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FULL COMMITTEE HEARING ON MODERNIZING THE TAX CODE: UPDATING THE INTERNAL REVENUE CODE TO HELP SMALL BUSINESSES STIMULATE THE ECONOMY

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

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FULL COMMITTEE HEARING ON MODERNIZING THE TAX CODE: UPDATING THE INTERNAL REVENUE CODE TO HELP SMALL BUSINESSES STIMULATE THE ECONOMY

Thursday, April 10, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., in Room 1539 Longworth House Office Building, Hon. Nydia Velázquez [chairman of the Committee] presiding.

Present: Representatives Velázquez, Hirono, Chabot, Akin, Fortenberry, Davis, Fallin, and Buchanan.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

Chairwoman VELÁZQUEZ. Good morning, everyone. I now call this hearing to order on updating the Internal Revenue Code to help small businesses stimulate the economy.

As we approach April 15th, millions of Americans are preparing to make the tax filing deadline. Individuals and businesses are busy working through tax forms and schedules to determine what they owe the IRS.

For entrepreneurs, however, the tax code has become an obstacle to success rather than a means of encouraging expansion of their firms. Today's hearing will look at ways U.S. tax policy can be improved to provide immediate relief for these leaders of U.S. economic activity.

While the most recent economic stimulus package was focused on rebate checks which aimed to boost consumer spending, more can and must be done to foster sustainable economic growth. The tax code is often used to influence and encourage individual and business decisions. In fact, the Internal Revenue Code is filled with numerous preferences, deductions, credits or favorable tax rates that boost investment, savings for retirement, and home ownership.

However, in numerous ways the tax code is stacked against the average small business owner. Despite a number of changes in the past ten years, there continue to be an abundance of inequities and unnecessary complexities in our tax laws.

While fundamental reform may be years away, there is an opportunity to modernize some of the more antiquated provision which

raise major obstacles and are particularly harmful to entrepreneurs.

Today's hearing will focus on those aspects of the tax code that can and should be updated or simplified without delay. In conjunction with this hearing, the Committee will also release a report outlining those reforms that will aid small businesses during the economic downturn and put us on the path to recovery.

In its review of this nation's tax laws and their impact on entrepreneurs, the Committee found that a number of provisions failed to adequately reflect the changing economy. Tax policies simply have not kept up with the shift to a service-based economy and lack adequate recognition of the role technology plays.

Furthermore, home-based businesses are unnecessarily hampered by paperwork burdens and depreciation schedules that do not reflect the realities of the equipment and buildings that are part of today's small companies.

Last but not least, there are provisions in existing law that shift investment away from small firms. The report outlines reform for each of these problems, while reflecting a need to update the tax code to spur innovation and growth.

Given that the last major reform of the tax code took place in 1986, it is clear these changes are long overdue.

Today we will hear from business owners who can provide us with additional insights into how the tax code is affecting this important sector of the economy. From what we already know, the facts are not encouraging. While small firms are America's job creators, just last week we learned that 80,000 more jobs were lost in March. We must take action to stop these trends and instead of losing jobs make sure we are creating them.

I believe there exists an opportunity to implement some reforms immediately. Doing so will have immediate benefits for small businesses. It will also insure the nation's long-term economic growth.

I would like to thank all of the witnesses for testifying today, and I now yield to the Ranking Member for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr. CHABOT. I thank the Chairwoman for yielding, and good morning to everyone. I thank you all for being here as we examine ways to simplify the tax code for small businesses.

I want to thank you, Madam Chair, once again for recognizing this pressing issue and for calling this timely hearing.

April 15th is right around the corner, and it is this time of year that we all become more attuned to the tax burden placed upon all of us by our federal and state governments. Small business owners feel this burden profoundly as the question how will this affect my tax bill echoes all year long in each decision that they make.

The complexity and uncertainty of the tax code limits small business growth, slows job creation and puts a damper on our overall economy. In many respects the tax code makes decisions for entrepreneurs, and all too often those decision are to not upgrade equipment or offer health insurance or make other key investments because of the tax complications.

According to the Nonpartisan Tax Foundation, Tax Freedom Day, the day that we begin to work for ourselves as opposed to

working to pay taxes, falls on April 23rd this year. So that means that the average person, from January 1st through April 23rd, all of the income that they earn goes to the government, either the federal government, state government, local governments, government in one form or another. It is not until after April 23rd for the rest of the year that the person is working for themselves or their own family. That is outrageous as far as I am concerned.

That means we work 113 days of each year to pay Uncle Sam or the state or local versions of Uncle Sam before we earn a single dollar for ourselves. In 2001 and 2003, Congress passed legislation to cut taxes across the board on all Americans. Unfortunately, these tax cuts are set to expire at the end of 2010. In other words, taxes will go up in two years unless Congress takes action to prevent that from happening.

