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REFORMING THE TAX CODE TO ASSIST SMALL BUSINESSES

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

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FIRST SESSION

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REFORMING THE TAX CODE TO ASSIST SMALL BUSINESSES

WEDNESDAY, SEPTEMBER 21, 2005

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Committee met, pursuant to call, at 2:18 p.m., inRoom 2360, Rayburn House Office Building, Hon. Donald Manzullo [Chairman of the Committee] Presiding.

Present: Representatives Manzullo, Bartlett, Kelly, Velazquez, Lipinski, Faleomavaega, and Bordallo.

Mr. BARTLETT. [presiding.] Our Committee will come to order. Chairman Manzullo is currently occupied on the floor of the House speaking on behalf of a manufacturing bill. He will join us as soon as he completes his speech on the floor. As acting chair, I welcome you to this hearing.

Our first witness today will be Mr. Fortenberry from Nebraska.

Before I yield to our ranking member for her statement I would like to note that from a personal perspective the best way we could help small business is to reform the Tax Code by abolishing it and putting in its place the fair tax. That would be very simple and would remove lots of pages of regulations.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Given the fact that the world is not that simple, let me just make my statement.

With the recent disaster in the Gulf region, our country is again reminded of the powerful role small businesses play in our economic recovery. Through our Nation's history it has been small firms that have been credited with acting as an economic stimulus, creating jobs and bolstering recovery during times of economic hardship. When it comes to providing assistance and assuring small firms have the tools they need to succeed, one thing has been clear: The Tax Code only continues to create barriers for a sector that does not need any more challenges.

As we continue to rely heavily on our small businesses for economic revitalization, we need to ensure these small companies start seeing some tax relief. The truth is many entrepreneurs have not seen any real tax relief from the series of tax cuts that have been passed over the past 5 years. Only 1 percent of all small business owners actually see any benefits from the top rate cut, rather, what they have gotten are increasing compliance costs, and little or no savings.

There are several reasons for this. One is the increasing complexity of the Tax Code. While there have been a number of tax

cuts over the last 4 years, the complexity of the Tax Code has increased significantly. Despite the fact that the Bush administration recognized the problem, the last two bills, tax bills, have actually increased the complexity of the Tax Code even further.

The complexity has serious implications for small business owners. The IRS has noted that it takes the typical American family 8 hours more to do their taxes than it did a decade ago. Given that, small business owners' tax returns are much more complicated than the average American family's. They are now having to spend more and more resources on their tax returns.

The Office of Advocacy released a study in 2001 that showed tax compliance costs for small firms, $1,200 per employee for a small firm versus 562 per employee for their larger counterparts. This is clearly an injustice to our Nation's small businesses. Instead of helping them cope with the Tax Code, small businesses are being overburdened with costs and time. What good is passing a tax cut which may give $500 to a small business when they only have to turn around and spend $1,000 on an accountant or an attorney so they are able to comply with the Tax Code.

Small business owners do not have the resources to deal with this change. As a result of this, small firms are making fewer investments back into their businesses and more are hiring accountants and attorneys.

To compound these problems, the IRS is now going after small firms in an attempt to close the tax gap. There are increasing audits on small businesses. Once again it is this Nation's entrepreneurs that are bearing the burden of a Tax Code that no one can figure out.

Clearly the administration needs to step back and examine who, if anyone, is benefiting from the current Tax Code. What needs to happen now is that the administration start listening to the needs of small businesses who want to see provisions such as section 179 made permanent so they can successfully invest in capital expenditures and expand.

Right now, as the Gulf Coast region and our Nation gears up to recover from Hurricane Katrina, we will be reminded of the critical role small firms play in making an economic recovery a reality. What Louisiana, Alabama and Mississippi need today is revitalization, and in order to do that there must be investment in small businesses. For an economic recovery with robust job creation, tax policies must be in place that makes small firms the centerpiece rather than an afterthought.

It is time the administration recognizes that they have put small businesses at the back of the line. They need to start making changes to the Tax Code that would allow small businesses to flourish and expand so the Gulf region and our Nation's economy can finally move forward.

Thank you, Mr. Chairman.

Mr. BARTLETT. Thank you very much.

In a former life I was a small business owner. I am one of maybe 35 who came to the Congress as a member of NFIB. We always filled out our own taxes. Not only did we have a small business, we did land development and built homes. We also ran a farm. So we had to fill out those forms. And we filled out the itemized de-

ductions and we did the taxes ourselves. So I am very familiar with the tax burden on both the individual taxpayer and on small businesses.

We are very happy to have one of our own here today as our first witness. Mr. Fortenberry, the floor is yours.

I am sorry. Different committees have different procedures for opening statements. I would like to ask now are there opening statements from other members? Okay, thank you.

Mrs. KELLY. I didn't realize that you weren't going to call for opening statements, I am sorry. But since you have given me the floor, I want to thank our colleague and friend, Jeff Fortenberry, and I look forward to hearing about the work that he is doing.

The small businesses in the Hudson Valley are constantly telling me that they want a simple and a fair Tax Code. The amount of time and money that we small business owners spend on complying with the Tax Code is just mind boggling and everything that we spend in terms of time affects our ability to do business. That is really a disservice to the American economy. And I just simply know that we saw benefits in the aftermath of September 11th and the resulting recession because small businesses, three-quarters of them—new jobs are created by small businesses and that worked for New York.

We employ half of the private sector workforce, and we pay 44 percent of the U.S. Tax private payroll. One of the interesting things to me is that women-owned small businesses in the United States of America employ more than all the Fortune 500 companies put together.

With this emergency in Katrina, I think it is absolutely important that we knock down the barriers to success that are in the U.S. Tax Code. So I look forward to hearing what you have to say, Mr. Fortenberry, and I am delighted you are willing to come from the Committee today.

Thank you, Mr. Chairman.

Mr. BARTLETT. Thank you. Without objection, the opening statements of all of our members, those who are here and not here, are made part of the Record.

Ms. Bordallo.

Ms. BORDALLO. Thank you, Mr. Chairman. I really don't have an opening statement, but I do have some questions of the witnesses.

Mr. BARTLETT. Thank you very much.

Are there other opening statements? Okay. Anyone who wishes to have an opening statement in the record we would ask unanimous consent for that to be done.

Now, Mr. Fortenberry, the floor is yours.

STATEMENT OF THE HON. JEFF FORTENBERRY (NE-1), U.S. HOUSE OF REPRESENTATIVES, U.S. CONGRESS

Mr. FORTENBERRY. Thank you so much, Mr. Chairman. I really appreciate the opportunity to be with you. And Ranking Member Velazquez, thank you so much for the opportunity to speak.

I want to speak about a particular issue regarding tax reform that I think could be extraordinarily helpful to small businesses. At the outset, though, I want to talk to you about a fascinating trend,

and I recognize this trend myself intuitively but had it affirmed recently by more empirical data.

Young adults, commonly known as Generation X, are interested in two ideals, family life and entrepreneurship, and I really believe that these ideals flow from the same desire, a desire for self-possession and a desire for self-donation. And if you think about it, in the family, a person enters through a commitment into a community of intimacy and builds a community of love and life. And this most solemn ideal is a great gift of the human experience and also a serious responsibility, and one that many young people are eager to embrace, even given the difficulties that they may have faced in their own upbringing.

The second ideal of entrepreneurship embraces the freedom to use one's own gifts to produce a good for the community, to build something that is the very imprint of one's own self, to create, using one's own hands and mind, receiving in turn the full fruits of one's own labor. Again, this ideal is the essence of rewarding hard work and is a desire expressed readily by young people.

Mr. Chairman, no more 40 years and a gold watch it appears. I think we may very well be entering the age of entrepreneurship.In recognizing this reality, I believe we must work to adjust our tax laws to assist those who want to create new opportunities for themselves and their families.

I will soon introduce two bills promoting entrepreneurship and long-term economic security. First, I will proposal allowing individuals to roll over portions of their retirement accounts into health savings accounts. Second, I will propose to change the traditional IRA to allow small business investors to take loans from these retirement accounts similar to the existing loan provisions in 401(k) plans. These bills address two key areas of concern for small businesses, providing increased access to insurance coverage and gaining access to capital.

Before I go into the details of these proposals I believe it is important to review why small businesses are so important—and Mrs. Kelly you pointed out many of the facts that we all already know. Small businesses are the most productive sector. It is where most people work, earn, try to get a little bit ahead in life.

According to the SBA, small businesses account for 75 percent of net new jobs added to the economy, and employ half of all private sector workers. They represent 99 percent of all employees and 97 percent of all U.S. Exporters. I believe we must develop policies to encourage this important sector of the economy.

I have a keen interest in reducing barriers to entry into small businesses. I initially focused on access to capital issues, but quickly saw how the lack of available health insurance and rising healthcare costs decreases productivity and distorts social and economic decisions. For instance, it is not uncommon in my district among farm families for a spouse to drive very long distances simply to maintain a job for healthcare coverage. How can we count the loss of new ideas and new productivity because someone makes an undesired economic decision based solely on health insurance coverage reasons?

As we have learned, the rising cost of providing health coverage for employees is a growing obstacle for small business owners, or

those who wish to join the ranks. It is not surprising that only 63 percent of smaller companies can even afford to offer health insurance, and this is a primary reason why three out of five uninsured persons in our Nation are small business owners, their employees and their families.

Recently the Small Business Committee held a field hearing in my district, and during this forum we examined the increasing cost of health insurance and possible solutions. The hearing emphasized the importance of an underutilized tool for small business, the health savings account, which were established as a part of the Medicare prescription drug law. These tax preferred accounts, coupled with high deductible health insurance, help alleviate the ever increasing cost of traditional health insurance premiums and empower families to better control their own healthcare costs as well.

According to a survey conducted by the Kaiser Family Foundation and Health Research and Educational Institute, or Educational Trust, only 20 percent of employers who offer health insurance provide a high deductible policy option. The same survey found that only 2.4 million workers outside the Federal Government are enrolled in such plans.

While the number of individuals utilizing health savings accounts is increasing, I believe we need to do more to give small business owners and entrepreneurs the ability to take advantage of this important new policy innovation. In fact, of the new policies, 37 percent were taken out by individuals who were previously uninsured and 27 percent were taken out by employers who did not previously offer their workers health insurance.

As mentioned in my proposed legislation, individuals will be able to roll over portions of their retirement accounts into health savings accounts. This rollover will not subject the retirement account to the usual 10 percent penalty for an early distribution. Moreover, all individuals with retirement accounts would be eligible to take advantage of this opportunity. This will help meet the important policy objectives of increasing access to health insurance coverage and overcoming a major barrier entry into small business.

An additional barrier that entrepreneurs often encounter is gaining access to capital, as we all know. Earlier this year the Committee considered and passed House Resolution 22, the Small Business Bill of Rights, which identified access to capital as a key concern for small businesses. According to the SBA again, the majority of small businesses use some form of external credit. Sadly, 46 percent of all these small business owners are using their own personal credit cards as a source of capital. The bill I propose will provide additional sources of capital by changing the traditional IRA to allow small business investors to take loans from these retirement accounts.

The provisions of these IRA loans are similar to the existing loan provisions of the 401(k) plan in several ways. First, they permit individuals to borrow up to the greater of half of their IRA account balance or $10,000. In either case the loan would be capped at a maximum of $50,000.

Second, the provisions will require the individual to use the money to finance small business capital expenditures. And third,

individuals will have 5 years to repay the loan to ensure that the loan is not treated as a simple withdrawal from the IRA.

Mr. Chairman, I believe these initiatives will encourage young people to jump-start and give them a jump-start into promising business opportunities, enable more advance workers to potentially have greater access to capital for the formation of small businesses, and potentially allow more senior workers who must often be risk averse potentially start new spin-off side ventures.

These goals are consistent with the purpose of retirement savings in that they will allow more persons to be owners, possess the means of production, and provide long-term economic security for their families.

Again, what a privilege it is to be on this side of the table today to have the opportunity to speak with you. This is a little bit different experience, but I really appreciate the opportunity to be before you.

Thank you, Mr. Chairman.

[Mr. Fortenberry's testimony may be found in the appendix.]

Mr. BARTLETT. Thank you very much. As is my custom, I will reserve my comments and questions until the other members of the Committee have had a chance to make their comments and ask their questions.

Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. I have no questions.

Mr. BARTLETT. Ms. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I have no questions.

Ms. BORDALLO. Mr. Chairman, I don't have any questions.

Mr. FALEOMAVAEGA. Mr. Chairman, I thank our colleague and good friend from Nebraska for his testimony. And as it is customary, also, most members, we don't have questions of your testimony, but we do thank you for your eloquent statement and look forward to working with you on your legislation, also. Thank you very much.

Mr. BARTLETT. Thank you very much. Just one quick comment. Fourteen years ago, when I was running for this House seat, Pat Rooney, President of Golden Rule Insurance Company, explained what I thought was a surprising new concept. He called them medical savings accounts. We now tend to call them health savings accounts.

I like the idea of health savings accounts. I tell people we don't really have a healthcare system in our country, we have a really good sick care system, and I hope we can move from that to the true healthcare system, and the medical savings accounts, now called health savings accounts, help move us in that direction.

Thank you for your initiative in making these more broadly available. Thank you very much for your testimony.

Mr. FORTENBERRY. Thank you, Mr. Chairman.

Mr. BARTLETT. The second panel is taking the cue and they are taking their seats, I see. Thank you. Thank you very much. I would like to welcome the members of our second panel.

Thomas Sullivan, Chief Counsel for the Office of Advocacy, U.S. Small Business Administration; Nina Olson, National Taxpayer Advocate; Thala Rolnick, Price, Kong & Company, CPA, Phoenix, Arizona; Marilyn Landis, Basic Business Concepts, Pittsburgh,

Pennsylvania—I grew up near Pittsburgh—Kristie Darien, Executive Director of Legislative Offices, National Association for the Self-Employed; and John Irons, Director, Tax and Budget Policy, Center for American Progress.

There is something about the Office of Chief Counsel for Advocacy. I noted in the prior Administration that the person who held that when he talked and said ″we″ he was talking about small business and when he said ″them″ he was talking about government bureaucrats, and I think that that is a characteristic of the people who serve in this very important office.

Our first witness this afternoon is Tom Sullivan, the Chief Counsel of Advocacy at the Small Business Administration. Mr. Sullivan is no stranger to this Committee, having appeared before on several occasions in the past. He will discuss his recommendations for assisting small business through the Tax Code, as well as certain provisions in the Small Employer Tax Relief Act of 2005. Mr. Sullivan, the floor is yours.

STATEMENT OF THE HONORABLE THOMAS SULLIVAN, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SULLIVAN. Thank you, Congressman Bartlett, Congresswoman Velazquez, members of the Committee. Thank you for giving me the opportunity to appear this afternoon.

As you know, my office is an independent office within the SBA, so therefore the comments expressed in this statement don't necessarily reflect the position of the administration or the SBA.

This testimony was not shared in draft form for comment with OMB; however, I distributed copies of the testimony to colleagues at OMB and at the Department of Treasury as a courtesy.

I am honored to join these panelists to help the Committee's deliberations, and I believe that recent research already cited by the previous witness done by the Office of Advocacy will add weight to the support for tax reforms beneficial to small business.

These studies are cited in detail in my written statement, and with the Chair's permission I would like to summarize key points. Without objection, I will summarize.

Lower marginal rates. First of all, the research conducted by Donald Bruce and Tami Gurley published this past March entitled, Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data reveals that decreasing marginal tax rates across the board will spur entrepreneurship by increasing the rate of new firm formation and slowing the rate of firm closing.

Decreasing the complexity of the Tax Code. A study released 2 days ago by my office updates the study that Congresswoman Velazquez cited in her opening statement. This is a study that is published about every 4 years, and it shows the regulatory burden on small business. The study released 2 days ago continues to show the disproportionate impact of Federal regulations on small business. The study shows that on average it costs small businesses 45 percent more to comply with Federal rules than their larger business counterparts. The cost disparity and compliance costs between small and large business is most severe when it examines small

manufacturers and how much they have to spend to comply with the Tax Code.

The study by Dr. Mark Crain shows that tax compliance costs are $2,582 per employee for very small manufacturers compared to $767 per employee for their larger business counterparts. Very small firms in the sector pay three times more per employee to figure out the Tax Code versus the large firms.

