasury Department, 1.77 million returns included deductions for a home office. In that same year, $4.1 billion in deductions were taken by these taxpayers, which means that the average home-office deduction for those using the current provision equals $2,331 per return.

Like the 1040 standard deduction, the home office deduction would be optional. Owners could still choose to deduct the depreciated amount plus operation costs, as they are currently allowed to do. Or they could choose the new standard deduction. We feel that this is the best and simplest way and to allow small business owners to take the deductions that they are legally entitled to.

The third change to the tax code that we believe would dramatically impact small business owners is updating automobile expensing. During the recent debate on the

President's tax plan, many of you may have heard about something called the "SUV loophole." Congress never intended to create an incentive for small business owners to buy SUVs, however changes in the tax code often come with unintended consequences. Under current law, small business owners are allowed to expense up to $100,000 of equipment in a taxable year. Computers, office equipment and copier machines are all examples of expensible items.

However, Congress does not allow small business owners to expense automobiles. There is one notable exception: in order to allow farmers to purchase farm equipment, Congress did allow for the expensing of vehicles that were over 6000 pounds. Cars or vehicles under 6000 pounds have to be depreciated over a period of time. Not only are small business owners required to depreciate vehicles under 6000 pounds, in addition, Congress put further limitations on the amount that can be depreciated. The maximum depreciation that can be taken under current law is $14,460. The result of these laws is that there is a disincentive in the tax code for small business owners to buy cars under 6000 pounds, and there is a tax incentive to buy larger, heavier and often times more expensive vehicles.

Many small business owners need to use larger cars, such as minivans and SUVs because they are delivering products or need to drive groups of people (such as a real estate agent). But, finding a larger sized car that costs $14,460 is next to impossible these days. It's important to note that in order to deduct the cost of a vehicle, small business owners are required to follow extensive reporting requirements. They must use the vehicle for business at least 50 percent of the time. They must log the hours that the vehicle is used to prove that it's being used for business purposes. And they may only deduct the percentage that the vehicle is used for business. In other words, if the vehicle is used 75 percent of the time for business, then the owner can deduct 75 percent of the cost.

NFIB believes that Congress should remove the unfair incentive to buy larger vehicles, by allowing all vehicles regardless of weight to be expensed. Given the option, a small

business owner would rather buy a lower priced, more fuel-efficient car. They should be allowed to expense that vehicle for business use.

These are just a few examples of tax code improvements that would have a significant impact on small businesses. There is still much that needs to be done. Our members are constantly frustrated with the complexity of our tax code, and they pay millions of dollars annually for accountants and tax advisors. More and more of them face the nightmare of the alternative minimum tax every year. And they are still paying costly fees to attorneys and accountants to avoid losing their business to the death tax. But, this hearing is a sign of the progress being made. Mr. Chairman and members of the committee, thank you for your efforts on behalf of small business owners.

FOR IMMEDIATE RELEASE
April 14, 2003

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NFIB Unveils "Top 10 Ways Congress Can Help Overtaxed Small Businesses"

As the April 15 deadline for filing federal income taxes looms, the small-business group NFIB today released its list of the top ten ways the U.S. Congress can help overtaxed Main Street small businesses:

10. **Provide full deductibility of health costs for the self-employed.** While small businesses will be able to deduct the costs of health care from their annual income fully by next year, the code still prevents entrepreneurs from deducting these costs from the wage base for self-employment taxes (Social Security and Medicare). This means entrepreneurs are treated differently than Americans who receive their health care from a corporation - they are forced to pay more taxes simply because they are self-employed.

9. **Update automobile expensing.** Depreciation of automobiles, minivans and sport utility vehicles (under 6000 lbs.) is limited by the law. The maximum depreciation that may be taken by a business owner for these assets is $14,460. When Congress drafted this law, minivans and SUVs did not even exist in their current form or maintain significant market share. Today, small-business owners rely heavily on these types of vehicles. Congress should update the law to reflect the changes in the marketplace and raise the depreciable amount to $25,000 and index it for inflation.

8. **Reduce unemployment insurance taxes.** While unemployment insurance is essentially a state-level program, small businesses are hit with a double whammy because unemployment taxes are collected at both the state and federal levels. The federal unemployment tax (FUTA) pays for the program's administration, and the state tax pays for the actual benefits. This is an inefficient system that imposes its tax burden on employers and helps make payroll taxes the highest of all the taxes that small business pays. Congress should eliminate the FUTA "surtax," lower the FUTA tax and return the unemployment insurance system to the states.