That also includes one of the most, I believe, egregious taxes, and that is the federal inheritance tax or the death tax in which the federal government can take up to 55 percent of what a person has when they pass away, and that is generally property that has already been taxed during a person's lifetime.

And the two groups that are hit most acutely with this tax are small businesses and farmers. That is oftentimes why the business or farm does not make it to the next generation, because it has to be literally sold in order to pay for the federal death tax, and those employees lose their jobs oftentimes.

Higher taxes, particularly on capital, cause the level of private investment to fall, a devastating blow to the many small businesses who rely on private investors for their livelihood.

Before it sunsets, I want to see Congress make this tax relief permanent. It is not just the added benefit of paying lower taxes, but the certainty that comes with it. Small businesses are always better off when they can plan for the future, and having stable and predictable bills is a big part of that.

The complexity of our tax code is staggering. At over 54,000 pages or, if you stack it one on top of another, it's eight Bibles thick, the code is a morass of laws and regulations that has been bloated to an unmanageable proportion. For small businesses just starting out, it can be especially difficult to know exactly what to do and when to do it. Small businesses simply do not have the technical expertise and in many cases the financial ability to hire accountants to help them understand what deductions and benefits they might be eligible for.

There's also a huge disparity in the way in which smaller firms compare with larger ones when it comes to tax compliance. In 2001, the Small Business Administration's Office of Advocacy released a report on the regulatory cost faced by small firms that contained an estimate of the paperwork compliance cost. The report showed that small businesses with fewer than 20 employees spend over $1,200 per employee to comply with tax paperwork, record keeping, and reporting requirements, more than double their larger competitors.

Sounder, simpler tax policies would benefit both the government and small business owners by improving compliance and lowering cost. A local veterinarian near my district in Cincinnati found out the hard way just how complex the tax code is. Last April the prac-

tice passed an employee wage threshold that required it to change how its 941 forms were deposited. Of course, the IRS didn't notify the veterinarian until August.

She contacted her CPA and followed his advice, but the next letter from the IRS was a fine. After sending a letter citing as she put it ignorance as first time business owners—that was her quote—she received not guidance but a new penalty bill, bringing her fees to more than $2,400. That is a lot and often too much for a small business to absorb.

Her biggest argument was that she used the IRS' electronic federal tax payment system and did not see why there wasn't a system built in to alert users to things like passing into a new threshold. Most of all, she just wanted to know why things could not be simpler.

We are here today because that is a fair question that deserves an answer. I am looking forward to hearing from our panel their recommendations for simplifying and modernizing the tax code. Outdated provisions simply do not reflect real world experiences and the way business is done domestically and globally.

Again, I want to thank the Chairwoman for calling this hearing, and I look forward to working with the Chair to help our colleagues on the Ways and Means Committee provide real tax relief, simplification, and certainty to our small businesses.

Once again, thank you, Madam Chair, and I yield back.

Chairwoman VELÁZQUEZ. Thank you, Mr. Chabot.

And now I recognize our first witness, Mr. Scott Mackey from the Wireless Association. He is with Kimbell Sherman. He consults to major wireless telecommunication providers, and is testifying on behalf of CTIA, the Wireless Association. CTIA represents all sectors of the wireless communication industry, including cellular and personal communications services.

Gentlemen, you will have five minutes, and in front of you there is a timer that will let you know when your time has expired.

Welcome.

STATEMENT OF MR. SCOTT MACKEY, ECONOMIST/PARTNER, KIMBELL SHERMAN ELLIS, LLP, ON BEHALF OF CTIA - THE WIRELESS ASSOCIATION

Mr. MACKEY. Thank you very much, Madam Chair, Mr. Chabot, members of the Committee, for holding this timely and important hearing.

As you both said, tax policy is very important for small businesses.

I am a partner at Kimbell Sherman Ellis in Montpelier, Vermont, and so I am here today wearing two hats, one as a part owner of a small business that has to comply with the regulations and provisions that you both mentioned, and also I have the privilege of representing CTIA, the Wireless Association and its many, many members that are involved in a very high tech and competitive business of wireless.

The business that I am in, one of the things we do is provide an electronic bill tracking system for folks that are following what is going on in our states in terms of legislation that affects them in

many ways, and so our business has been able to grow from eight employees in 2006 to 22 today, which that is not a lot of employees, but for us it is a lot.

And quite simply, we could not have grown our business without the advances that have taken place in the last few years in wireless technology, communications technology, and information services. So when I talk to you about these provisions that affect the wireless industry, these are also indirect in our ability to be productive and make money and be successful in business.