Lower marginal tax rates. The concepts of lower marginal rates and less complexity, two of the key parts of my testimony, echo throughout the Small Employer Tax Relief Act of 2005 that was introduced in the House of Representatives this morning. The act makes permanent the expensing provisions of section 179, allows health insurance premiums to be deducted against self-employed payroll taxes and eliminates the AMT. These are key to achieving the tax reforms necessary for small business.

Expanded expensing provisions. The Office of Advocacy and the small business community have consistently applauded the benefits of the expanded section 179 provision, specifically within the 2003 Jobs and Growth law. The expanded limits will sunset on December 31, 2007. Small businesses have asked that the increased limits be made permanent. The President's 2006 budget request also proposes that the expensing provisions of section 179 be made permanent. The Small Employer Tax Relief Act would grant permanence to the increased provisions of section 179, certainly a benefit to small business.

Tax deduction on self-employment taxes for health insurance. We have already heard about healthcare even before the witnesses started testifying, but there is really no greater crisis issue than healthcare if you ask any small business man or woman anywhere in the country. I applaud this Committee's action that has already taken place, Congresswoman's Velazquez's leadership, Chairman Manzullo's leadership in passing association health plans. Obviously there is more to do.

The Small Employer Tax Relief Act of 2005 helps make healthcare more accessible. Under the bill, self-employed taxpayers would be permitted to deduct their health insurance premiums when calculating their payroll tax.

Repealing the individual Alternative Minimum Tax. I think it is unfortunate that when I say AMT, more and more people realize what the acronym stands for. The small business community has consistently supported repeal or reform of the AMT. Repeal of the AMT will lower marginal rates on small business, simplify compliance by eliminating a notoriously complex calculation, and it will increase predictability of the Tax Code and as a result small firms will gain more time and capital to grow their business.

In conclusion, my office believes that the Small Employer Tax Relief Act will be helpful for small business, and for that reason you can count on my support.

Thank you.

[The Honorable Sullivan's testimony may be found in the appendix.]

Mr. BARTLETT. Thank you very much.

Our second witness this afternoon is Nina Olson, the National Taxpayer Advocate at the IRS. As a National Taxpayer Advocate,

Ms. Olson serves as an advocate for tax payers to the IRS and Congress. She included a number of proposals in her most recent report to Congress that impacts small businesses in the Small Employer Tax Relief Act of 2005, and we look forward to your testimony. Thank you very much.

STATEMENT OF NINA OLSON, INTERNAL REVENUE SERVICE

Ms. OLSON. Thank you, Congressman Bartlett, Congresswoman Velazquez and distinguished members of the Committee. Thank you for inviting me to testify today about the tax burdens facing small businesses and proposals to reduce these burdens through changes to the Internal Revenue Code. I commend Chairman Manzullo for introducing the Small Employer Tax Relief Act of 2005, which contains a number of proposals that I have long advocated and believe would benefit small businesses considerably.

For many small business owners tax issues are the single most significant set of regulatory burdens. Now it seems to me that Congress and the executive branch should try to identify the behavior they want to promote, and then make it as easy as possible for taxpayers to comply with these expectations. However, sometimes tax law provisions have unintended consequences despite our best intentions. Thus Congress should periodically review the tax rules applicable to small businesses to ensure that they are narrowly tailored to accomplish their objectives and do not require small business owners to jump through unnecessary hoops.

The tax treatment of married couples who are business co-owners is an example of this law of unintended results. An unincorporated business jointly owned by a married couple is classified as a partnership for Federal income tax purposes. As such, the business is subject to complex record keeping requirements and must file a partnership income tax return. 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, this 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 make matters worse, the Internal Revenue code imposes a penalty on taxpayers who fail to file a required partnership return. The IRS, however, has issued guidance that in the case of partnerships with 10 or fewer partners it won't impose the penalty because these partnerships have reasonable cause for not filing because of their size.

So here we have government passing a law that requires certain taxpayers to behave in a way that is counterintuitive to their practice, then we impose a penalty on these taxpayers for failure to comply with that requirement, and then finally we issue guidance that says we won't impose that penalty after all. All of this instead of just simply enacting the appropriate law that drives the appropriate behavior.

I am pleased that Chairman Manzullo has adopted my recommendation to amend the Code to address the problems experienced by married co-ownersof unincorporated businesses.

In my written testimony, I describe several other legislative proposals and administrative initiatives that will ease the tax and compliance burden for small businesses,including changing the due date for electing statuses of small business corporations under subchapter S of the Code.

On consistency and equity grounds I, too, have recommended that self-employed individuals be allowed to deduct the cost of health insurance in computing net earnings of a sole proprietor from self-employment. This approach places the tax treatment of health insurance for self-employed taxpayers on a par with the tax advantages enjoyed by wage earners.

And of course one of the most complex provisions in the Code, which I identified as the most serious problem for taxpayers in 2003, is the individual Alternative Minimum Tax. For business owners the AMT recaptures section 179 expensing and can postpone the benefits of business tax credits. Quite simply, Congress must repeal the AMT or revamp it substantially to achieve its original objectives.

I would like to draw your attention to one proposal not in the bill because I think it really provides relief to small businesses that are trying to comply with the labyrinth of tax laws and regulations, and because it illustrates the common sense approach to tax administration that I believe we should strive for.

The first time penalty waiver, which I also call the one-time-stupid-act proposal, authorizes the Secretary to grant a one-time abatement of the failure to file and failure to pay penalties for taxpayers who have a history of compliance. Given the complexity of the tax law and the tax administration system, it is easy to see how taxpayers can make mistakes, even stupid ones. Traffic cops are permitted to give warnings rather than tickets for first time or minor infractions, why can't the IRS?

In closing, there are many common sense proposals that can help eliminate burdens on small business. I appreciate the opportunity to testify before you today about a few of them, and I commend the continuing efforts of this Committee and look forward to answering any questions.

Thank you.

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

Chairman MANZULLO. [presiding.] Our third witness this afternoon is Thala Rolnick. Ms. Rolnick is a senior tax manager of Price, Kong & Company in Phoenix, Arizona, where she specializes in providing tax services to small businesses. In addition, she is Co-Tax Chair for Region IX of the White House Conference on Small Business, and also serves on the Council on Small Business in the U.S. Chamber of Commerce.

She appears before us today on behalf of the U.S. Chamber of Commerce, which I am proud to say has endorsed the Small Employer Tax Act of 2005. We look forward to your testimony.

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

STATEMENT OF THALA ROLNICK, PRICE, KONG & COMPANY, CPA

Ms. ROLNICK. Thank you, Mr. Chairman, and Ranking Member Velazquez. Thank you very much for inviting me to speak here today.

As has been said, my name is Thala Rolnick and I am a CPA from Phoenix, Arizona. And as you know, I am here also supporting the U.S. Chamber, who applauds you and supports your leadership on introducing the Small Employment Tax Relief Act of 2005.

The Chamber has spelled out its small business priorities in detail in the written testimony. I would like to address IRS's current audit programs of small business, which has become a growing concern.

We all know that the IRS has announced plans to carry out the National Research Program to audit 5,000 randomly selected S corporations. The Commissioner said that this is necessary to make sure that corporations and high income individuals are paying their fair share.

Right after this announcement ETAAC released its findings of IRS's audits that it made during 2001 through 2004 of small businesses and S corporations with assets of under $10 million. Over this period, the IRS audited over 27,000 S corporation returns. This average is about the same average as they hope to cover in the NRP audits. Of those returns, 42 percent, or over 11,500 returns, resulted in a no change. Only about 1,300 of those returns resulted in a change of tax liability to the individual shareholder. The report stated that IRS is doing a very poor job of selecting returns to audit. That is why they say they need this program. I counter with, why can't they obtain the statistics they need from the audits they have already completed?

This is the announced program, but there are two unannounced programs that are truly affecting my small business clients. The first is an audit program for first and second year S corporations. The second is an audit of individual returns where there are W-2 wages and Schedule C losses. I asked the agent why, and she said that the IRS wants to make sure new businesses are doing it right from the beginning. I believe the taxpayer education and communications are the first people from the IRS that should be visiting my small clients, not the IRS audit agent.

I am currently working on an S corp audit. The taxpayer actually had wages, a small profit and minimal distributions. That means that she did everything right. We feel that if the auditor were to make an adjustment of $20,000, which we really don't believe will happen, this will result in an additional $3,000 of taxes and we expect our fees to run about $5,000. I don't see where this benefits the small business or the IRS.

I have just completed one of the schedule C audits. The client I represented was a start-up dentist. She had wages and a small Schedule C loss in the year of the audit. The following year she had no wages and a small profit. And in the current year she expects her income to be that of what she would have expected in her fifth year of practice. If the auditor had been allowed to lay these 3 years side by side, he would have seen the progression of a start-

up business. And if he would have been able to limit his audit scope to, say, her working capital loan, then maybe we could have reduced the time of the audit from 4 days to 1 day.

What complicated this audit even further was that the agent requested information the taxpayer was prohibited from providing based on HIBR rules. He wanted to see every patient's charge sheet and every lab's expense. The client's patient sheet filled a four-inch binder. We finally got him to agree to 1 month. All these documents had to be sanitized before we could present them, and it took her time away from her practice. As I said, we are expecting a no change audit, and this audit cost her from our fees some place between $2,000 and $3,000. Again, I see no benefit.

When I discussed these audits with a friend of mine, his response was, as a taxpayer I am a shareholder in the IRS, and this does not sound like a good return on my investment.

I started by stating, sharing with you the Commissioner's reasons for these audits. I don't see how these audits accomplish that goal of making sure corporations and the highly wealthy pay their fair share.

Thank you for allowing my time to share my experiences.

[Ms. Rolnick's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you very much.

Our next witness is Marilyn Landis, President of Basic Business Concepts, Incorporated, which provides consulting services to small businesses located in Pennsylvania. In addition, she is Chair of the National Small Business Association's Legislative Action Committee. She appears before us today on behalf of the National Small Business Association, which I am proud to say has also endorsed the Small Employer Tax Relief Act of 2005. We look forward to your testimony.

STATEMENT OF MARILYN LANDIS, BASIC BUSINESS CONCEPTS

Ms. LANDIS. Thank you.

Chairman Manzullo, Ranking Member Velazquez, members of the Committee, thank you for inviting me to provide testimony on an important topic, the intersection of small business and the Tax Code.

As introduced, I am Marilyn Landis. I am the President of Basic Business Concepts, a company that I founded, a multi-faceted service that provides financial consulting to small businesses in Pennsylvania and throughout the Northeast.

I also have a background prior to starting my own business of working for three of the largest SBA lenders in the country, marketing and originating SBA loans. I had a career in a variety of finance related fields that touched small business, from consumer loans to mortgage development, delinquent collection and a coordination of the operations of a multibank merger. And outside the business world, I dedicate my time to serving on several nonprofit boards that oversee social and economic development.

So I am here today first as a business owner, which I am, second as the Chair of the National Small Business Organization's Legislative Action Committee.

As you know, SBA is the Nation's oldest nonpartisan small business advocacy group, and we represent 150,000 small business owners, and my role as the Chair of that Committee is to oversee the formation of the policy issues for those small business owners.

Both my personal experience, as I have outlined it, my role in NSBA, have allowed me to see small business owners wrestle with a complicated tax system. In fact, in the 108th Congress two of my fellow NSBA members have testified on the difficulties a small business faces with the Tax Code.

Many excellent studies have been conducted.They estimate a cost of complying with the Tax Code when calculated. It is important to remember that this cost is not the money paid to the Treasury, but as we have talked about here, the time, opportunity lost, the changing practices, maintaining records, paying professionals go into the cost of complying.

The National Small Business Office of Advocacy, as we have talked about, have done numerous studies. Chief Counsel for Advocacy, Tom Sullivan, has detailed those, the results are the same. Because of their size, because of the availability of resources, small business owners pay a disproportionate amount of time and money to comply with the Tax Code.

Compounding compliance costs to the costs faced by employers and employees at small firms who are prohibited from participating in tax advantage benefits that are available to companies of larger sizes, being financially excluded from pension plans, pretax health savings and fringe benefit plans have a real economic impact on entrepreneurs.

The issues facing small business owners of the Tax Code are so vast we that we at NSBA commissioned a study to root through the Code and return the most egregious examples of inequities. Members of NSBA have testified before this and other committees on the findings of the studies. We are very pleased that some of our top priorities are included in Chairman Manzullo's recently introduced legislation, the Small Business Tax Relief Act.

One recommendation from the NSBA tax equity report that has been addressed by Chairman Manzullo and Representative Velazquez in past legislation—and National Taxpayer Advocate in recent reports—is the repeal of the self-employment tax on healthcare. As the law stands now, self-employed individuals still pay for their healthcare with money that has been subjected to the self-employment tax. All employed individuals pay the FICA tax on their wage income, 6.2 percent is allocated to Social Security, 1.4 percent for Medicare. Employers are required to match that with 7.6 percent. Self-Employed individuals are required therefore to pay both sides of this tax, resulting in 15.3 percent 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 15.3 percent self-employment tax on the cost of their healthcare premiums. No other worker is required to pay FICA taxes on any portion of their employer-sponsored healthcare benefits. With healthcare 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. NSBA

is encouraged to see that Chairman Manzullo included this important issue in the Small Business Tax Relief Act.

Another issue from the tax equity report—and I am going to skip over that for time. We have created in the 104th Congress a SIMPLE plan allowance which is designed to be a simple tax plan. Unfortunately this legislation, even though it allowed for the fact that it cost more for small businesses to provide services only allows them to save up to $8,000, where the rest of the 401 traditional plans would allow for a savings of $12,000 a year.

The Small Business Tax Relief Act of 2005 would also fix this inequity in the amount of pension funds that small business owners are able to put aside.

The Small Business Tax Relief Act of 2005 includes many additional tax reforms that are important. I again thank the Committee for the opportunity to share my thoughts on how the Tax Code might be reformed to assist small business.

As a final thought, we would appreciate the Tax Code being eliminated. As you know, NSBA supports the fair tax, but we commend the changes that are being made.

Thank you.

[Ms. Landis' testimony may be found in the appendix.]

Chairman MANZULLO. Thank you for your testimony.

The next witness is Kristie Darien, Executive Director of the National Association of the Self-Employed. Ms. Darien operates out of NASE's Washington office. NASE is a strong advocate on behalf of small businesses. I am delighted to have Ms. Darien here today before the Committee. I would also like to add that NASE has also endorsed the Small Business Tax Relief Act of 2005.

Ms. Darien, we look forward to your testimony.

STATEMENT OF KRISTIE DARIEN, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

Ms. DARIEN. Thank you very much. Thank you very much, Chairman Manzullo and Nydia Velazquez and members of the Committee, for having me here today to talk about important issues facing small business.

As the Executive Director of the National Association for the Self-Employed, I am here to speak on behalf of our 250,000-member micro-businesses, all of which have 10 or fewer employees.

The importance of micro-businesses to our economy cannot be overstated, and more than ever our Nation needs these businesses to marshal their resources and continue to advance the American economy by doing what they do best, create, innovate, produce, build and grow.

The complexities and inequities within the Tax Code have long placed a significant burden on the self-employed and micro-business owners. Small business specific tax reform would assist in creating a favorable environment for the growth and success of small firms. The NASE strongly supports this Small Employer Tax Relief Act of 2005, and we feel that the provisions included in the bill would greatly assist the micro-business community.

In particular, I would like to highlight two key provisions and their importance to the self-employed, the SETA tax deduction on

health insurance premiums and the annual standard home owner deduction of $2,500.

As many of you are aware, the state of healthcare among our Nation's micro-businesses is critical. The number of uninsured Americans continue to rise, and many of these individuals are owners or workers in small businesses. We believe in removing current inequities within the Tax Code would make purchasing health coverage more affordable and also remove a disincentive for the self-employed to insure.

NASE member Scott Falnes is an owner of a carpentry and construction company located in Lake in the Hills, Illinois, in Chairman Manzullo's district. He pays about $336 annually in self-employment tax and health insurance premiums. Scott calls this extra tax on sole proprietors unfair. He states, ″Obviously the tax is not fair across the board. The general population is not affected. I have to fight to keep my prices competitive, pay the bills, and hopefully have enough to let my business grow. I don't mind paying my 'fair' share so long as it's fair.″

Mr. Falnes is of course referring to the fact that he and 16 million other sole proprietors and partnerships with earned income have to pay the equivalent of payroll taxes amounting to 15.3 percent on their health insurance premiums.