7. **Repeal the Alternative Minimum Tax (AMT).** According to the Joint Committee on Taxation, in 1998 fewer than one in 150 taxpayers were subjected to the Alternative Minimum Tax. By 2007, however, that number is expected to

grow to one in 14, with the largest increase coming from taxpayers earning between $50,000 and $100,000. The individual AMT is a remarkably complex provision in a tax code not known for its clarity. It requires taxpayers to calculate their taxes twice, and then pay the larger amount. While originally designed to ensure that wealthy Americans pay a reasonable level of their income in taxes, the AMT has the side effect of hitting taxpayers - increasingly small-business owners - when they can least afford the bill. The AMT literally kicks taxpayers "when they are down" and should be eliminated.

6. **Establish Social Security Personal Retirement Accounts (PRAs).** Small-business owners, like all Americans, are concerned about the future of Social Security. Their perspective on the issue is unique, as it is both that of the future retiree and of the employer paying the payroll taxes. Individually controlled personal retirement accounts (PRAs) should be a major part of any Social Security reform.

5. **Establish a standard home-office deduction.** Business location currently complicates common tax deductions. Home-based businesses incur expenses that would be easily deductible if the businesses were not located in a home. Many business owners do not take legitimate deductions because of the complexity of the paperwork involved in doing so. The complicated record keeping now required by the IRS to qualify for a home-office deduction is a barrier to many who would qualify but don't have the time and staff to do the paperwork. That barrier would be removed if a standard deduction for home-based businesses were allowed. Like the 1040 standard deduction, the deduction would be optional. Owners could choose to continue to deduct the depreciated amount plus operation costs, as they are currently allowed to do, or they could choose the new standard deduction.

4. **Kill any proposed gas-tax increases.** Some in Congress have proposed increasing the federal gasoline tax as a way to pay for new transportation projects. NFIB members recognize the need for improved safety on our roads and the reduction of traffic congestion. However, at a time when small-business owners are struggling, funding these spending increases by higher taxes will only result in a setback for our economy. That is why 71 percent of our members have said they oppose an increase in the federal gasoline tax.

3. **Simplify the tax code**. The current IRS tax code is a maze of complex rules, regulations and laws. Small-business owners potentially face more than 200 different IRS requirements, and 80-85 percent rely on professional tax practitioners to prepare their tax returns.

2. **Make the death-tax repeal permanent.** The Economic Growth and Tax Relief Reconciliation Act of 2001 reduces death tax rates and increases the exemption every year until the tax is repealed entirely during 2010. But Congress didn't finish the job -- the death tax returns at its full 55 percent in 2011! Until the death tax is permanently repealed, it will continue to hurt small businesses. That's why NFIB leads the fight against the death tax as the co-director of the Family Business Estate Tax Coalition, a group of

businesses, trade associations and people committed to permanent repeal of the death tax.

1. **Pass the president's jobs and growth package.** President Bush has proposed a tax-relief package that will help small-business owners lead the way to job creation and economic growth. One way the plan will help Main Street is by accelerating scheduled income-tax relief; since at least 85 percent of NFIB members pay individual income taxes, this would put more money in their pockets immediately. The proposal would also increase small-business expensing from $25,000 to $75,000 a year. Since a majority of NFIB's members exceed the current annual expensing limit by the end of March, tripling the limit will encourage investment and provide an immediate boost to the economy. Finally, ending the double taxation of dividends would help millions of shareholders and return approximately $20 billion this year to the private sector, which will in turn boost the nation's overall economy and create a better environment for all small businesses.

The National Federation of Independent Business (NFIB) is the nation's largest small-business advocacy group. A nonprofit, nonpartisan organization founded in 1943, NFIB represents the consensus views of its 600,000 members in Washington and all 50 state capitals. More information is available on-line at www.nfib.com.

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NFIB CORE VALUES

We believe deeply that:

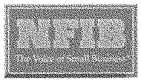
Small business is essential to America.

Free enterprise is essential to the start-up and expansion of small business.

Small business is threatened by government intervention.

An informed, educated, concerned and involved public is the ultimate safeguard.

Members determine the public policy positions of the organization.

Our employees, collectively and individually, determine the success of the NFIB's endeavors, and each person has a valued contribution to make.

Honesty, integrity, and respect for human and spiritual values are important in all aspects of life, and are essential to a sustaining work environment.