There are many issues I could be talking about today. Some of the other panelists will address some of these. I am only going to focus on three. The first one is the issue of cell phones as listed property. The second is extension of the research and development tax credit. And the third, which is slightly off point but very important, is a bill soon to be introduced which would impose a moratorium on discriminatory state and local taxes on the wireless industry.

The first issue, listed property, is a very difficult paperwork burden that is being imposed on small business. I mean, basically what it says is if you provide a cell phone or a Blackberry for your employees, that is not deductible as a business expense unless those employees go through their bill and identify each and every call and its business purpose.

Now, we have ten employees that have cell phones. The time that it would take for those employees to go through and look through hundreds and hundreds of calls, it is just a paperwork nightmare, and the issue is that if the IRS were to audit us, they would say that this is not a nontaxable fringe benefit. It is a taxable item, and therefore, we would have to collect back payroll taxes, Social Security and other taxes, and so this issue needs to be addressed.

Small businesses, most of the folks I talk to, do not even know it exists, and yet on audit potentially they could be paying hundreds or thousands of dollars in back taxes. So this issue needs to be addressed, and fortunately there is a bill pending, H.R. 5450, by Representatives Johnson and Pomeroy that would fix this, and we urge this Committee to support that.

The second issue is the research and development tax credit. Many folks may not view the wireless industry as small business because of the number of customers that subscribe to wireless technologies, but having just come back from the CTIA show in Las Vegas, there were thousands and thousands of small entrepreneurs that are developing little niche products and services that were run over wireless networks, and the R&D credit is very important to those small businesses that are really on the cutting edge of technology and innovation.

And while our firm does not use the R&D credit, we rely on those innovations and technologies that are coming out of the industry to provide us new tools to do business and be more productive and profitable. So I think all small businesses whether they claim the credit or not benefit from the innovation in technology that comes from providing that credit to our smaller entrepreneurs and other businesses as well.

And then the final issue is a moratorium on discriminatory state and local taxes on wireless service. I recently published a study which found that a typical wireless consumer pays double the rate of taxes that other taxable goods and services that are taxed in the states, and so this is a very important issue for businesses like mine and other small businesses that end up having to pay a lot of money in state and local taxes on their wireless service.

Fortunately, Representatives Lofgren and Cannon will be introducing either this week or next week, I hear, a five-year moratorium on discriminatory taxes. So this would allow states to tax wireless service if they are taxing other goods and services under the same tax, but would present the singling out of wireless services and wireless consumers for taxes just because 20 years ago telecom was a monopoly and, therefore, these old taxes are still on their books.

So this is a very important piece of legislation that, while not covered under the Internal Revenue Code, is something that members of Congress could do to help small businesses that rely on wireless technologies to compete.

So in conclusion, thank you very much for the opportunity to testify on these issues. I look forward to any questions that you might have at the conclusion of the panel.

And, again, thank you.

[The prepared statement of Mr. Mackey may be found in the Appendix on page 34.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Mackey.

Our next witness is Mr. Jeffrey Hoops. He is with Ernst & Young in New York. He is here representing the American Institute of Certified Public Accountants. AICPA has served the accounting profession since 1887. The association has more than 350,000 members, including CPAs in business and industry, public practice, government, education, and international associates.

Welcome, sir.

STATEMENT OF MR. JEFFREY R. HOOPS, PARTNER, ERNST & YOUNG, LLP, ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. HOOPS. Good morning. Thank you for inviting me.

Madam Chairwoman Velázquez and Ranking Member Chabot and other distinguished members of the Committee, I am here on behalf of the American Institute of CPAs. Our 300,000 members represent literally millions of small businesses, and at this time of the year especially we see first hand both the staggering complexity that you mentioned and the unnecessary complexities that you mentioned that face small businesses when trying to comply with the tax laws.

We have submitted a number of important changes that we think could be made to modernize the tax code and help small businesses be more competitive, especially in a global marketplace, and I would request that our previously submitted testimony be include in the official record of this hearing.

Today I would like to focus on a few of those items that we believe could make the tax code simpler, as you suggested. Some of

those have to do with S corporations. As you probably know, S corporations are a very popular vehicle for small business owners when it comes to forming their corporations. One significant hurdle that is faced by a C corporation that wants to convert to an S corporation is the LIFO recapture tax. This is a tax which is computed on the difference for inventories computed under the LIFO method of taxation and the FIFO method of taxation. And that recapture tax is paid that the date that the corporation elects to be taxed as an S corporation.