On a national scale, according a recent Kaiser Family Foundation Study, the self-employed pay on average $10,880 for family health coverage. Because they cannot deduct these premiums as a business expense, they are required to pay approximately $1,655 in additional taxes that no other business entity must pay. This is money that our members tell us they would use to reinvest in their business, hire part-time assistance, or utilize to offset the rising premium costs they face each year and hold on to their health coverage a little longer.

NASE member David Caffrey, an electrical contractor in New Mexico, pays an additional $715 annually in self-employment tax on his health insurance premiums. He says that this extra cost adds to the high burden for small businesses and increases his healthcare burden. If David didn't have to pay this extra cost, he would use it to help pay his increase in gasoline costs.

The issue is about fairness. Again, let me restate, the self-employed are the only segment of the business population that do not receive a full deduction for health insurance premiums. This inequity needs to be corrected, and we are pleased to see this issue addressed in the Small Employment Tax Relief Act of 2005.

In addition to inequity within the Code, the self-employed struggle with the complexity of tax regulations. Increasingly, entrepreneurs are utilizing their home as a primary place of business. Over 50 percent of NASE's membership are home-based businesses. According to SBA Office of Advocacy, home-based businesses represent 52 percent of all firms and provide 10 percent of total revenue to the economy, yet many home-based business owners do not make use of the home office deduction due to the complexity of the deduction and the stringent criteria that they must meet. The form for the home office deduction is very complicated. The taxpayer must differentiate between direct and indirect ex-

penses, as well as other complicated calculations. The words ″see instructions″ appear on this one-page form 16 different times.

The option of a standard deduction of $2,500 for use of a home office is an excellent step towards tax simplification and would allow the myriad of home-based businesses in our Nation to utilize this important deduction.

Overall, an overwhelming hardship faced by the self-employed and micro-businesses continues to be complexity, vagueness and at times unfairness of tax regulations. Understanding and then complying with the Tax Code is extremely difficult and time consuming for a self-employed business owner. The inequities within the Code are unfair and greatly hinder their ability to contribute to our economy.

The introduction and hopefully eventual passage of the Small Employer Tax Relief Act would greatly assist in removing roadblocks to success and strengthening the competitiveness of our Nation's micro-businesses. Again, the National Association For the Self-employed is pleased to support this important legislation, and we applaud the Committee's leadership on these crucial issues faced by the self-employed.

Thank you.

[Ms. Darien's testimony may be found in the appendix.]

Chairman MANZULLO. Thank you.

Our final witness is Dr. John Irons, who is Director of Tax and Budget Policy at the Center For American Progress.

Dr. Irons, we look forward to your testimony.

STATEMENT OF JOHN IRONS, CENTER FOR AMERICAN PROGRESS

Mr. IRONS. Thank you, Mr. Chairman. I would like to thank you and Ranking Member Velazquez for inviting me to testify before this Committee.

As you mentioned, my name is John Irons. I am a Ph.D. Economist by training, and I am currently the Director of Tax and Budget Policy at the Center for American Progress, which is a nonprofit think-tank here in Washington, D.C.

As an economist, I am continually amazed by the resiliency of the American economy and the creativity of our Nation's small business owners. While the title of this hearing is Reforming the Tax Code to Assist Small Businesses, I feel it is important to note at the outset that the small business community does quite well on its own, and the goal of tax policy in many ways should be to get out of the way of private activity while still raising adequate revenue for vital domestic and international priorities.

Analysts often think about the following three basic principles in setting tax policy: Simplicity, fairness and economic growth. The Center For American Progress has developed a broad reform package based upon these principles. A copy of that proposal is included this my written testimony.

The principles that guide overall tax reform should also be followed when looking at taxation of small businesses. I think it is important to keep in mind that most small businesses are, indeed, small. The medium number of employees is fewer than four, and 89 percent of firms employ less than 20 people. Recent estimates

of IRS data from the Tax Policy Center, for example, show that in 2004 only 1.3 percent of those that reported small business income on their tax returns were in the top marginal income tax bracket, and nearly half of those of small business incomes are in the 10 and 15 percent tax brackets.

Now let me return to the three principles of simplicity, fairness and growth.

First, the Tax Code needs to be simple and predictable. I think we all know the Tax Code needs to be simplified, yet the Tax Code has been more complicated and less predictable over the last several years. In order for small businesses to make sound investment decisions, tax policy must also be stable so businesses can be confident in their business projections. To take one implication, the use of reconciliation in the budget process to enact tax policy should be avoided.

Some would argue that making the President's tax change permanent would solve some of this uncertainty, but doing so would simply lock in complicated policy and permanent deficits. I would argue that reform of the Tax Code is indeed necessary, but it should be reformed in a very different direction than current policy.

Second, most small businesses are not at the top end of the income scale, thus any restructuring that cuts revenue from the top will either shift the Tax Code to the middle and low income small business owners or will increase the deficit, which can then harm small businesses through higher interest rates. Small business efficiency requires a fair, progressive rate structure, not a flat structure.

Third, to be efficient and to have solid growth, incentives for investment in physical capital must also be balanced with incentives for investment in human capital. A tax cut that already favors wealth and investment in capital goods ignores the fact that it is human capital that is often the most important component of modern businesses. Also, Federal expenditures in other areas are vital for small businesses, and raising adequate revenue to fund our national priorities is essential.

We need to resist the temptation to claim that the small business community needs a tax cut each year to survive. Massive budget deficits, which can increase the long-term interest rates, do far more damage to small businesses and investments than a few tax breaks here and there.

Overall, the goal of small business policy should be to create the right environment for growth. The American small business community is vibrant, resilient and helps to make our country economically strong. The goal of tax reform should be to simplify the Tax Code, while keeping a progressive rate structure and preserving the incentive to add value to the economy.

Thank you.

[Mr. Irons' testimony may be found in the appendix.]

Chairman MANZULLO. Thank you, Dr. Irons.

Mrs. Kelly.

Mrs. KELLY. Thank you for calling on me.

I would like to ask Mr. Sullivan about what he thinks we can do in terms of these IRS audit programs and problems that have been presented here today with regard to the audits and small

firms. If you have got any answers or any ideas about that, I would like to hear them.

Mr. SULLIVAN. I think the most simple answer, Congresswoman Kelly, to what can the Committee do about the NRP and other audit programs is to continue to hold vigorous oversight of the programs.

I think in the last hearing that this Committee held in that regard, you got some very good commitments from Commissioner Everson that possible inaccuracies of draft data be corrected in between the draft and final stages. I think that we are expecting that the final data from the NRP be available in the fall, and I am optimistic that the Commissioner corrects some of the inaccuracies in that data.

I think one of those inaccuracies was a problem that this Committee looked at, and that was the potential for oversampling the small business sector. I think that the message from this Committee was loud and clear. I think the commitment by the Commissioner to try to address those inaccuracies is something that deserves this Committee's continued attention.

So I think that that is primarily a good focus for this Committee, and you are making a difference as far as that oversight goes because the IRS heard the message that this Committee is looking over their auditors' shoulders.

I think one other emphasis by the Committee that other witnesses, in particular Thala Rolnick, emphasized was to encourage the IRS to look at existing data sets for the information that they are professing to need these audit programs for, and I think that that bears further investigation by this Committee. Are they conducting audits to get information that already exists within the master file and within the return file?

Mrs. KELLY. So you are suggesting that perhaps a check with them on redundancies within their systems would be good, overlap redundancies, things like that?

Mr. SULLIVAN. Yes, Congresswoman.

Mrs. KELLY. Thank you.

Mr. Irons, you talked about a progressive structure. Given the problem that we have had with Hurricane Katrina and possibly with another one following close on its heels today, if you were to put in place a progressive structure, what would it look like?

Mr. IRONS. Well, I think for the overall tax cut, I think the first thing to keep in mind is the right frame that you raise, which is Katrina. We have a $300 billion deficit. With Katrina, it is going even higher than that, exactly how much about that, you know more about that than I do. But that is the context and we have to realize that we are going to need for revenue and in the tax plan which has been included in the testimony, we have a progressive rate structure which has three tax brackets which is down from the current 5 or 6 brackets and we set the rates at 15 percent, 25 and 39.6 percent which initially sounds high. But we also balance that out by eliminating the employee's side of the payroll tax.

So actually, in the plan that we submit, we reduce taxes on 70 percent of the population so essentially make the entire tax system more progressive and make people or ask people at the high end of the income scale to pay a bit more.

Actually what we do is we reverse some of the tax cuts at the high end for people who have benefited the most.

Ms. KING. Thank you, Mr. Chairman, for letting me go.

Chairman MANZULLO. Thank you.

Mrs. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Irons, Congress has passed nearly $2 trillion in tax cuts in the past 4 years. But the lack of relief for small businesses is outstanding. In 2001, we passed a $1.35 trillion tax cut, a $42 billion tax cut in 2002, and $350 billion tax bill in 2003, and $137 billion tax cut in 2004.

Yet despite all of this cutting, small businesses have never seen a more complex Tax Code and the amount of relief has been minimal.

Mr. Irons, you talk about how small firms are reluctant to invest because of the use of the sunsets in these tax bills. Why do you think that some of the targeted provisions aimed at small businesses have been sunset when we have nearly $2.2 trillion in budgetary cuts to work with?

Mr. IRONS. I am reminded of the statement, I believe the statement was cast in terms of millions, but I will talk about billions. A few billion here and a few billion there and you are talking about real money pretty soon.

We have spent quite a bit on tax cuts, $2 trillion. Last year if you look at the percentage of revenue as share of the economy, it was down to 16.3 percent, which is the lowest level in 50 years. So we are realizing very, very low levels of revenue. When you look at what could have been done with that money, immense strides could have been made simplifying the Tax Code. You have less revenue, and I think what is needed is a simplification as much as providing relief to targeted people.

I don't think small businesses, I don't think the American public was well served by having a Tax Code that I believe is moving in the wrong direction. So some reversal of what we have already done coupled with some simplification, I believe, is the way to go.

Ms. VELAZQUEZ. Thank you. Mr. Sullivan, in your testimony, you also talk about the importance of predictability and certainty for small businesses. Would you agree that providing permanent relief for some of these targeted small business measures should be a priority as opposed to extending provisions such as the diffident tax cut?

Mr. SULLIVAN. I actually consider extending and making permanent very similar for the predictability in the use of small business planning with regards to the tax cut.

Ms. VELAZQUEZ. Ms. Olson, I know your organization works with the IRS assisting small businesses to properly file their taxes. I would like for you to expand on your comments on some of the restructuring efforts at the IRS. Do you believe that the reduction in staff at the IRS Small Business Self-Employed Division will lead to small businesses spending more on tax professionals?

And I am also concerned about the impact on the self-employed. Do you believe that the IRS and the changes that they have will lead these micro entrepreneurs to hire accountants and lawyers that they would not otherwise?

Ms. OLSON. I am concerned about whether the IRS is achieving the right balance between, as the commissioner is want to say, service and enforcement. The recent changes with the outreach in education functions in the small business component concerns me.

I think that my colleague to my left is right when we say that we should have an education contact perhaps before an audit contact, particularly for start-up businesses. And I am concerned that the IRS is walking away from a physical presence, a face-to-face presence with business owners and relying on more passive interaction like Internet, which may be cheaper for the IRS but more expensive for all taxpayers in the long run because people make mistakes.

My office is very much watching that and we are finding more and more that my local taxpayer advocates around the country are the first point of contact that small business owners and their practitioners and preparers make.

Ms. VELAZQUEZ. Thank you. Ms. Rolnick, Congress has tried to pass some measures such as bonus depreciation and increased expensing to spur investment through reduced tax liability for entrepreneurs. However for these measures to work, we need for small businesses not to worry about taking advantage of these changes.

Do you think some small businesses will be reluctant to use these tax breaks out of concern that they might be red flagged by the IRS and subject to an audit?

Ms. ROLNICK. I have never had that experience. Of course, they are working with me, not working on their own, so they come to me for my expertise. And when I say to them we can take this and that is fine, I have never had one say no, I am afraid that is going to raise a flag. I have had clients say I really have some more expenses, but that is going to put in a loss situation, so I am not going to give them to you.

Chairman MANZULLO. We are going to have a series of votes. I would like to give everyone a chance to ask a question. Ms. Bordallo, please give us your best one or two questions.

Ms. BORDALLO. Thank you, Mr. Chairman. I guess the one that is most pressing is the one for Attorney Sullivan. What are the tax relief provisions available to small businesses following disaster situations as in the aftermath of Hurricane Katrina? I ask this because Guam is located in what is commonly known as ″typhoon alley.″ typhoons can have devastating effects and small businesses have limited resources to respond to the catastrophe. Tax relief at time of crisis is essential—

Chairman MANZULLO. I need your question, otherwise I cannot get everybody else time before the next votes.

Ms. BORDALLO. Okay. What, in your opinion, should we do to cover all future national disasters and should this be in the tax relief package?

Mr. SULLIVAN. Actually, I don't know. I know that Congress is focused on that type of stimulus.

Ms. BORDALLO. Talking about the future.

Mr. SULLIVAN. I don't know.

Ms. BORDALLO. Can anybody answer? Should it be in that package?

Ms. OLSON. I think both Houses of Congress are looking at provisions that include things like re-employing people who are victims in a disaster area, making them eligible for the work opportunity credit for employers. Looking at even more stimulation for rebuilding in the area, education incentives for retraining when people have to move around. Incentives for employers to rehire people when they have to be retrained and moved around. Those sorts of things.

Chairman MANZULLO. Mr. Faleomavaega, we will keep going with questions until the bells ring.

Mr. FALEOMAVAEGA. A question, I gather, from some of the recommendations that members of panel have made have all been incorporated in the chairman's proposed bill for 2005? Some of them? So it is not enough yet. How do you tell an independent agency like the IRS not to conduct these audits? Does this require a presidential mandate?

Mr. SULLIVAN. Very carefully.

Ms. OLSON. When I heard the audit stories, my first thought was my colleague should have come to the taxpayer advocate service. I think that the IRS is trying to conduct audits and do a balanced approach to making sure everybody pays the fair taxes.

I think that right now, we have to be careful about the messages that we are sending to the front line IRS employees, and sometimes I think the IRS employees get a little bit too vigorous in their requests. And your continuing oversight will help. If you hear from your constituents, I would like to hear about it as well because we will look at each individual case.

Ms. ROLNICK. And I do believe that IRS should have audit functions that is important but there need to be better choice of who they audit.

Chairman MANZULLO. Mr. Lipinski, do you have a question for the witnesses?

Mr. LIPINSKI. I have a more specific question. I was just in Chicago on Monday with the chairman and we were speaking with manufacturers. Manufacturers, Chamber of Commerce people, local leaders, officials, speaking specifically about problems with American manufacturers. One of the ideas that was thrown out there is we have an industry, manufacturing, that is facing some really significant immediate problems right now. And one of the ideas that they gave to us was giving them a temporary tax break to allow them to deal with what they are facing in terms of foreign competition.

Is this something that—does anyone have any comments on that? It is something we have seen done in the past to good ends? Or do you think that this is not something that would be useful or good?

Mr. SULLIVAN. Actually, I would like to take a stab at it. First of all, any complexity in the Tax Code disproportionately impacts small manufacturers more than any other sector of the economy. That was really the stark findings from the research issued by my office 2 days ago. We are talking about three times the compliance cost for small manufacturers versus their larger business counterparts. So when you look at any part of the Code and simplify it,

you have three times the benefit to small manufacturers than any other part of the sector.

I think the one part of this bill that you get the twofer on, lowering rates and simplicity and gaining more attention and purchasing from the manufacturing perspective in section 179 expensing. The idea of encouraging folks to take 179 expensing and actually purchase products from their neighbors their friends and other manufacturers. Not only do you get greater predictability that you make a provision, you remove a sunset provision so you get greater predictability. It is a simplicity dream for small businesses to have 179. And you are encouraging folks to purchase other products throughout the United States. So you really—that provision stands out as a win, win, win, provision within this legislation.