We believe that this tax could be more than sufficiently addressed through the built in gains tax, and we believe that the repeal of this provision, Section 1363(d) of the Internal Revenue Code, would allow more small businesses such as car dealerships, jewelry stores and others, to participate in this popular form of doing business, the S corporation.

A second corporate level tax that is paid by S corporations is what is known as the passive investment income tax or also more popularly known as the sting tax. This is paid by many corporations who have previously accumulated earnings as a C corporation, and when their gross receipts as an S corporation exceed more than 25 percent or royalties, rents and interest and dividends exceed more than 25 percent of their gross income.

In addition, if this happens for three years in a row, the S corporation election is automatically terminated. We believe that the law should be changed to eliminate the termination provisions because we think that the penalty provision or the sting tax is enough and that business owners should not be penalized by having their S corporation status repealed.

I would like to spend a couple minutes also focusing on partnerships. Many new businesses, small businesses form partnerships and partnerships or limited liability companies have become the preferred method for most new businesses that involve more than one person. Generally Subchapter K of the Internal Revenue Code, which governs the taxation of partnerships and partners, can be extremely complex, and yet there are only a limited number of de minimis rules or other ways for small businesses that are required to report under partnership rules to simplify their lives by electing out of Subchapter K.

One recent enactment created what is called the qualified joint venture, and this was based on a noble congressional desire to simplify the tax life of husbands and wives operating businesses together and to make certain that both spouses receive credit for purposes of Social Security and Medicare. This election allows the two partnership participating spouses to forget about the complexities of Subchapter K and to file as separate sole proprietors.

Unfortunately, a recent IRS interpretation of this new statute provides, if this interpretation is allowed to stand, it is very unclear as to which, if any, of these small businesses operating as husband and wives would be allowed to take advantage of this provision. That should be clarified.

We agree, by the way, with Mr. Mackey with respect to the treating phone and personal PDAs as listed property, and we think that that should be repealed.

And finally, we would like Congress to change the rules which currently provide that a taxpayer can take a position without penalty on the Internal Revenue Code that a tax preparer could not take without disclosure or being subject to penalty. We think that makes the playing field unfair, and we would like to see that changes as well.

Thank you very much.

[The prepared statement of Mr. Hoops may be found in the Appendix on page 39.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Hoops.

Our next witness is Dr. Andrew B. Lyon. Dr. Lyon is with PricewaterhouseCoopers. He is a leader in NEC's legislative and regulatory economic practice specializing in analyzing the revenue and economic effects of legislative and regulatory proposals. He is considered an expert in the tax field and contributed to the 2005 President's Advisory Panel on Tax Reform.

Welcome.

STATEMENT OF DR. ANDREW B. LYON, PRINCIPAL, NATIONAL TAX SERVICES, PRICEWATERHOUSECOOPERS, LLP

Mr. LYON. Thank you.

I thank the Committee for this opportunity to testify on the appropriate design of the tax system, especially as it applies to small business. My testimony is my own, and any opinions are not necessarily those of PricewaterhouseCoopers.

I understand your interest is both with respect to the current economic environment and also a forward looking interest in the promotion of long-term economic growth. While short-run economic concerns may create deviations from the most desirable permanent tax structure, I believe the long-term growth of the U.S. economy and small businesses is best promoted by providing a simple, transparent tax system with the lowest possible tax rates.

Small business plays a vital role within the broader private economy. In 2005, businesses with less than 500 employees represented 99.7 percent of all businesses and accounted for half of all private employment.

Government data also show that a relatively small number of large businesses also play an important role in the economy, and as an example, firms receiving more than $50 million in receipts represent just a tiny fraction of all firms, yet they account for about 69 percent of total business receipts.

Given the important role of both small and large businesses in the economy, there is a general consensus among economists that the tax system should not try to favor one form of business over another. The basic rationale is that in the absence of taxes, the market economy on its own would come up with the best allocation of small and large businesses that would maximize output in the economy. So in the presence of taxes, you would not want to try to change the outcome that would occur without taxes.

The one complication with this argument is that the very presence of a tax system can impose inordinate compliance burdens on small businesses, and while to some this might justify the use of special incentives to try to offset this compliance burden, the spe-

cial incentives themselves may create new compliance burdens, and the cost of claiming those special incentives, again, the burdens, may fall disproportionately on small businesses.

My written testimony touches upon several provisions in the tax code that create some distinctions between small and large businesses. Some of those differences are favorable to small businesses. Some are unfavorable. The point I want to emphasize is the inordinate compliance cost placed on small businesses today.

IRS data indicate that there are both significant amounts of under reporting of income by small businesses and significant compliance costs placed on small businesses, and there may be a correlation between the two. While noncompliance is not to be condoned, it can be understandable how the heavy compliance burdens may generate the result of noncompliance with some of the rules of the tax system.

Examining compliance costs, one IRS study found that businesses with less than $10,000 in annual receipts faced compliance costs that were twice as large as the total receipts of the business. Even as you expand to slightly larger small businesses, for example, those businesses with receipts between $100,000 and $500,000, compliance costs are estimated to be about five percent of total receipts. Again, that is measured relative to receipts, not income.

Income for such firms on average is about seven and a half percent of total receipts. As a result, compliance costs for these businesses represent an additional 60 percent tax on their income.

In summary then, as you think about reforming the tax system, it is essential to drive down the cost of complying with the nation's tax laws by reforming them with the goal of producing a clear, simple, and transparent tax system. As I mentioned at the beginning, I think this can best be achieved by creating a tax system with the lowest possible tax rates on business and with a minimum of special incentives. And in this way we can best foster entrepreneurship, innovation, and the long-term investment that will raise this nation's living standards.

Thank you.

[The prepared statement of Dr. Lyon may be found in the Appendix on page 49.]

Chairwoman VELÁZQUEZ. Thank you, Dr. Lyon.

Our next witness is Mr. Frederick Rosenthal, National Restaurant Association. Mr. Rosenthal is the president of Jasper's Restaurants. Jasper's has been in operation for over 25 years and has three locations in Maryland. Mr. Rosenthal is testifying on behalf of the National Restaurant Association, founded in 1919. The association is the leading advocate for the restaurant industry. It's 945,000 members employ 13.1 million people.

Welcome, sir.

STATEMENT OF MR. FREDERICK ROSENTHAL, PRESIDENT, JASPER'S RESTAURANTS, ON BEHALF OF THE NATIONAL RESTAURANT ASSOCIATION

Mr. ROSENTHAL. Thank you.

I would like to thank the members of the Committee for giving me this opportunity to offer testimony on behalf of the National

Restaurant Association about ways to update the tax code and help stimulate the economy.

I have been an entrepreneur in the restaurant business for over 40 years, building catering halls first in Baltimore, and restaurants since 1981 in Prince George's, Montgomery, Anne Arundel, and Calvert Counties in Maryland.

I am proud to be a part of an industry that plays such a critical role in this nation's economy. The restaurant industry is the second largest private sector employer outside of the federal government, with more than 13 million employees, representing more than nine percent of the job base. The first is the health care industry, but we are a close second.

The restaurant industry sales for this year are projected at $558 billion equaling four percent of the U.S. gross domestic product. Nationwide there are 945,000 restaurant and food service outlets. More than seven out of ten of these are small businesses, more than seven out of ten! We are truly a small business industry becoming an economic powerhouse more and more so each year.

I am here today to discuss the need for reforms in depreciation schedules, specifically to shorten the write-off for restaurant buildings and improvements to 15 years. This change would create immediate economic activity within the industry, which in turn would reverberate throughout the economy.

There is currently legislation pending in the 110th Congress which addresses the accelerated restaurant depreciation for new construction and improvements. H.R. 3622 championed by Congressman Kendrick Meek from Florida and Patrick Tiberi from Ohio would make permanent a 15-year depreciation schedule for newly constructed restaurants, as well as restaurant improvements.

The bill currently enjoys bipartisan support with 113 sponsors, including ten members of this Committee. There is no question that restaurant depreciation schedules are outdated. According to the tax code, restaurant buildings have a life of 39 and a half years in which they are written off. To suggest that a restaurant building's actual life is 39 and a half years is ludicrous. In fact, I wonder how many of you have know a restaurant that has even been in existence 39 and a half years.

Would any of you eat in a restaurant that had not been updated 40 years? I cannot even imagine the condition of the bathrooms and the carpeting in the building.

One hundred and thirty-three million individuals patronize this industry on a daily basis. Restaurants must constantly make changes to keep up with the daily assault of traffic in their buildings. In fact, most restaurants remodel and update their buildings every six to eight years, a much shorter time frame than is reflected in the current depreciation schedule.

Over the years Congress has made numerous changes in the depreciation schedules. They have granted specific benefits to gas stations and convenience stores, recognizing the need in those industries, and there have been other changes that create faster write-offs creating economic advantages.

The tax code should not pick winners and losers in the restaurant industry. It should allow a level playing field on which all

can play. In today's environment with high commodity costs, restaurants and small businesses are now yielding bottom lines of three to four percent, down from ten percent in the 1980s. Most of these small businesses are unable to remodel their buildings. It is a spiraling effect, downturn of sales, increasing costs, and in many ways forcing small businesses to close when the patronage drops below an economic level of sustainability.