Ms. OLSON. If I might make a point about the depreciation, which I made in my testimony. Every time someone takes a large deduction for section 179, there is the possibility that is—it is added back in in one's alternative minimum taxable income and it may pull you into the AMT. So you give them the deduction on the one hand and then you tax them again on the AMT under the other. You have to really watch out for that.

Chairman MANZULLO. Mr. Bordallo, second question.

Ms. BORDALLO. Thank you, Mr. Chairman. To Director John Irons, tax reform can be used to guide—

Chairman MANZULLO. I believe Mr. Irons' title is ″Doctor.″

Ms. BORDALLO. It says ″director.″

Chairman MANZULLO. Sorry about that. Please proceed.

Mr. IRONS. I wish I was the director of the organization. I am only the director of tax and budget policy inform.

Ms. BORDALLO. All right. In your opinion, how effective have recent tax cuts been for providing incentives for small businesses to grow and also in your opinion what is the most pressing important reform that is needed currently to assist small business?

Mr. IRONS. On the growth front, I think if you look at growth of the overall economy over the past several years, you have seen reasonably robust growth or the past 2 or 3 years, but you really saw very slow poor recovery to the 2001 recession. And so I think when you look at small businesses, you see the same general pattern. You see relatively reasonable growth, nothing spectacular over the past several years.

I think the economy should be doing stronger than it is, which leads to second part of your question about what we can do.

And there, I think let me come back to my testimony, it is important to realize that most small businesses are small and when your talking about spurring small business growth, you are talking about really helping out people lower in the middle of the income distribution, not people at the high end. So the tax plan that we have put forward as I put in my testimony actually lower tax burden on people at the lower and middle end of the income distribution and that should be good for growth, good for small businesses to preserve the incentives, and it should really help out the economy by looking at where the bulk of small businesses are.

The second component of that is it is important to realize that it is really the human capital, it is education, training, skills, that drive most of the economy. So that is true of small businesses as

well. So I think incentives, not just for capital equipment, but also incentives for school and incentives for training. I believe that is a really important part of how we should think about the Tax Code. And to not just focus solely on wealth and capital as the end all and be all of tax policy, but there is this whole other component that is really what the modern economy relies on.

Chairman MANZULLO. Mr. Faleomavaega, second question? Mr. Lipinski, second question? If we have no additional questions, I will ask a question. We have been concerned that the IRS is too energetic in going after small business people in audits. I have talked to Commissioner Everson about it, and Tom Sullivan has mentioned the flawed NRP study. But this is a new situation, where, I think, Ms. Olson, you testified that the IRS is going to start auditing S corporations during their first and second years. Were you the one that testified to that? Or was it Ms. Rolnick?

Ms. ROLNICK. I was the one.

Chairman MANZULLO. Where did you learn that information?

Ms. ROLNICK. My first audit. I had a client audited. It was her first year as a corporation, and the auditor came in and said why are you auditing this client? Why do you audit first year businesses? They never make a profit? And she said this is a program and we want to make sure they do it right at the beginning. I am still in the process of that audit. I think we started the audit about 2 months ago.

Chairman MANZULLO. Would you send me a letter on your letterhead? I will send that letter to Mark Everson and ask him if this is another program that the IRS has started. I think that is terrible. It is something that we did not know about the last time that we had a hearing on this.

All right. Does anybody else have any more questions or comments? Ms. Velazquez? Please proceed.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Irons, going back to a possible Katrina tax bill, I would like to hear your thoughts on some of the proposals that are out there. There has been talk about allowing small businesses to deduct more of their income through a higher section 179 expensing level. Given that many of these small firms would have little or no profit, this would be more attractive to offer a refundable tax credit aimed at the small firms?

Mr. IRONS. Obviously, a deduction that you do not get to take is not worth anything. So for a lot of small businesses having something that is refundable putting money in your pocket is probably a very good idea.

Ms. VELAZQUEZ. Thank you. Thank you, Mr. Chairman.

Mr. FALEOMAVAEGA. If the chairman would yield. I would like to offer a humble recommendation if there were other recommendations offered by members of the panel that we would seriously look at it and make it a part of our proposed bill and not be lost in the cracks, so to speak, and maybe the majority and minority staffs would seriously consider those recommendations, Mr. Chairman.

Chairman MANZULLO. Okay. We have completed all of the questioning. Thank you for your patience in this sort of a roulette way of asking questions. I want to thank each of you for coming here and spending time with us and sharing your thoughts.

Ms. Landis, please take 30 seconds. You had raised your hand, and I caught you in the corner of my eye after I recognized another Member. Do you remember what you wanted to say?

Ms. LANDIS. I do. Just in general, when you were talking about ways to benefit small business. The point you had made is that a tax deduction is a benefit if you have a profit to deduct it against. When small businesses are struggling whether it is Katrina or the economy or whatever it is, simplifying the Tax Code so that their energy can be spent on growing the business instead of hours with professionals on how to deal with their taxes. And any savings, because most business owners that I know and I work with hundreds of them, any dollar saved they invest in their business and employees and benefits to their employees.

So any way that you can enable the business owner to keep more money on the table for his company he will invest—he or she—in their business. I appreciate deductions they are wonderful when I have a profit to take them against. But anything that can be done to simplify the Tax Code or enable me to save tax dollars I can pass on to my employees, like the things in your plan with the self-employment tax or the pension benefits are important.

Chairman MANZULLO. Thank you. Ms. Rolnick?

Ms. ROLNICK. You commented that there was something else that was left out of the bill that I thought might be a good aid to small business. What I see on a regular basis is when we have somebody buying into a new business, somebody is retiring and the new person is buying in. We have covenants to not compete, and they are paid over 5 years and they are amortized over 15 years. That means the taxpayer has to pay out the money in 2 to 5 years and does not get the benefit except for over 15.

Chairman MANZULLO. Thank you. Again, thank you for coming. This hearing is adjourned.

[Whereupon, at 3:37 p.m., the committee was adjourned.]

Opening Statement

Donald A. Manzullo, Chairman

Reforming the Tax Code to Assist Small Businesses

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

Wednesday, September 21, 2005, at 2:00 p.m.
2360 Rayburn House Office Building

Today, the Committee will investigate proposals for assisting small businesses through reforming the tax code. With our economy still suffering from the aftershocks of Hurricane Katrina and another potentially devastating storm on the way, we know that small businesses lead the way in any economic recovery. The primary focus of the hearing is the provisions in the *Small Employer Tax Act of 2005* that I introduced earlier this morning, which is aimed toward assisting our nation's dynamic small business sector. Hopefully, the President's tax reform commission whose report is due later this fall will adopt many of the recommendations contained in SETA.

The Small Employer Tax Act of 2005 includes a number of provisions to fix some of the long-standing problems in the tax code. For example, this bill allows deductions from self-employment taxes for health insurances premiums, makes small business expensing permanent, phases out the alternative minimum tax for individuals through 2009, and liberalizes the election and revocation provisions for S corporations. There are also numerous other provisions that benefit small businesses.

I have strongly supported recent efforts in Congress to modify the tax code in ways that promote and enhance small businesses. In the 108th Congress, two tax bills with provisions that assist small businesses were enacted with my support: the *Jobs and Growth Reconciliation Act of 2003* and the *American Jobs Creation Act of 2004*.

The *Jobs and Growth Reconciliation Act of 2003* 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 income tax 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 have found helpful.

The *American Jobs Creation Act* cut taxes on our nation's manufacturers that commit to keeping production in America and also extends the small business expensing provisions. It also allows small businesses to deduct up to $5,000 of start-up or organizational expenditures in the tax year in which the trade or business commences. Finally, many changes were made to liberalize the S corporation rules, the vast majority of which are small businesses. The changes include increasing the maximum number of shareholders from 75 to 100 and treating the members of a family as a single shareholder.

We have with us this afternoon several outstanding witnesses, including a fellow committee member, Mr. Fortenberry from Nebraska. After Mr. Fortenberry provides his testimony, we will hear from a distinguished panel of government and private sector witnesses that will provide their unique prospective on the items that need to be addressed in the current tax code to promote and enhance this nation's small businesses.

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

9/21/2005 9:05:04 AM

United States Congressman — First District, Nebraska

JEFF FORTENBERRY

Statement by the Honorable Jeff Fortenberry

Small Business Committee

Reforming the Tax Code to Assist Small Businesses

September 21, 2005

Chairman Manzullo and Ranking Member Velazquez: Thank you for holding this important hearing.

At the outset, I must tell you of a fascinating trend. I recognized this trend myself intuitively, but had it affirmed by more empirical data. Young adults – commonly known as Generation X – are interested in two very great ideals: Family life and Entrepreneurship. I believe these ideals flow from the same desire. A desire for self-possession and self-donation. In the family, a person enters through commitment into a community of intimacy, and builds a community of love and life. This most solemn ideal is a great gift of the human experience and a serious responsibility – one that many young people are eager to embrace, even given the difficulties that many have faced in their own upbringing.

The second ideal of entrepreneurship embraces the freedom to use one's own gifts to produce a good for the community – to build something that is the very imprint of one's self, to create using one's own hands and mind, receiving in turn the full fruits of one's own labor. Again, this ideal is the essence of rewarding hard work and is a desire expressed readily by younger people. No more "40 years and a gold watch." We may well be entering the age of the entrepreneur.

Recognizing this reality, I believe we must work to adjust our tax laws to assist those who want to create new opportunities for themselves and their families. I will soon introduce two bills to promote entrepreneurship and long-term economic security. First, I propose allowing individuals to roll-over portions of their retirement accounts into Health Savings Accounts. Second, I will propose to change the traditional IRA to allow small business investors to take loans from these retirement accounts similar to the existing loan provisions for the 401(k) plan. These bills address two key areas of concern for small businesses -- providing increased access to insurance coverage and gaining access to capital.

Before I go into the details of these proposals, I believe it is important to review briefly why small businesses are so important. Quite simply, small business is the most productive sector, where most people work, earn, and try to get a little bit ahead in life. According to the SBA, small businesses are responsible for about 75 percent of the net new jobs added to the economy and employ half of all private-sector workers. They also

represent 99 percent of all employers and 97 percent of all U.S. exporters. We must develop policies to encourage this important sector of the economy.

I have a keen interest in reducing barriers to entry into business. I initially focused on access to capital issues, but quickly saw how the lack of available health insurance and rising health care costs decreases productivity and distorts social and economic decisions. For instance, it is not uncommon among farm families in my district for a spouse to drive long distances to maintain a job primarily for health care coverage. How can we count the loss of new ideas and new productivity because someone makes an undesired economic decision based solely on health insurance coverage?

As we have learned, the rising cost of providing health coverage for employees is a growing obstacle for small business owners, or those who might wish to join their ranks. It is not surprising that only 63 percent of smaller companies can even afford to offer health insurance. This is a primary reason why three out of five uninsured persons in our nation are small business owners, employees, and their families.

Recently, the Small Business Committee held a field hearing in my district. During this forum, we examined the increasing costs of health insurance and the possible solutions. The hearing emphasized the importance of an underutilized tool for small businesses -- Health Savings Accounts, which were established as part of the Medicare Prescription Drug Law. These tax preferred accounts, coupled with high deductible

health insurance, help alleviate the ever increasing costs of traditional health insurance premiums and empowers families to better control their own health care costs.

According to a survey conducted by the Kaiser Family Foundation and Health Research & Educational Trust, only about 20 percent of employers who offer health insurance provide a high-deductible policy option. The same survey found that only 2.4 million workers outside the federal government are enrolled in such plans. While the number of individuals utilizing these accounts is increasing, we need to do more to give small business owners and entrepreneurs the ability to take advantage of this policy innovation. In fact, of the new policies, 37 percent were taken out by individuals who were previously uninsured and 27 percent were taken out by employers who did not previously offer their workers health insurance.

As mentioned in my proposed legislation, individuals will be allowed to roll-over portions of their retirement accounts into Health Savings Accounts. This roll-over would not subject the retirement account to the usual 10 percent penalty for an early distribution. Moreover, all individuals with retirement accounts would be eligible to take advantage of this opportunity. This will help to meet important public objectives of increasing access to health insurance coverage and overcoming a major barrier to entry that small businesses face.

An additional barrier entrepreneurs encounter is gaining access to capital. Earlier this year, the committee considered and the House passed H.Res.22, the Small Business

Bill of Rights, which identified access to capital as a key concern for small businesses. According to the SBA, the majority of small businesses use some form of external credit. Sadly, 46 percent of these small business owners are using their own personal credit cards as a source of capital.

The bill that I propose will provide additional sources of capital by changing the traditional IRA to allow small business investors to take loans from these retirement accounts. The provisions of these IRA loans are similar to the existing loan provisions of a 401(k) plan in several ways. First, they would permit individuals to borrow up to the greater of half their IRA account balance or $10,000. In either case, the loan will be capped at a maximum of $50,000. Second, the provisions will require the individual to use the money to finance small business capital expenses. Third, individuals will have five years to repay the loan to ensure that the loan is not treated as a simple withdrawal from an IRA.

These initiatives will encourage young people to get a jump start into promising business opportunities, enable more advanced workers to potentially have greater access to capital for formation of small businesses, and allow more senior workers, who are often must be risk-averse, to start new ventures. These goals are consistent with the purpose of retirement savings in that they will allow more persons to be owners, possess the means of production, and provide long term economic security for their families.

Again, thank you, Chairman Manzullo and Ranking Member Velazquez for holding this hearing and allowing me to testify on these important issues facing our small businesses.

Chairman Manzullo and Members of the Committee, good afternoon and thank you for giving me the opportunity to appear before you 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, therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA.

The Committee has asked for Advocacy's views on small business tax reform and specifically, how the incremental reforms of the Small Employer Tax Relief Act of 2005 (hereinafter the Act) will affect small business. Advocacy takes its direction from small business. With the help of the small business community, our team of regulatory experts and economists seeks to fulfill our statutory responsibility to "determine the impact of the tax structure on small business 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 Nations economic well-being."[1] I am glad that the Committee has given me this opportunity to share the views of small business on tax reform and this important legislation.

This Committee certainly knows the contributions that small businesses make to the American economy. Of all U.S. businesses, 99% are small businesses which employ over 50% of the American workforce. When the Nation's economy has faced serious challenges small businesses have led the way to growth and prosperity. Therefore, tax reform must be focused to minimize unnecessary tax burden on this vital sector of the economy.

What Small Firms Need

Taxation affects the creation, financial performance, and growth potential of small business. To encourage and support the growth of small firms, tax reform must reduce the marginal rates, decrease the complexity and increase the predictability of the tax code.

Lower Marginal Rates

Small firms need tax reform that lowers marginal tax rates. Research shows that increasing marginal tax rates on business income reduces the chances that entrepreneurs will open new firms while it increases the likelihood that they will exit the market.[2] Conversely, the study reveals that decreasing marginal tax rates across the board would

[1] 15 USC §634(b)(4).

[2] In a study funded by the Office of Advocacy it was found that marginal tax rates have an effect on individuals' decision to enter into entrepreneurial activities. Reducing rates may lead to increased entrepreneurial activity and survival. See *Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data*, by Donald Bruce, Ph.D., and Tami Gurley (March 2005).

actually spur entrepreneurship by increasing the rate of new firm formation and slowing the rate of firm closure.[3]

Decrease Complexity of the Tax Code

A study released just this week by my office on Federal regulatory burden shows that tax compliance costs for firms with fewer than 20 employees were almost twice as much, per employee, as large firms with more than 500 employees.[4] Tax compliance costs $1304 per employee for very small firms versus $780 for large firms.[5] The smallest of the small firms pay just under twice as much as large firms to meet their tax responsibilities. The cost disparity between small and large employers described above is significant. However, when the same analysis is done comparing very small manufacturers to large manufacturers the differences are more extreme. Tax compliance costs $2582 per employee for very small manufacturers compared to $767 per employee for larger manufacturers.[6] Very small firms in this sector pay more than three times more per employee than large firms.

A large portion of the cost is the time and effort required for the owner to collect and decipher the voluminous tax laws and regulations. This adds cost and administrative burden to small businesses. Simplifying the tax code will reduce the costs of compliance for small business.

Predictability

Advocacy's research shows that when there is less predictability in the tax code, then there is more uncertainty in the economic future of a business, which inhibits planning.[7] Sunset provisions, phase-outs, and threshold levels introduce a higher level of variability in small firm expectations. Unexpected shifts in the tax rate and structure exacerbates the difficulties inherent in conducting a small business.[8] This uncertainty requires business owners to make allowances for unknown changes in the tax laws, while planning for their future. Certainty in the tax code gives small business confidence and allows them to make decisions for the future.