All of these changes are addressed in my written testimony as well as a detailed explanation of the issue, and in respect for everyone's time, I will just hit a few points.

The restaurant industry is projected to spend $70 billion over the next ten years for building construction and renovation. Finally, there is no question as to whether or not this provision would immediately spur economic activity. Look what happened when Congress enacted a provision to provide restaurants a 15-year schedule for improvements to restaurant structures in 2004. In 2005, that provision was in effect. The restaurant industry spent more than $7.5 billion on improvements, a 42 percent increase over the previous year before enacted.

We urge the members of this Committee to consider the information as evidence to keep a strong restaurant industry in order to help this nation's overall economy.

In conclusion, on behalf of the National Restaurant Association, thank you for allowing me to testify, and thank you to those members of the Committee who have co-sponsored and championed this important legislation.

I will be happy to answer any questions when my turn comes.

[The prepared statement of Mr. Rosenthal may be found in the Appendix on page 61.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Rosenthal.

Our next witness is Mr. Drew Greenblatt, National Association of Manufacturers. He is the president of Marlin Steel Wire Products, established in 1968 in Baltimore. He is testifying today on behalf of the National Association of Manufacturers.

NAM has advocated for small manufacturers since 1895. Founded in Cincinnati, Ohio, it has 14,000 member companies in all industry sectors located throughout the nation.

Welcome.

STATEMENT OF MR. DREW GREENBLATT, PRESIDENT, MARLIN STEEL WIRE PRODUCTS ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. GREENBLATT. Thank you.

Good morning, Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee. My name is Drew Greenblatt. I am the president and owner of Marlin Steel Wire Products in Baltimore, Maryland.

Marlin was founded in 1968. We manufacture wire baskets, hooks, and wire forms. We have the capability to produce a wide range of custom products for our customers. Our products are used in industrial, aerospace, medical and automotive, factories and industries. We have clients like Caterpillar, Toyota, Boeing.

Thank you for the opportunity to let us appear today and on behalf of the National Association of Manufacturers, we appreciate it.

The NAM is the nation's largest industrial trade association, and we represent small and large manufacturers in every industrial sector in all 50 states. I am pleased that you have addressed this subject of updating the Internal Revenue Code. It will help small businesses stimulate the economy.

The NAM's tax policy agenda is designed to promote U.S. jobs and competitiveness and insure continued economic growth. I would like to touch on a few of these specific concerns that we have, and they include making the income tax cuts permanent, providing a strengthened R&D credit, and repealing the three percent withholding requirement on all government contracts.

Because Marlin Steel is an S corporation, we pay taxes at an individual rate. Many manufacturers like us are in the same boat. In fact, about half of all NAM members are similarly organized as flow-through companies, meaning they pay individual rates.

For us, the legislation passed in 2001 and 2003 lowered the top individual tax rates. This has been very good for us. Lower tax rates mean more money after taxes to expand our operations and create new jobs. When enough manufacturers expand, we fuel economic growth. This translates into more money for the government to spend and lower deficits.

It is paradoxical but true that lower rates mean higher tax revenues. Conversely, letting the Bush tax cuts expire effectively raises taxes in 2011. This will mean that we will be thinking about cutbacks right in the middle of an economic downturn.

There has been a lot of talk recently about raising taxes only on the upper brackets, but many folks in Congress think this means that they are only raising it on the super wealthy, but I am here today to remind you that these rates will strike at the heart of small business. My tax return includes all of my business income, even though we have never paid a dividend. We pour every penny of profit back into the company to let it grow. This so-called profit that the IRS is taxing me on is not cash in my pocket. It is money that I keep in my company so we can buy another welding machine to make a basket like this right here.

If my taxes go up, I will have to have less money to buy that welding machine or less money to hire a welder in Baltimore. The toll will not only be paid by manufacturers like myself, but it is also going to be one less machine that the welding machine company sells, and it is also going to be another unemployed person in Baltimore City.

Wouldn't it be better off if I was buying new equipment? Wouldn't it be better off for me to be hiring new people an the unemployment rolls to be smaller?

The R&D tax credit is also instrumental in maintaining our competitive edge. We are the primary innovator in the United States. Manufacturers understand that R&D drives new productivity. R&D is how we stay fresh, how we stay competitive. I cannot compete with other countries when it comes to wages. So I have to win on innovation.

Chairman Velázquez, let me give you a concrete example. Travers Tool is one of the excellent companies in your congres-

sional district. They buy this basket right here from me. They resell it worldwide. No one is going to get rich from just this one basket model. Travers needs a steady flow of new, fresh ideas, new products that are competitive, that are different.