An example of how tax rates, complexity and the lack of predictability have created a difficult situation for both taxpayers and the Internal Revenue Service is the proposed National Research Program (NRP) focused on S corporations. On July 25, 2005, IRS Commissioner Mark Everson announced that the IRS plans to conduct an NRP study of S corporations. The NRP is the process by which the IRS measures payment,

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[3] Id.
[4] See *The Impact of Regulatory Costs on Small Firms,* an Advocacy funded study by W. Mark Crain (September 2005).
[5] Id.
[6] Id.
[7] See the working paper by Dr. Radwan Saade, *Rules Versus Discretion in Tax Policy*, located at *www.sba.gov/advo/stats/wkp02rs.pdf.*
[8] Id.

filing and reporting compliance for different types of taxes and various sets of taxpayers. Essentially, NRP is an audit study to help the IRS select returns for greater scrutiny.

The NRP as directed by the IRS has a history of focusing on small business.[9] This NRP is directed at small business in that the majority of S corporations are small firms. The study is supposed to help the IRS understand how income, deductions and credits are reported by S corporations. However, if measures were taken to lower marginal rates, simplify compliance and provide permanence to our tax system there would be less confusion on the part of taxpayers and the IRS about how entities use preferential taxing provisions granted by Congress. An argument can be made that any irregularities found in the NRP are a product of the disparate tax treatment of different types of income and not by improper activity on the part of S corporation taxpayers. Tax reforms focused on marginal rate relief, simplified compliance and predictability, would benefit both taxpayers and the IRS because it would permit them to devote more resources to achieving their business and regulatory goals.

Small Employer Tax Relief Act of 2005

The Small Employer Tax Relief Act of 2005 will help to improve the tax environment for small firms. The Act makes permanent the expensing provisions of Section 179,[10] allows health insurance premiums to be deducted against self-employed payroll taxes and eliminates the individual Alternative Minimum Tax (AMT). These are key to achieving the tax reforms necessary for small business. These three cornerstones of tax reform are addressed by provisions in the Act, which are highlighted below:

Expanded Expensing Provisions

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRR) began the process of removing tax roadblocks for small business. The provisions of Section 179 were expanded by JGTRR. Section 179 permits small firms to expense the cost of purchased business equipment placed in service during the tax year. My office was pleased with the gains achieved by JGTRR at that time, but more can be done.

Prior to JGTRR small businesses were permitted to expense capital investments up to $25,000. The phase-out limit was set at $200,000 and reduced the expensing amount dollar for dollar. Thus, if capital investments exceeded $225,000 the expensing privilege was lost. As a result of JGTRR, the expensing limit was indexed to inflation and set at $100,000.[11] The phase-out limit was also indexed to inflation and increased to $400,000.[12] Advocacy and the small business community have consistently applauded

[9] Preliminary results of an NRP which studied the 2001 tax returns of high wealth individuals and Schedule C filers (sole proprietors) were released on March 29, 2005. The IRS used this information to state that small business is responsible for the majority of the tax gap. Testimony of Mark W. Everson, Commissioner Internal Revenue Service, before the House Committee on Small Business on *Closing the Tax Gap and the Impact on Small Businesses*, April 27, 2005.
[10] All section references are to the Internal Revenue Code of 1986 as amended.
[11] In 2004 the expense allowance was $102,000. The amount for 2005 has not been announced.
[12] In 2004 the maximum expensing allowance was $410,000. The amount in 2005 has not been announced.

the benefits of the expanded Section 179 provision. The expanded limits will sunset on December 31, 2007.[13] Small businesses have asked that the increased limits be made permanent. The President's 2006 budget request also proposes that the expensing provisions of Section 179 be made permanent. The Small Employer Tax Relief Act would grant permanence to the increased provisions of Section 179 as requested by the President and the small business community.

Without Section 179, small businesses must depreciate the cost of business assets by using permitted depreciation methods. Under Section 179 marginal rates are decreased for small firms because capital investments are allowed to be expensed instead of depreciated over several years. Section 179 also addresses simplified compliance because depreciation calculations do not have to be done yearly. Finally, permanence is achieved because small firms can count on the expensing provisions when they plan their future.

Tax Deduction on Self-Employment Taxes for Health Insurance

The Small Employer Tax Relief Act rectifies an imbalance in the tax code created in Section 162(l). In general, Section 162(l) provides that the costs of health insurance premiums are ordinary and necessary business expenses. This permits taxpayers conducting a business to deduct their health insurance premiums from their income when calculating their income tax liability. Under Section 162(l)(4) this deduction is not permitted when self-employed taxpayers determine their payroll taxes.

In addition to this unfair tax on health insurance premiums the cost of health insurance continues to rise at a rapid pace, especially for small firms.[14] A recent study funded by the Office of Advocacy found that only 31.5 percent of workers in small firms with fewer than 10 employees had access to employer sponsored health insurance.[15] Correcting this imbalance will provide some relief from the high cost of health insurance and will reduce the marginal tax rate on the self-employed.[16]

The current Section 162(l)(4) disadvantages sole proprietors, partners, and shareholders in an S corporation. The Tax Code generally views these types of business owners as self-employed taxpayers. Thus, these types of business owners are responsible for self-employment taxes. However, if these same business owners conducted their business as a C corporation, and were employees, then their health insurance premiums would not be included when calculating their employment taxes. The small business

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[13] The increased provisions of Section 179 was set to expire on December 31, 2005, but the American Jobs Creation Act of 2004 extended the provisions.

[14] *Id.*

[15] *Cost of Employee Benefits in Small and Large Businesses*, Popkin, Joel and Company, August 2005, U.S. Small Business Administration, Office of Advocacy (SBAHQ03M0562), available at http://www.sba.gov/advo/research/rs262tot.pdf.

[16] In a study funded by the Office of Advocacy it was found that marginal tax rates have an effect on an individuals' decision to enter into entrepreneurial activities. Reducing rates may lead to increased entrepreneurial activity and survival. See *Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data*, by Donald Bruce, Ph.D., and Tami Gurley (March 2005).

community has repeatedly identified this issue as an area of major concern. The Small Employer Tax Relief Act of 2005 addresses this issue by repealing Section 162(l)(4). As a result, self-employed taxpayers would be permitted to deduct their health insurance premiums when calculating their payroll tax.

Increased Deduction for Business Meal Expense

Currently Section 274(n)(1) permits a 50 percent deduction for business meals. The proposed legislation would increase the permitted deduction to 80 percent for business meals. Small firms do not have large marketing budgets. They unlike larger businesses rely upon restaurants as their conference room to attract business. Much of small firms' business is generated by face to face interactions over meals.

Although the business meal deduction is not specific to small businesses, small firms realize on average a larger reduction in their effective tax rate than large businesses. Specifically, small firms' effective tax rate is reduced by 0.86 percent while large firms reduce their effective tax rate by only 0.11 percent.[17] Increasing the deduction for business meal expenses assists small businesses by reducing their effective tax rate.

Repeal the Individual Alternative Minimum Tax

The individual Alternative Minimum Tax is an alternative income tax calculation. Its purpose is to ensure that individuals do not avoid paying taxes through the use of special credits and deductions. The AMT increases the marginal rate of taxpayers by denying them deductions and credits granted by Congress. When first enacted, the AMT was justified because there were 156 "high income" individuals that did not pay any income tax. The AMT is expected to apply to 33 million taxpayers by 2010.

For sole proprietors, partners, and S corporation shareholders, the individual AMT increases tax liability on their business earnings. This is done by limiting the 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 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 taxpayers. Even in cases where the AMT does not apply, small business taxpayers still have to perform 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 reform of the AMT. The Act phases out the AMT for individuals between 2006 and 2009 and eliminates it in 2010. Additionally, the corporate AMT would be limited so that small corporations are shielded from the AMT.

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[17] *The Impact of Tax Expenditure Policies on Incorporated Small Business*, Innovation & Information Consultants, Inc., April 2004, U.S. Small Business Administration, Office of Advocacy (SBAHQ-02-Q-0027, available at http://www.sba.gov/advo/research/rs237tot.pdf.

The cornerstones of tax reform for small business are addressed through the repeal of the AMT. Repeal of the AMT will lower marginal rates on small business, simplify compliance by eliminating a notoriously complex calculation for small business and increase predictability of the Tax Code. As a result, small firms will gain more time and capital to grow their business.

Conclusion

Tax reforms directed at marginal rate reduction, simplified compliance and permanence are of critical importance to small business. Advocacy and the small business community believe that the Small Employer Tax Relief Act will achieve the important reforms outlined in this testimony. We look forward to working with the Committee to promote these and other tax reforms benefiting small business.

Thank you for allowing me to present these views. I would be happy to answer any questions.

WRITTEN STATEMENT OF NINA E. OLSON
NATIONAL TAXPAYER ADVOCATE

BEFORE THE

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

ON

TAX BURDENS FACING SMALL BUSINESSES

SEPTEMBER 21, 2005

Mr. Chairman and distinguished Members of the Committee:

Thank you for inviting me to testify today about tax burdens facing small businesses and proposals to reduce these burdens through changes to the Internal Revenue Code. I commend Chairman Manzullo for introducing The Small Employer Tax Relief Act of 2005, which contains a number of proposals that I have long advocated and believe would benefit small businesses considerably. (I discuss these proposals in more detail below). All businesses bear heavy burdens in complying with the tax code. Large corporations, however, can hire sophisticated law and accounting firms to handle the complex provisions affecting business taxpayers. Small business owners, on the other hand, generally must comply with both individual and business tax provisions, often with little or no professional assistance.

For many small business owners, tax issues are the single most significant set of regulatory burdens.[1] While some of these rules and regulations are unavoidable, Congress should periodically review the tax rules applicable to small businesses to ensure that they are narrowly tailored to accomplish their objectives and do not require small business owners to jump through unnecessary hoops. Moreover, the IRS should periodically review its compliance strategies to ensure that small business initiatives are appropriately designed for the problem they seek to address. Thus, to increase voluntary compliance in the small business sector, the IRS must make it easier for these taxpayers to comply. It must use education, assistance, and innovation, as well as traditional audit and collection techniques.

Before addressing the specifics of the bill, I will briefly describe the functions of my office, the problems we see that most affect small businesses, and how we can assist small businesses.

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[1] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 386-87.

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).[2] 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.[3] 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 (LTA) in each state.[4] LTAs and the Case Advocates on their staffs assist in resolving specific taxpayer problems, ranging from simple IRS processing errors or delays to complex examinations and appeals. Any individual or business taxpayer having difficulty resolving a problem through normal IRS channels may, subject to certain criteria, obtain assistance from the Taxpayer Advocate Service. Taxpayers may contact their local taxpayer advocate (telephone numbers are listed in the Blue Pages of the phone book and in IRS Publication 1546, How to Get Help With Unresolved Tax Problems) or call 1-877-777-4778.

The other component of TAS is Systemic Advocacy. The goal of our Systemic Advocacy function is to identify issues that unduly burden groups or segments of individual and/or business taxpayers, and develop solutions to those problems. We receive hundreds of suggestions every year from inside and outside the IRS. Taxpayers may submit systemic issues to us through our website, http://www.irs.gov/advocate.

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.[5] Through these reports, we generally address the proposals to which we assign the highest priority. The December 31st report comprises three major sections that:

- Identify at least 20 of the most serious problems facing individual and business taxpayers.

[2] Pub. L. No. 105-206 (1998).
[3] IRC § 7803(c)(2)(A).
[4] IRC § 7803(c)(2)(D)(i)(1).
[5] IRC § 7803(c)(2)(B).

- Recommend 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

Through June of 2005, small business cases accounted for 39.6 percent (or 55,143) of TAS' total case closures for fiscal year 2005. Of these cases, 80.2 percent came into TAS because of systemic problems, most notably delays, rather than because the taxpayer experienced economic hardships. Table 1 shows the top ten issues identified in TAS cases encountered by small business and self-employed (SB/SE) taxpayers for fiscal year 2005 through June 2005, and the percentage of those cases in which TAS was able to provide either full or partial relief.

TABLE 1, SMALL BUSINESS / SELF-EMPLOYED TAXPAYER ISSUES IN TAS FOR FISCAL YEAR 2005 THROUGH JUNE 2005

Core Issue Description	Volume	% of Total SB/SE Cases	% Where Relief Provided
Criminal Investigation	4,711	8.5%	48.4%
Processing amended returns	3,477	6.3%	75.3%
Levy	3,075	5.6%	60.8%
Processing original returns	2,477	4.5%	83.2%
Audit Reconsideration/Substitute for Return (SFR)	2,395	4.3%	66.8%
Open audit	2,219	3.9%	64.1%
Failure to File (FTF) / Failure to Pay (FTP) penalties	1,790	3.2%	77.0%
Revenue protection strategy (Earned Income Tax Credit (EITC) claims)	1,713	3.1%	52.0%
Missing/incorrect payments	1,555	2.8%	79.4%
Combined Annual Wage Reconciliation (CAWR)/ Federal Unemployment Tax Act (FUTA)	1,514	2.7%	82.6%

Since I became the National Taxpayer Advocate four years ago, I have identified a number of issues affecting small businesses in my reports to Congress. Many of these issues are reflected in TAS' case inventory. Some of the problems I have addressed include:

- The Confounding Complexity of the Tax Code[6] – In my most recent Annual Report to Congress, I identified Internal Revenue Code complexity as the

[6] National Taxpayer Advocate 2004 Annual Report to Congress at 2-7.

most serious problem facing taxpayers (and the IRS). For example, business taxpayers must grapple with a patchwork of rules that cover such items as the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and vague factors that govern the classification of workers as either employees or independent contractors.

- Education and Outreach Efforts[7] – Tax law and administrative complexity can baffle all taxpayers and lead to compliance problems. Small Business taxpayers cannot always afford sophisticated professional tax advice. These taxpayers need IRS help and assistance in understanding and complying with their tax obligations. I am concerned that inadequate IRS taxpayer education efforts may significantly affect compliance in this complex environment. It is unclear whether changes in the IRS Small Business/Self-Employed Division's Taxpayer Education and Communication (TEC) program will lead to the right kind of outreach and education.

- IRS Customer Service and Access[8] – As the IRS has increased enforcement efforts, my office has observed a corresponding decrease in certain taxpayer services. Examples include the elimination of telefile, which was the only free method for electronically filing employment tax returns (Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, and Form 941, Employer's Quarterly Federal Tax Return); the elimination of Electronic Tax Law Assistance (ETLA), which could be developed into a self-help tool accessible to small business owners; the reduction in questions answered in walk-in sites, many of which are small business oriented; and the potential closing of Taxpayer Assistance Centers (TACs).

- IRS Examination and Collection Strategies[9] – As the IRS increases its enforcement activities, I am concerned that the IRS does not have sufficient information and research to determine how best to allocate its resources between examination, collection, and taxpayer service. Nor do we know the right approach, including taxpayer service, for the particular type of taxpayer. Because business taxpayers have frequent dealings with the IRS, IRS' focus will significantly impact these taxpayers.

- Navigating the IRS[10] – In fulfilling their tax obligations, small business owners have multiple contacts with the IRS. Business taxpayers file employment and excise tax returns in addition to income tax returns. They also are required to make employment tax deposits and file information returns such as Forms W-2 and 1099. Finding the right IRS employee to address a particular

[7] National Taxpayer Advocate 2004 Annual Report to Congress at 51-66.

[8] National Taxpayer Advocate 2004 Annual Report to Congress at 8-42.

[9] National Taxpayer Advocate 2004 Annual Report to Congress at 211-245.

[10] National Taxpayer Advocate 2003 Annual Report to Congress at 122-134; 2002 Annual Report to Congress at 7-14.

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 – My office has identified numerous problems with this program in past reports to Congress.[11] If the continuing problems with this program 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 deposits and payments and who are attempting to become compliant and get a "fresh start".

- Collection Due Process (CDP)[12] – The CDP process is relatively new to the IRS, but a backlog of cases has nevertheless grown very quickly.[13] Established by RRA 98, it allows taxpayers an opportunity to have a hearing before an independent Appeals Officer to explore alternatives to proposed collection levies or 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. My office will continue to monitor CDP case timeliness, processes, and procedures to ensure that taxpayers understand the available collection alternatives and have a meaningful opportunity to raise them.

- Federal Tax Deposits (FTD)[14] – The IRS assesses a large number of penalties when taxpayers fail to make employment tax deposits when due or in the correct manner,[15] but the rules are complicated and may change during the life of a business. For small businesses, these penalties can be very severe and potentially impact their ability to continue operations. My office is continuing to monitor this problem. Currently, the IRS assesses FTD penalties against one out of 16 employment tax returns, yet it later abates more than 60 percent of the total amount originally assessed.[16]

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[11] National Taxpayer Advocate 2004 Annual Report to Congress at 311-341 and 433-450; 2003 Annual Report to Congress at 99-112; 2002 Annual Report to Congress at.15-24; 2001 Annual Report to Congress at.46-48 & 52-54

[12] National Taxpayer Advocate 2004 Annual Report to Congress at 451-470 and 2002 Annual Report to Congress at 110-115.

[13] Appeals had 18,732 Collection Due Process cases in inventory on Sept. 30, 2004, with 25 percent in process for over 6 months. *See* Appeals Inventory Report (AIR) for period ending Sept. 30, 2004.

[14] National Taxpayer Advocate 2003 Annual Report to Congress at 197-205.

[15] In fiscal year 2004, the IRS assessed 2,313,900 Employment Tax Federal Tax Deposits Penalties involving $3,722,213 and abated 536,873 Employment Tax Federal Deposit Penalties involving $2,270,799. IRS Data Book 2004, Table 27 - Civil Penalties Assessed and Abated by Type of Penalty and Type of Tax, at 45.

[16] TIGTA, *Federal Tax Deposit Penalties Have Been Significantly Reduced, but Additional Steps Could Further Reduce Avoidable Penalty Assessments*, Ref. No. 2004-30016 (Sept. 2005), at 4; IRS Data Book 2004, Table 27 (Civil Penalties Assessed and Abated by Type of Penalty and Type of Tax), at 45.

- Obtaining an Employer Identification Number (EIN)[17] – Acquiring an EIN is a crucial first step for new businesses. Historically, taxpayers encountered delays in obtaining an EIN. In response, the IRS developed a method for businesses to obtain identification numbers directly from the IRS website.[18] The taxpayer completes an application form online and the system issues an EIN immediately. This approach is a significant improvement that will benefit business taxpayers, and I commend the IRS for developing this long-needed automated application program.

- Missing/Incorrect Payments[19] – Missing or incorrect payments impose additional burdens on business and individual taxpayers, requiring them to substantiate their payments, often repeatedly. Through June of fiscal year 2005, TAS closed 4,792 cases involving problems with missing or incorrect payment and credit issues.

- Combined Annual Wage Reporting (CAWR) Reconciliation[20] – The IRS and the Social Security Administration (SSA) jointly administer the CAWR program, which matches earning and withholding statements from Form 941 (Employer's Quarterly Tax Return) and Form W-2 (Wage and Earnings Statements) for each employee and Form W-3 (Transmittal of Income Tax Statements). Ideally, all information reported on Form 941 should match the information on Forms W-2 for a given year, but this is not always the case. The IRS and SSA try to resolve discrepancies and may contact the employer. If the employer does not respond or does not file the correct forms, the IRS can assess a penalty against the employer for intentionally disregarding its filing requirements. In FY 2004, the IRS assessed 91,602 CAWR related penalties totaling about $2.2 billion, while abating 28,347 of these penalties totaling nearly $1.4 billion (31 percent of total assessments and 64 percent of total dollars assessed).[21] The frequent abatement of penalties indicates a serious problem with the administration of this program that adversely and unnecessarily affects small business.

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[17] National Taxpayer Advocate 2001 Annual Report to Congress at 43-45.

[18] IRS News Release IR-2003-77 (June 13, 2003).

[19] National Taxpayer Advocate 2002 Annual Report to Congress at 147-149.

[20] National Taxpayer Advocate 2003 Annual Report to Congress at 220-226.

[21] IRC § 6721(e) data as of Sept. 30, 2004 for Intentional Disregard Penalty (penalty reference code 549) from IRS Office of Enforcement Revenue Information System (ERIS). ERIS captures data on civil monetary penalties. The total numbers above include penalties assessed by the IRS Large and Mid-Sized Business (LMSB), Small Business/Self-Employed (SBSE) and Tax Exempt and Governmental Entities (TEGE) divisions. SBSE accounted for 83,941 of the assessed penalties and $841.6 million of total dollars assessed; and 25,474 of the abatements and $439.4 million of total dollars abated. Thus, the IRS SBSE division abated 30 percent of total assessments and 52 percent of total assessed dollars.

TAS Small Business Outreach

In addition to helping small business taxpayers resolve problems, TAS also reaches out to these taxpayers to improve their awareness of our services. In 2004, TAS created IRS Publication 4295, TAS Small Business Pamphlet, which specifically promotes TAS services to small business. Small business outreach is also among the primary objectives for Local Taxpayer Advocates throughout the year. During fiscal year 2005, LTAs have made approximately 400 contacts to small business markets. These contacts include small business associations, individual businesses, and participation at small business conventions reaching almost 200,000 small business stakeholders. Some examples of these local efforts include:

- A Local Taxpayer Advocate office coordinated with the local Small Business Administration office to have TAS information included in the Small Business Resource Guide on a permanent basis.
- LTAs contacted Small Business Development Centers and had TAS literature distributed to their field offices in certain states.
- LTAs attended Small Business Expos, Entrepreneurial Expos, Minority Small Business Expos, and Small Business Development Days throughout the country.

On a national level, TAS has developed and maintained a strong and positive partnership with the Small Business Administration (SBA) over the last several years. TAS provides a representative at all SBA Regulatory Fairness Hearings. These hearings provide a public forum for small business owners and trade associations to bring their concerns to top officials in Federal, state and local government agencies. In FY 2005, TAS participated in the SBA's Small Business Expo, a three-day event that brings together current and prospective small business owners, corporations, trade associations, Federal and other government employees, and community leaders to champion the development and growth of small businesses.

Small business taxpayers submit complaints regarding IRS enforcement actions to the SBA's Ombudsman in accordance with the Small Business and Agricultural Regulatory Enforcement Fairness Act of 1996.[22] TAS works these cases to ensure an independent review of IRS actions is completed. TAS is able to advocate and provide assistance once the taxpayer provides proper authorization. We issue a comprehensive report and analysis of each case to the SBA Ombudsman after TAS reviews the case and takes all appropriate actions to address the taxpayer's concerns. TAS received two new Small Business Regulatory Enforcement Fairness Act (SBREFA) cases through the second quarter of FY 2005 and currently has 17 open cases.

[22] Pub. L No. 104-121 § 222 (1996).

The Small Business Administration's National Ombudsman recently gave the IRS an overall rating of A-, and an A+ in quality of response based on the advocacy and casework provided by TAS in FY 2004. The IRS is one of only two federal agencies that received A+ ratings. The SBA commended TAS for resolving small business taxpayer issues.[23]

Legislative Recommendations Affecting Small Business

In the four year-end reports I have submitted to Congress since becoming National Taxpayer Advocate in 2001, I have made several legislative recommendations that would, if enacted, assist small businesses. I am pleased to note that The Small Employer Tax Relief Act of 2005 contains provisions identical or similar to five of my previous recommendations:

Married Couples as Business Co-Owners[24]
An unincorporated business jointly owned by a married couple is classified as a partnership for federal income tax purposes.[25] As such, the business is subject to 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, I recommend that IRC § 761(a) be amended to allow a married couple operating a business as co-owners to elect out of subchapter K[26] of the Internal Revenue Code. This election permits the taxpayer 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; and

[23] U.S. Small Business Administration 2004 National Ombudsman Report to Congress, 11-12.
[24] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 401-402 and 2002 Annual Report to Congress at 172-184. *See also* H.R. 1528 § 308, 108th Cong. (2003).
[25] IRC § 761(a).
[26] Subchapter K is a portion of the Internal Revenue Code that contains rules and regulations governing the taxation of partnerships.

- 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.

I 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 more than 99 percent of all sole proprietorship and farm schedules report income below the Social Security wage cap[27] and because my proposal would make this provision elective, few couples would experience a tax increase as a result of this recommendation, yet many would benefit from Social Security and Medicare eligibility.[28]

Election to be Treated as an S Corporation[29]
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.[30]

I 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 Form 2553, Election By a Small Business Corporation. If the corporation did not file a timely election, it may submit a private letter ruling (PLR) request (or, in certain circumstances a request under Rev. Proc. 2003-43[31]) to the IRS Office of Chief Counsel seeking a reasonable cause determination for its late filing.

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[27] *See* IRS Compliance Data Warehouse, Individual Returns Transaction File for Tax Year 2003, which contains the most recent filing data. The Social Security wage base limitation for 2005 is $90,000.

[28] Social Security Survivors Benefits, Publication No. 05-10084, May 2004; Social Security = Understanding the Benefits, Publication No.05-10024, January 2005; Social Security Administration: What Every Woman Should Know, Publication No. 05-10127, April 2003.

[29] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 390-393; 2002 Annual Report to Congress at 246.

[30] IRC § 1362 (b)(1)(B).

[31] 2003-1 C.B. 998.

To address the situation described above, I recommend that Congress amend IRC § 1362(b)(1)(B) 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 by aligning the act of making the election with the significant due date of filing the first corporate income tax return.

Health Insurance Deductions for Self-Employed Individuals[32]
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.[33] Wage earners who participate in pre-tax plans do not pay Social Security tax on their health insurance payments.

On consistency and equity grounds, I recommend 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.

Federal Tax Deposit (FTD) Avoidance Penalty[34]
Internal Revenue Code § 6656 imposes a penalty on employers who fail to deposit employment taxes (*i.e.*, withheld income taxes, Federal Insurance Contribution Act (FICA) taxes, and Federal Unemployment Act (FUTA) taxes) within the time and in the proper manner described in IRC § 6302 and the applicable regulations, unless the taxpayer can show that the failure was due to reasonable cause and not due to willful neglect. The FTD penalty ranges from two percent to ten percent of the underpayment, depending on how late the required deposit is made. The complexity of the FTD rules and regulations can cause taxpayers to be subject to FTD penalties for failing to make deposits in the required manner even when their deposits are timely and the taxpayers are making an honest attempt to comply with the complex deposit rules.

To alleviate this overly harsh penalty burden on employers, I recommend that IRC § 6656 be amended to clarify that: (1) the reasonable cause exception to the FTD penalty shall specifically apply to instances where a taxpayer has made a timely deposit, but failed to make the deposit in the prescribed manner and such

[32] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 388-389; 2001 Annual Report to Congress at 223. *See also* H.R. 1873, 108th Cong. (2003).

[33] IRC § 1401.

[34] *See* National Taxpayer Advocate 2004 Annual Report to Congress at 400; 2001 Annual Report to Congress at 222. *See also*, H.R. 1528 § 108, 108th Cong. (2003).

failure was not due to willful neglect; and (2) in no circumstance shall the FTD penalty exceed two percent of the underpayment amount when a taxpayer has made a timely deposit, but failed only to make the deposit in the prescribed manner.

This proposal would reduce from ten percent to two percent the penalty rate for failure to make a deposit in the prescribed manner and thus reduce burdens on taxpayers who have demonstrated a reasonable attempt to comply with the complicated FTD rules.

Alternative Minimum Tax (AMT) for Individuals[35]

The individual alternative minimum tax (AMT) is a parallel and complex tax structure imposed on top of the regular tax structure. Although the individual AMT does not affect small business directly, it can significantly impact small business owners or self-employed individuals. While the AMT was originally designed to prevent wealthy taxpayers from escaping tax liability through tax avoidance transactions, it now affects large groups of middle-class taxpayers with no tax avoidance motives at all. Many taxpayers are subject to the AMT simply because they have children or live in a high-tax state.

The AMT ensnares an ever-growing number of taxpayers because the amount of income exempt from the AMT is not indexed for inflation. When Congress first enacted a minimum tax in 1969, this "exemption amount" was $30,000 for all taxpayers. Had it been indexed, this amount would equal about $153,500 today.[36] Instead, the exemption amount, after a temporary increase that expires after 2005, is $45,000 for married taxpayers and $33,750 for most others[37] As a result, it is now projected that in 2010, 34.8 million individual taxpayers – or 34 percent of individual filers who pay income tax – will be subject to the AMT.[38] Among the categories of taxpayers hardest hit, 89 percent of married couples with adjusted gross income (AGI) between $75,000 and $100,000 and with two or more children will owe AMT.[39]

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[35] *See* National Taxpayer Advocate 2004 Annual Report to Congress, at 383-385; 2003 Annual Report to Congress at 5-19. *See also* H.R. 1103, 109th Cong. (2005).

[36] Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Nov. 17, 2004). Congress acted after hearing testimony that 155 taxpayers with adjusted gross incomes above $200,000 had paid no federal income tax for the 1966 tax year. *See* The 1969 Economic Report of the President: Hearings before the Joint Economic Comm., 91st Cong., pt. 1, p. 46 (1969) (statement of Joseph W. Barr, Secretary of the Treasury). The consumer price index has more than quintupled since 1966, so the kinds of taxpayers who caught Congress' attention back then would be making over $1.16 million today. *See* Department of Labor, Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers (CPI-U)* (Nov. 17, 2004). Yet the AMT today is not primarily affecting taxpayers with incomes over $1.16 million. By 2010, it has been estimated that 83 percent of all taxpayers affected by the AMT will have incomes under $200,000 – and 37 percent will have incomes under 100,000. *See* Leonard E. Burman et al., The Individual Alternative Minimum Tax: A Data Update, table 4 (Aug. 30, 2004) (accessible at 2004 TNT 175-15).

[37] IRC § 53(d).

[38] Department of the Treasury, Office of Tax Analysis (unpublished data furnished on Dec. 3, 2004).

[39] Leonard E. Burman et. al., The Expanding Reach of the Individual Alternative Minimum Tax, *Journal of Economic Perspectives* 17 (2): 173-86 (Spring 2003) updated May 2005.

The burden that the AMT imposes is substantial. In dollar terms, the average AMT taxpayer owed an *additional* $3,670 in tax for tax year 2003.[40] In terms of complexity and time, taxpayers often must complete a 12-line worksheet,[41] read eight pages of instructions,[42] and complete a 55-line form[43] simply to determine whether they are subject to the AMT. Thus, it is hardly surprising that 75 percent of AMT taxpayers hire practitioners.[44]

Perhaps most disturbingly, it is often very difficult for taxpayers to determine in advance whether they will be hit by the AMT. Many taxpayers are thus unaware that the AMT applies to them until they receive a notice from the IRS, and some discover they have AMT liabilities that they did not anticipate and cannot pay. To make matters worse, the difficulty of projecting AMT tax liability in advance makes it challenging for taxpayers to compute and make required estimated tax payments, which often results in those taxpayers being subject to penalties.

Thus, while the concept of a minimum tax is not unreasonable, the AMT as currently structured has evolved beyond its original purpose: it is hitting taxpayers it was never intended to hit because its exemption amount has not been indexed for inflation; it is penalizing taxpayers for such non tax-driven behavior as having children or choosing to live in a state that happens to impose high taxes; it is taking large numbers of taxpayers by surprise – and subjecting them to penalties to boot; it is imposing onerous compliance burdens; it is altering the distribution of the tax burden that exists under the regular tax system; it is changing the tax incentives built into the regular tax system; and it is neutralizing the effects of changes to tax rates imposed under the regular tax system.

To do away with this unfair and complex parallel tax structure, I recommend that Congress repeal the AMT, or revamp it substantially to achieve its original objective.

In addition to the above proposals included in The Small Employer Tax Relief Act of 2005, I have also recommended the following proposals that, if enacted, would assist small business:

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[40] Statistics of Income Spring Bulletin, 2005 Table 1.

[41] 2004 Form 1040 Instructions at 35.

[42] 2004 Form 6251 Instructions.

[43] 2004 Form 6251, Alternative Minimum Tax – Individuals.

[44] IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2002).