We use this R&D tax credit to do our Thomas Edison imitation so that we can be different, innovative, and fresh. This tax credit helps Marlin stay innovative and contributes to jobs in our district, in your district. Unfortunately, because it is a temporary nature, this R&D tax credit, on again, off again, the fact that we are never certain whether it is going to be extended, it is very hard for me to decide whether or not we should continue plowing ahead reinvesting into the company.

As of right now, the tax credit has expired. Because Congress failed to act, we are going to get hit with a big tax increase. Making this credit permanent would end the years of speculation, and it would give the business the certainty we need to plan ahead.

In conclusion, the tax relief enacted in 2001 for families and businesses have played an important role in stimulating economic growth and job creation. Making this tax relief permanent would be an insurance policy for continued economic growth. Lowering tax rates, doing the permanent R&D credit are critical.

Simplifying the tax code by repealing the three percent withholding, consolidating the AMT and the existing tax structure, and repealing the estate tax would go a long way towards helping the small business community.

I want to thank you again, the Committee, for the opportunity to be here today and talking about the tax code and its impact on Marlin Steel Wire. I am happy to answer any questions.

[The prepared statement of Mr. Greenblatt may be found in the Appendix on page 76.]

Chairwoman VELÁZQUEZ. Thank you, Mr. Greenblatt.

There is going to be a series of votes. So what I am going to do is I am going to ask the first question, and then defer to the minority members. Then when we come back after those series of votes we will continue the hearing.

I would like to address my first question to Mr. Rosenthal.

In your written testimony, you spoke about the connection between your industry and the construction trade. Obviously, because of the housing crisis, construction is one sector of the economy that is particular struggling. Can you discuss in greater detail how do you think that tax benefits that help restaurants will stimulate growth in your industry and in others?

Mr. ROSENTHAL. That is a very good point. To give you an example, right now we have one of our restaurants is overdue for remodeling and refurbishing. We have plans on the drawing board to redo our first floor, redo the exterior, redo the roof and ceiling line at a cost of approximately $175,000.

We are looking as to whether or not we can do this this year, and part of the problem is our bottom line at that store has dropped to about three percent. We are facing a perfect storm right now. Usually when we see economic dips like we are seeing right now, we find that demand drops and, therefore, our cost of doing business, supplies and food costs drop.

But with the weak dollar and extremely high commodity costs, our costs, the food costs and products, have exceeded a five percent increase over the last year, with high labor costs dropping our bottom line to under three percent.

Candidly, in an environment where we are only at a three percent profit line, we do not know if we can take the risk to make that investment. If we knew that we had the ability to look at getting accelerated depreciation, which would mean that approximately double our deduction next year, we would then be more likely to make that.

As far as the building is concerned, yes, all of the construction companies are eager to do business. Three years ago we could not find a company to remodel and today we have 20 biting at the bit to do the job because they are hurting.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Chabot.

Mr. CHABOT. Madam Chair, I am going to reserve my questions.

Before I yield to my colleagues here, I just want to thank the panel, and I think their testimony was really excellent. I certainly agree that we need, rather than more special incentives complicating the tax code, to simplify it is the best thing that we could do and make the tax cuts that we already passed permanent so that businesses know what they are going to be dealing with down into the future and can plan for that now. I think that is the best thing that we could do for the economy, and hiring more people.

But I will yield my time to the gentleman from Tennessee, Mr. Davis.

Mr. DAVIS. Thank you so much. I appreciate each of you being here today. Thank you for what you do in our economy.

You know, as I look around northeast Tennessee where I represent, I have been a small business owner myself before coming to Congress about 20 years. So I know what it is to make a payroll and have to pay taxes and hire accountants to make sure that I do everything the way I am supposed to.

And I appreciate the opportunity, Madam Chairman, to have this hearing on taxes because I honestly believe that you cannot tax and regulate yourself into prosperity, and I think we are seeing that now especially with energy costs that are going up. As energy costs go up, commodity costs go up, and you are starting to see that.

I signed onto a piece of legislation that several members of the House have signed onto called an economic growth package. I voted for the economic stimulus package. I think we actually need a growth package, and the best economic growth package is a good paying job. It is not higher taxes and more regulations.

That legislation does basically three things, and I would like for you to talk to me about how you see this working in the economy. It would lower the top corporate rate from 35 percent to 25 percent. That would bring us in line with the European Union nations. That would bring jobs back to America that have actually left America in my mind.

The second thing it would do is allow for immediate indexing for new equipment and buildings.

And finally, the third thing it would do is decrease the top corporate capital gains rates to 15 percent bringing it in line with individual capital gains rates, putting more money back into small businesses so that they can go out and create those jobs, the ultimate best economic stimulus package.