Regulation of Unenrolled Return Preparers[45]

Many taxpayers (including businesses) pay a third party to prepare their returns.[46] Of these paid preparers, only attorneys, certified public accountants, and enrolled agents are generally subject to regulation or oversight by the IRS or state licensing agencies.[47] Unlike the aforementioned (collectively known as "practitioners" because they are able to "practice" before the IRS[48]), 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 lack or fail to maintain the required knowledge. Since the tax return represents a taxpayer's entry point into the federal tax system, any 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, I recommend that preparers who are not attorneys, certified public accountants, or enrolled agents and who prepare tax returns 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 return. They should also be required to take either continuing professional education or testing annually 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 expenses. However, our recommendation will not require a significant investment in enforcement personnel. I envision a consumer education campaign that utilizes paid advertising, outreach,

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[45] *See* National Taxpayer Advocate 2003 Annual Report to Congress at 270-301; 2002 Annual Report to Congress, at 216-230. *See also* S. 832 § 4, 109th Cong. (2005).

[46] There were 130.6 million individual federal income tax returns filed in tax year 2003. Of those returns, 78.8 million (or 60 percent) were submitted by a tax return preparer. Statistics of Income Spring Bulletin, 2005.

[47] 31 C.F.R. part 10.

[48] 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.

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.

I believe this recommendation is administratively practical and efficient. Ultimately, more accurately prepared returns will benefit small businesses and other taxpayers, and reduce the resources the IRS must devote to examining incorrect returns and collecting tax.

First-time Penalty Waiver (the so-called "one time stupid act" proposal)[49]
Given the complexity of the law and the tax administration system, it is easy to see how taxpayers can make mistakes – even stupid ones. Penalties are designed to deter undesirable behavior, yet, what benefit is there to the government if it penalizes a taxpayer who would amend his ways merely through education and clarification? Thus, I propose that Congress authorize the Secretary to grant a one-time abatement of the failure-to-file and failure-to-pay penalties for taxpayers who have a history of compliance.

Current Advocacy Issues

TAS 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 implemented the Systemic Advocacy Management System (SAMS) in 2003. SAMS is a project identification and workload delivery mechanism that provides both internal and external stakeholders, including small businesses, with a voice in the identification of advocacy issues. SAMS is used for trend analysis and as a project management system for Systemic Advocacy analysts.

The Office of Systemic Advocacy has received 309 suggestions pertaining to small business issues since the inception of SAMS, including 71 issues during the current fiscal year.[50] From these suggestions, TAS has developed 131 small business advocacy projects that help identify the most serious problems and legislative proposals that could potentially be included in the Annual Report to Congress.[51]

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[49] *See* National Taxpayer Advocate 2001 Annual Report to Congress, at 188-192. *See also* H.R. 1528, sec. 106, 108th Cong. (2003).

[50] Through the 3rd quarter ending June 30, 2005.

[51] Through the 3rd quarter ending June 30, 2005.

TAS is also currently studying a number of small business issues, including:

- The complex rules and regulations governing employment taxes and the failure to deposit (FTD) penalties;
- Power of Attorney (POA) requirements for business who use a CPA's or attorney's address as the main business mailing address; and
- Allowing small businesses to report employment taxes on Form 1040, as is done with respect to household employees.

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.

During 2005, the TAP made a number of recommendations on issues that impact small businesses, including:

- Form 1065 Schedule D Change. Form 1065, Schedule D (Capital Gains and Losses for Partnerships), allows only four lines to record short-term capital gains and losses, and another four lines to record long-term capital gains and losses Additional transactions resulting in capital gain or loss are required to be reported on a supplemental sheet. The TAP recommended that additional lines be added to record both short-term and long-term transactions to alleviate the need for partnerships to attach a supplemental sheet to complete their tax return.
- EFTPS System Change. Tax professionals transmit quarterly estimated tax deposits to the IRS on behalf of taxpayers via the Electronic Federal Tax Payment System (EFTPS). When such payments are made in error, there are procedures to timely cancel the payment or obtain a refund, but many tax professionals are unaware of such procedures. The TAP recommended that the IRS add instructions to EFTPS brochures outlining remedies for taxpayers who make erroneous payments after the 48-hour cutoff.

The TAP also works closely with the 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).

I appreciate that you invited me to testify before you regarding tax burdens facing small businesses. I hope that my remarks prove helpful as you work on proposals to reduce these burdens through changes to the Internal Revenue Code.

STATEMENT
on
Reforming the Tax Code to Assist Small Businesses
Before
The House Small Business Committee
by

Thala T. Rolnick, CPA
Senior Tax Manager
Price Kong & Company
On Behalf of
The U.S. Chamber of Commerce
September 21, 2005

Chairman Manzullo, Ranking Member Velazquez and members of the Committee, I am Thala Rolnick, Senior Tax Manager for Price Kong & Company and soon to be the owner of my own private practice. My primary focus is on small business, startup, tax planning, financial services and individuals' tax matters. Previously, I have served on the Internal Revenue Service (IRS) Electronic Tax Administration Advisory Committee (ETAAC). Currently I am Co-Tax Chair for Region IX 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 start-ups 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 interests 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 finally achieved 100% deductibility of health insurance costs for federal tax purposes. Unfortunately, those self-employed and partners 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) calculations 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 health care – 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.

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 that depend 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 an 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 is made up of mostly small businesses. As such, to restore fairness to the tax code for small businesses by allowing full deductibility of meals 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 *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 2007, reverting to the $25,000 cap provided in earlier law. Bonus depreciation fully expired in 2004.

In general, businesses investing more than the annual expensing allowance must recover the cost of their expenditures 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.

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. Additionally, the 15 year amortization of the purchase of client lists and covenants not to compete, place unnecessary burdens on small business start-ups and expansions. Small businesses, in most cases, must pay for these contracts and services in five years or less. 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.

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.

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.

S Corporation Audits

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.

Currently, the IRS has launched a study to assess the reporting of S Corporations compliance as part of their National Research Program (NRP). Many of these audits are being conducted on newly formed S Corporations. These companies can least afford the costs of representation. According to the IRS commissioner, the program is supposed to be a "randomly selected" group of 5000 and it is needed to "ensure ..high income individuals are paying their fair share."

Additionally, all businesses, including S corporations, should have the right to have an IRS examination take place at a site other than the taxpayer's home or business premises.

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 of Marilyn Landis,

Basic Business Concepts, Inc.

On Behalf of
The National Small Business Association

House Small Business Committee Hearing
"Reforming the Tax Code to Assist Small Businesses"

September 21, 2005

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Chairman Manzullo, Ranking Member Velazquez, Members of the Committee. Thank you for inviting me to provide testimony on the important topic of the intersection of small businesses and the tax code.

My name is Marilyn Landis and I am the president of Basic Business Concepts, Inc., a multifaceted service firm providing financial consulting services to small businesses in Pennsylvania. Prior to starting my own business, I worked for three of the largest SBA lenders in the country—marketing, originating and underwriting SBA loans. In my career, I have worked in a variety of finance related fields including consumer loan and mortgage developments, delinquent loan collections and coordinating operations for a muli-bank merger.

Outside of the business world, I dedicate my time to serving on many non-profit boards overseeing social service and economic development. I am here today first as a concerned business owner and second as chair of the National Small Business Association's Legislative Action Committee. As you know, the NSBA is the nation's oldest non-partisan small business advocacy group representing more than 150,000 small business owners across the country. My role as chair of the Legislative Action Committee allows me to oversee the formation of all the NSBA's policy positions. Both personal experience and my role in the NSBA have allowed me to see small business owners wrestle with our complicated tax system. In fact, in the 108th Congress, two of my fellow NSBA members testified on difficulties small businesses face in the tax code.

Cost of the Code

Many excellent studies have been conducted that estimate the cost of complying with the U.S. Tax Code. It is important to remember that the "cost" these reports detail is not the money paid to the U.S. Treasury, but the opportunity cost of the time spent on studying the code, changing business practices, maintaining records and paying professionals to minimize taxes paid.

The Small Business Administration's Office of Advocacy continues to be an excellent source for such data. While I will leave the testimony of Chief Council for Advocacy Tom Sullivan to detail those studies, the results are always the same. Because of their size and available resources, small business owners pay a disproportionate amount of time and money complying with the Tax Code.

Compounding compliance costs are the costs faced by employers and employees at small firms who are prohibited from participating in tax advantaged benefits available to companies of a larger size. Being excluded from pension plans, pre-tax health savings and fringe benefit plans have a real economic impact on entrepreneurs.

Tax Equity

The issues facing small business owners in the Tax Code are so vast that we commissioned a study by the Prosperity Institute to root through the code and return the

most egregious examples of inequities. Members of NSBA have testified before this and other committees on the findings of the study. We are very pleased to see some of our top recommendations included in Chairman Manzullo's recently introduced legislation, "The Small Business Tax Relief Act of 2005."

One recommendation from the NSBA Tax Equity Report that has been addressed by Chairman Manzullo and Representative Velazquez in past legislation—and National Taxpayer Advocate Olson in recent reports—is the repeal of the self-employment tax on health care. 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 wage income, of which 6.2 percent is allotted for Social Security and 1.45 percent goes to Medicare. Employers are required to match employee contributions with a 7.65 percent contribution of their own. Self-employed individuals are required to pay both sides of this tax resulting in a total 15.3 percent 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 percent 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. NSBA is encouraged to see that Chairman Manzullo included this important issue in the Small Business Tax Relief Act.

Another issue from the Tax Equity report that was included in the chairman's legislation is parity for small business qualified pension plans. A recent CRS report, *Pension Sponsorship and Participation: Summary of Recent Trends* (RL30122), documented the relatively low percentage of small businesses offering pension plans compared to larger businesses. One reason for this disparity is the complexity and cost associated with offering the plans. 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 $14,000 in tax-advantaged dollars for retirement while a SIMPLE 401(k) participant may only save $10,000. 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. Fortunately, the Small Business Tax Relief Act of 2005 would fix this inequity.

The Small Business Tax Relief Act of 2005 includes many additional tax reforms for small business including extended Section 179 expensing and increased standard home-office deduction. NSBA looks forward to working with Chairman Manzullo and members of the committee to enact this important legislation.

Fundamental Tax Reform

While the changes in NSBA's Tax Equity Report and Chairman Manzullo's legislation would greatly improve the U.S. Tax Code, the system still continues to act as a break on the economy.

At the 2005 Small Business Congress in February, NSBA members met to vote on the organization's priorities in the 109th Congress. When the votes were counted, the clear winner was fundamental tax reform. Specifically, NSBA members voted to endorse the Fair Tax.

The Fair Tax would replace the individual income tax, corporate income tax, capital gains taxes, estate taxes and payroll taxes with a 23 percent inclusive national sales tax on the purchase of all new goods and services. Under the Fair Tax, compliance costs will fall to less than $10 billion, creating enormous net savings that would eventually be incorporated in lower product prices for consumers. The tax will be collected at retail businesses, taking the tax burden out of the hands of the consumers.

Forty-five states already have a sales tax system, and the Fair Tax would simply add an additional line on the current sales tax reporting form. Businesses will collect the tax and send it to the state tax collecting authority. All businesses serving as collecting agents will receive a fee for collection, and the states also will receive a collection fee. While the Fair Tax should not be interpreted as a tax cut, the reduction in work required to administer the new tax will certainly be a relief for business owners and consumers alike.

It was a stroke of good luck that President Bush issued an executive order establishing an Advisory Panel on Federal Tax Reform a month before our membership chose fundamental tax reform as a top issue. While the panel's recommendations have been delayed, we expect that a form of the Fair Tax will be included as an option for reform.

Conclusion

As it stands now, the U.S. tax code is difficult to comply with and administer. The code also includes elements that act as a disincentive to entrepreneurship and business growth. A recent report from the IRS National Research Project (NRP) found there to be a $300 billion tax gap, much of it attributed to small business owners. I also understand that a similar study will be conducted focusing on businesses that are organized as S corporations. While there are undoubtedly tax cheats in any system, it is also true that in a complex system like the U.S. Tax Code many participants will be out of compliance unintentionally. We encourage the IRS to consider complexity when evaluating the final results from the NRP.

I once again thank the committee for the opportunity to share my thoughts on how the tax code might be reformed to assist small businesses. As a final thought, while it is ok to try and use the tax code to help small business owners, our ultimate goal should be to get it out of their way.

National Association for the Self-Employed

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Testimony of

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The National Association for the Self-Employed

House Committee on Small Business
"Reforming the Tax Code to Assist Small Businesses"

September 21, 2005

On behalf of the National Association for the Self-Employed's 250,000 member businesses, we would like to thank Chairman Manzullo, Ranking Member Nydia Velazquez and the Members of the House Committee on Small Business for convening this hearing to discuss reforming the tax code to work with rather than hinder micro-businesses. The NASE is a leading resource for the self-employed and micro-businesses, businesses with ten or less employees. Today, this vital segment of the small business population within our nation numbers more than 18 million.

The complexities and inequities within our tax code have long placed a significant burden on the smallest of businesses in our nation. More than ever, America needs micro-businesses to marshal their resources and continue to advance the American economy by doing what they do best - create, innovate, produce, build and grow. Small business-specific tax reform would assist in creating a favorable environment for the growth and success of small firms.

The NASE strongly supports the Small Employer Tax Relief Act of 2005 and feels that the provisions included in the bill would significantly assist micro-business owners and the self-employed. In particular, I would like to highlight two key provisions and their importance to the self-employed: the self-employment tax deduction on health insurance premiums and an annual standard home office deduction of $2,500.

SECA Tax Deduction for Health Insurance Premiums

A chief impediment that micro-businesses and the self-employed are facing is the ever-increasing costs of health coverage. The state of health care among the nation's micro-businesses is critical. The number of uninsured Americans continues to grow and many are owners or workers in small businesses. The NASE strongly support removing current inequities in the tax code that make the purchase of health coverage more costly and a disincentive for the self-employed.

NASE Member Scott Falnes, owner of a carpentry and construction company located in Lake in the Hills, Illinois pays an additional $336 annually in self-employment tax on health insurance premiums. Scott calls this extra tax on sole proprietors unfair. "Obviously the tax is not fair across the board. The general population is not affected. I have to fight to keep my prices

competitive, pay the bills, and hopefully have enough to let my business grow. I don't mind paying my 'fair' share, so long as it's fair." Falnes, is of course referring to the fact that he – and 16 million other sole proprietors and partnerships with earned income have to pay the equivalent of payroll taxes on their health insurance premiums.

All employees who receive compensation from employers pay FICA taxes. FICA comprises Social Security (6.2 percent) and Medicare (1.45 percent) taxes. Employers are required to withhold from gross compensation 7.65 percent for FICA. In addition to the FICA withheld from the employee, the employer is required to "match" the FICA withholding. Therefore, the employee and employer contribution for FICA is 15.3 percent of compensation (subject to applicable annual limits).

The self-employed pay into the Social Security Fund at a rate equivalent to employees and employers. FICA tax for the self-employed is called "self-employment tax." The self-employment tax is computed at the same rates (15.3 percent) as employee/employer FICA and is subject to the same annual limits.

The tax inequity faced by the self-employed when purchasing health insurance lies in the fact that Schedule C filers (sole-proprietors) and Schedule E filers (partners in partnerships with earned income and 2 percent owners in S Corporations) do not receive a "business deduction" for health insurance premiums. The premiums are not deducted for purposes of the self-employment tax and, accordingly, the sole proprietor(s), partners in partnerships and S corporation owners pay self-employment tax (15.3 percent on self-employment income up to $90,000) on the insurance premiums. **The self-employed are the only segment of the business population that has to pay this extra tax on health insurance.**

C corporations, on the other hand, receive a deduction for health insurance premiums as an ordinary and necessary business expense for all employees including owners. Since the premiums paid for health insurance are not considered compensation to the employee or employee owner, they are not subject to FICA (Social Security and Medicare) taxes for either the employee or the employer.

While 100 percent deductibility of health insurance premiums has phased in, it does not solve this tax inequity. The self-employed are required to pay two types of taxes on their annual tax returns: income tax and self-employment tax. One hundred percent deductibility relates only to

income tax and not self-employment tax. Thus, the self-employed still pay the 15.3 percent self-employment tax on their health insurance premiums.

According to the most recent Kaiser Family Foundation study, the self-employed pay on average $10,880 for family health coverage. Because they cannot deduct these premiums as an ordinary business expense, they are required to pay $1,665 in additional taxes that no other business entity must pay. This is money that our members tell us they would use to reinvest into their business, hire part-time assistance, or utilize to offset the rising premium costs they face each year so they may hold on to their coverage a little longer.

NASE Member **David Caffrey**, an electrical contractor in Rio Rancho, New Mexico pays an additional $715 annually in self-employment tax on his health insurance premiums. He says that this extra cost adds to the already high tax burden for small businesses in New Mexico and increases his health care burden. If David did not have to pay this extra cost, he would help pay for his gasoline expenses. **Rob and Laurie Wren**, real estate investors in St Louis, Missouri tell us that they would invest the $1,744 tax savings they would on additional advertising in order to increase sales. Laurie says that the additional tax "definitely increases my health care burden-both for my family and my employee whose insurance I pay for as well."

To achieve tax equity between all forms of business entities, the self-employed must receive exclusion of health insurance premiums from self-employment tax regardless of the entity form under which they choose to operate. Health insurance premiums of the self-employed should be deductible on Schedule C or E as an ordinary and necessary business expense rather than the deduction above the line on Form 1040. This issue is not only one of fairness but, in the current health care climate, the self-employed are disproportionately affected. Removing this extra tax on health insurance premiums would make health coverage slightly more affordable. The NASE is pleased to see this issue addressed in the Small Employer Tax Relief Act of 2005.

Standard Home Office Deduction

Increasingly, entrepreneurs are utilizing their home as a primary place of business. Over 50% of the NASE's 250,000 members are home-based businesses. According to research commissioned by the SBA Office of Advocacy, home-based businesses represent 52 percent of all firms and provide 10 percent of the total revenue of the economy. Many home-based business owners do

not make use of the home office deduction due to the complexity of the deduction and stringent criteria they must meet.

The form for the home office deduction is very complicated. The taxpayer must differentiate between direct and indirect expenses and also between deductible mortgage interest and excess mortgage interest. Some of the expenses are deductible even if the business has a loss and some aren't. The words "see instructions" appear on this one page form 16 different times. Those instructions say the form will take an average of 1 hour and 15 minutes to complete. A standard deduction for the use of a home office is an excellent step towards tax simplification for the myriad of home-based businesses in our nation.

Conclusion

An overwhelming hardship faced by the self-employed and micro-businesses is the complexity, vagueness, and unfairness of tax regulations. Understanding and then complying with the tax code is extremely difficult and time consuming for a micro-business owner. The inequities within the tax code that this vital segment of the small business community must contend with are unfair and greatly hinder their ability to contribute to our economy.

The introduction, and hopefully eventual passage of the Small Employer Tax Relief Act of 2005, would greatly assist in removing key roadblocks to success and strengthening the competitiveness of our nation's micro-businesses. Again, the National Association for the Self-Employed is pleased to support this important legislation and we applaud the Committee's leadership on these crucial issues faced by the self-employed.

Written Testimony to the U.S. House of Representatives,
Small Business Committee
on
"Reforming the Tax Code to Assist Small Businesses"

John S. Irons, Ph.D.

September 21, 2005

Thank you Mr. Chairman, I would like to thank you and Ranking Member Velazquez for inviting me to testify before this committee.

My name is John Irons. I am a Ph.D. economist by training, and I am currently the director of tax and budget policy at the Center for American Progress, a nonprofit think-tank here in Washington, DC.

As an economist, I am continuously amazed at the resiliency of the U.S. economy, and at the creativity of our nation's small business owners. While the title of this hearing is "Reforming the Tax Code to Assist Small Businesses," I feel that it is important to recognize up front that the small business community does quite well on its own, and the goal of tax policy in many ways should be to get out of the way of private activity, while still raising adequate revenue for vital domestic and international priorities.

When talking about the overall tax code, analysts often think about following three basic principles of simplicity, fairness, and economic growth.

The Center for American Progress has developed a broad reform package based upon these principles. A copy of that proposal is included in my written testimony.

The American Progress tax proposal calls for a variety of changes to the tax code, and includes the elimination of the employee side of the Social Security payroll tax and an elimination of the AMT.

However, we do not simply cut these revenue streams without making other adjustments. Rather, we shift the tax share onto a restructured income tax that is more progressive than our current tax structure. And we tax all sources of income for very high earners according to the same, progressive rate schedule. In total, we are able to increase revenues by about $500 billion over 10 years compared with current policy. And we are able to reduce taxes for about 70 percent of the population. Those at the high end of the income distribution—those that have benefited the most from recent tax cuts—would likely see an increase in their tax share.

A reduction in the employee side of the payroll tax would mean an immediate reduction in the taxes for a large swath of low- and moderate-income small business people.

The principles that guide overall tax reform should also be followed when looking at taxation of small businesses, and my submitted written comments are organized along those three themes as well.

But first let me first frame some of my comments by considering the general makeup of small businesses in the U.S.

Who are Small Businesses?

I think it is important to keep in mind that most small businesses are indeed small. The median number of employees is fewer than 4, and 89 percent of firms employ less than 20 people.[1]

The average amount of receipts for firms with 1-4 employees is $348,000. And the average per-employee payroll is just over $27,000. Over 80 percent of partnerships have less than $1 million in assets.[2]

While there is no consensus on how to officially define a "small business," those with small business income are spread throughout the income distribution. Recent estimates of IRS data from the Tax Policy Center show that in 2004, only 1.3 percent of those that reported small business income on their tax returns were in the top marginal income tax bracket. And of those with more than 50 percent of their income from business income, only 2 percent were in the top marginal income bracket.[3]

Nearly half of those with small business income are in the 10 and 15 percent tax brackets.

Therefore, any policy that simply reduces the top marginal brackets or that provides a windfall profit increase for larger companies is not a policy that helps most small businesses. And in our tight fiscal environment, any reduction at the top means potentially harmful adjustments elsewhere.

Small Businesses Taxes

Let me return to the three principles of simplicity, fairness and growth. A summary of the main points are as follows:

- First, the tax code needs to be simple and predictable. I think we all know the tax code needs to be simplified, yet the code has become more complicated and less predictable over the last several years. In order for small businesses to make

[1] Small Business Administration data based on Census Bureau survey, available at http://www.sba.gov/advo/research/data.html

[2] Joel Slemrod, "Small Business and the Tax System," Mimeo prepared for the conference "The Crisis in Tax Administration," University of Michigan, February, 2004. As Slemrod points out, the distribution of business income across business type—sole proprietorship versus Subchapter S for example—varies significantly with income.

[3] Estimates derived from W. Gale, "Small Business and Marginal Income Tax Rates," Tax Notes, April 26, 2004, p.471.

sound investment decisions, tax policy must also be stable so businesses can be confident in their business projections. To take one implication, the use of reconciliation in the budget process to enact tax policy should be avoided.

Some would argue that making the president's tax changes permanent would solve some of this uncertainty. But doing so would simply lock in a complicated policy and permanent deficits—I would argue that a reform of the tax code is indeed necessary, but it should be a reform that takes a very different direction than recent policy.

- Second, most small businesses are not at the top end of the income scale. Thus, any restructuring that cuts revenue from the top will either shift the tax share to the middle- and low-income business owners, or will increase the deficit, which can then harm small businesses through higher interest rates. Many so-called fundamental reforms, such as replacing the income or corporate tax with a value added tax (VAT), a national retail sales tax, or a flat tax would not be good for most small businesses. Small business efficiency requires a fair, progressive rate structure, not a flat structure.

- Third, to be efficient and to have solid growth, incentives for investment in physical capital must also be balanced with incentives for investment in human capital. A tax code that already favors wealth and investment in capital goods ignores the fact that it is human capital that is often the most important component of modern businesses. Also, expenditures in other areas are vital for small businesses, and raising adequate revenue to fund our national priorities is essential. For example, the budget for the U.S. Small Business Administration has been cut by nearly a third over the past several years.

Increasing Complexity in the Tax Code

The last several years have seen remarkable increases in tax complexity.

While there is no perfect measure of complexity, we can look at some simple statistics that might point to increasing complexity.

- There are now 61,000 pages of federal tax rules, including tax code, regulations, and IRS rulings, an increase of about 15,000 pages since 2001.[4]
- The IRS estimates the total amount of time to file the IRS 1040 and related forms, schedules and worksheets is 68 hours and 53 minutes, up 17 percent from 1995.[5]

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[4] The page count is from CCH Standard Federal Tax Reporter. For 2001, see Chris Edwards, "Simplifying Federal Taxes," CATO, October 2001, available at http://www.cato.org/pubs/pas/pa416.pdf. For current 2005 data, see written statement of Mark Everson, IRS commissioner to the House Committee on Government Reform, May 25, 2005.

[5] Schedule C has increased by 13 percent from 1990 to 2004 and is approaching 11 hours according to the IRS's analysis. The time to file schedule E increased by 7 percent and is now over 6 hours.

The number of pages in the 1040 instruction booklet has increased by 34 percent and is now 128 pages.

- H&R Block's revenue from tax preparation has increased by 219 percent since 1996, and is now over $2.3 billion.

Also, much of the paperwork burden for small businesses is due to the provision of employee benefits such as pensions, health care, etc. The tax code must ensure that efforts to provide solid benefits are not penalized by excessive filing burdens.

I think virtually everyone agrees that the tax code for small businesses is too complicated.

I would like to focus on one particular aspect of the degree to which our tax code has been mangled: the uncertainty of tax policy over time. Businesses routinely must assess the value of investment projects, meaning they must compare future projected revenues with today's costs. To the extent that future policy is uncertain, it adds just another component to an already risky decision.

For example, for the very few businesses that must prepare for the estate tax, the current path of elimination and resurrection is bordering on the ridiculous. A better option would be to set the estate tax exemption to a reasonable $2.5 million exemption level, as American Progress has proposed, and index that level to inflation.

Other examples include other provisions in the code that are set to expire, or that will need to be adjusted, including the AMT, certain depreciation rules, tax preferences for capital gains and dividends, not to mention the bulk of the 2001 and 2003 tax laws set to expire in 2010.

Some would argue that making the president's tax changes permanent would solve some of this uncertainty. But doing so would simply lock in a complicated policy and permanent deficits—I would argue that a reform of the tax code is indeed necessary, but it should be a reform that takes a very different direction from current policy.

The lesson we should take from recent tax policy is this: Congress should make permanent changes, unless the desire is explicitly a short-run economic boost—and in that case the provisions should be allowed to expire. And Congress should not use reconciliation in the budget process to make significant tax changes, since this virtually guarantees that policy will be continually revisited.

Fairness and Efficiency

As I've already mentioned, most small businesses are indeed small, and the tax rates faced by most small businesses are well below the top bracket.

Small business efficiency requires a fair, progressive rate structure, not a flat structure.

This means that the tax structure for small businesses must reflect the tax structure of a progressive tax code. When just getting started, businesses will have low levels of revenue and profits, and should face lower levels of taxation than larger companies, which can better afford higher tax rates. In addition, by their very size, larger corporations utilize more public resources—for example, they have more trucks on the road, use more of our ports, and rely more on the protections that our court system provides.

Lower tax rates on smaller businesses can also be justified by the fact that compliance costs (e.g. for regulations and taxes) are higher on a per-revenue, or per-employee basis for smaller businesses than for larger businesses.

Furthermore, small businesses must also pay the payroll tax for their employees as well as for themselves. Removing the employee side of the Social Security payroll tax would benefit not only small business employees, but would also improve the take-home pay of the owners themselves.

Tax reform requires making choices and setting priorities. In today's tight budget environment, tax cuts for those at the top of the income distribution necessarily mean shifting the tax share to middle-class taxpayers and most small businesses.

Economic Growth

A strong economy is essential to the health of small businesses and vice versa. And both require educated and skilled workers.

Human Capital

The tax code should not focus solely on what economists call physical capital—computers, trucks, machinery, etc.—but should also focus on building "human capital"; that is, education, on-the-job training, and advanced skill formation, thereby increasing the capabilities of employees to be better and more efficient at their jobs.

Already, we provide substantial preferences for income from accumulated wealth through preferences for capital gains and dividends and the expensing (or accelerated depreciation) of physical assets.

We need to create a tax code that balances incentives for investment in physical capital with investment in human capital.

Revenue Adequacy

Businesses also rely on a range of public services that are supported by tax dollars. Businesses obviously benefit from roads and ports, but they also benefit from a solid educational system and a clean environment. A small Internet design firm cannot survive

without educated designers and computer experts, and a fisher cannot make a living from a polluted river.

Tax reform must ensure that there are adequate resources overall to ensure an economic environment that is conducive to a strong small business sector and solid economic growth. And that requires raising adequate revenue to fund national priorities to ensure a vibrant economy.

To take another example of how tax and budget policy can harm the small business community: the Small Business Administration's budget has been cut by a third over the past 5 years from $900 million in 2000 to $610 million in 2005.

New Business Creation

Finally, we need to not only unleash the creativity and work ethic of our nation's business owners, but also respect the work of all Americans, including those who may not have the means to start their own companies.

In fact, part of growing the small business community is about making sure that as many people as possible have an opportunity to start their own businesses.

On Fundamental Reform Proposals

A number of fundamental reform ideas have been floated in recent years. The flat tax, a value added tax (VAT), and the national retail sales tax are all examples of policies that have emerged as replacements for the current income and/or corporate tax code.

First, evaluation of fundamental reform must be done in light of the current budget situation. The low rates one often sees in VAT, flat tax, or national sales tax proposals are often unrealistically low—and would simply put an inexcusable drain on already scarce national resources.

Second, one must look at the macroeconomic effects of these proposals. It is claimed that by reducing the top marginal tax rate and exempting capital income from taxation, one is promoting economic growth. Yet, most, if not all of these benefits are eroded if these changes add to the federal deficit and raise interest rates in the long run.

Third, as cited above, since most small businesses are owned by those in lower tax brackets, cuts at the top do nothing for the bulk of small businesses. And the inevitable shift in the tax share towards low- and middle-income business owners can be harmful to those businesses most in need of resources with which to grow their business.

It is often falsely argued that these reforms (or less ambitious versions) are somehow needed for our economy to grow. To take one example, those who wish to repeal the estate tax argue that it is harmful to family farms and businesses and is thus bad for economic growth. However, there is little evidence that there would be a significant

impact on the economy from estate tax repeal. Our economy thrived, for example, in the late 1990s despite having a lower estate tax exemption than today. And the nearly $1 trillion that would be added to the debt over the first 10 years of repeal would certainly place a drag on the economy. I would suggest that the booming economy of the 1990s did more for small businesses than all of the tax changes over the past few years.[6]

By making other changes that reduce tax rates on higher-income taxpayers or larger businesses, we are necessarily shifting the tax share onto those with lower incomes or smaller businesses. Providing additional incentives to a few at the top thus means reducing productive incentives to the bulk of people in the middle.

Sometimes it seems that virtually any proposed tax cut, tax reform, tax deduction, or tax credit is claimed to be "good for small business." The task of policymakers is, in many ways, to sort out these claims and apply a high standard: what is the *best* use of public resources.

If you gave me a check for $10 billion today, I could create a bunch of jobs and add value to the economy, but while I would certainly encourage you to do so (and I can provide you with a direct deposit account number if you like), I would also suggest that there might be better ways to provide targeted incentives to both existing and not-yet-born small businesses.

To be most effective in stimulating growth, tax incentives need to reward new investments in innovation and technology in a targeted way, and not simply create a windfall for income derived from past investment decisions – which is what many of these policies will do.

Also, fundamental shifts in the code can also shift the burden of compliance. For example, under a VAT, the costs of complying with the tax code would be shifted onto businesses, including small businesses.

Conclusion

Overall, the goal of small business policy should be to set the right environment for growth. The American small business community is vibrant, resilient, and helps to make our country economically strong.

We need to resist the temptation to claim that the small business community needs a tax cut each year to survive. Massive budget deficits which can increase long-term interest rates do far more damage to small businesses and investments than a few tax breaks here and there.

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[6] A recent CBO study dramatically illustrated just how few small businesses are actually significantly impacted – with a 3.5 million exemption, just 200 estates would not have had sufficient liquid assets to pay the estate tax in 2000. The CBO report estimated the number of estates that would have be affected by the estate tax in 1999 and 2000 for various levels of exemptions.

The goal of reform should be to simplify the code, while keeping a progressive rate structure and preserving the incentive to add value to the economy.

Thank you for the opportunity to present to this vital committee.

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