If each of you or some of you could talk about an economic growth package with those fundamental principles and what it would do to our economy, I would appreciate hearing your thoughts.

Thank you.

Mr. HOOPS. Thank you.

I think that any package that reduces taxes will improve the economy. You certainly put more money into the pockets of small business owners. I think it is a fruitful debate and discussion to take into account whether those provisions will simplify the code or make them more complex. I appreciate the fact that the title of this hearing is modernizing the code, not simplifying it, and in an economic downturn, I suppose that modernizing is more important than simplifying.

So I would say in general although your stimulus package will undoubtedly make the code more complex, it could very well have the effect of stimulating the economy by putting more money in the pockets of small business owners.

Mr. LYON. Let me address the corporate rate reduction. If you look back prior to 1986, the United States had one of the highest corporate tax rates in the world. The 1986 Tax Reform Act reduced the corporate rate from 46 percent to 34 percent, and at that time did give the U.S. an advantage over most of our trading partners.

However, what happened since 1986 in the 20-plus years is that all of our trading partners reduced their rates, and so as you mentioned, today the average combined federal and local corporate tax rate in the European Union is less than 25 percent. It is about 24 and a half percent. So the U.S. corporate rate, by not changing on its own, became out of line with our trading partners and in many cases creates a competitive disadvantage for U.S. companies.

And even at a 25 percent federal rate, companies would still be liable for state and local taxes, which on average would add close to four or five percentage points on top of that 25. So many companies might say that that is not even going far enough.

Mr. ROSENTHAL. I think it was said here before that most of us in small business are taking the money from our, quote, unquote, profits and putting them back into our businesses. What this does, to lower the tax rate it enables us to invest and expand at a greater rate when we are burdened with higher taxes.

Most people do not realize that our industry, the restaurant industry, today is a highly professional industry. We are not providing the stereotype of minimum wage jobs. We are providing major jobs for folks who have growth opportunities in executive positions, many of whom are in six figures or more, running restaurants, and in order to expand that, getting a great job, we need to expand our business. And at a time when taxes are high and we are unable to use that money to plow back into our business, then they obviously are not going to provide those jobs.

Mr. GREENBLATT. this is a wonderful idea. We need you to win. We need more jobs to grow. We need to invest more back into the company. We need all of our other factories to invest back in.

We are not competitive. Right now our structure is not competitive against France. It is not competitive against our major trading partners. This is crazy. We should be a low tax environment so that we can fight the French, so that we can fight the Germans, so that we can fight the Canadians and be more competitive.

And by you leading the charge on this, we encourage you to do that because we really need the relief, and now is the time. Thank you for doing what you are doing.

Chairwoman VELÁZQUEZ. Your time has expired. Ms. Hirono.

Ms. HIRONO. Thank you, Madam Chair.

I know that the tax code has not been revised substantially since 1986, and so what we have had to add to the complexities is basically piecemeal legislation. So I commend the testifiers for focusing on those things that can modernize the tax code, and thank you for the specific bills that have been introduced.

I do have one question for Mr. Greenblatt. You mentioned in your testimony that the impact of sunsetting the Bush tax cuts will have a terrible impact, negative impact, on small businesses like yours. Do you have any information or data to support your contention and the extent of that kind of a negative impact on small businesses?

Mr. GREENBLATT. Thank you for the question.

It will be the biggest tax increase in American history, and that is the wrong thing you want to do when the economy is on shaky grounds, number one.

Number two, we pay on a flow-through level. So the money that is coming into us is money that we are reinvesting everything back into the company. So mean you cream off 35 percent at the top rate, that is a lot of money.

Ms. HIRONO. Well, I understand that. What I was asking was whether you have information from a much more industry-wide basis what the impact would be. Because these tax cuts are due to sunset, and if they do not get sunsetted, we are going to need to apply pay-go rules, and there are going to be massive cuts in many other programs in order to pay for the extension of the tax cuts that were supposed to be sunsetted.

So, you know, I am interested in the adverse impact of the sunsetting on small businesses. So if you can direct me and this Committee to information that would allow us perhaps to look at the impact on small businesses as a separate matter, then I think that would be very helpful.

Mr. GREENBLATT. I would be delighted to send you the information. The bottom line is we are the ones that create jobs, and our people pay the taxes that make this all work. And if we are scared because the money is going to go away, then we are not going to hire as many people, and that is going to impact how much the tax receipts are in the future.

Ms. HIRONO. Dr. Lyon.

Mr. LYON. I could mention again there are a huge number of small businesses, I believe something on the order of 21 million businesses, and the income they earn is taxed at individual rates

largely. I believe Treasury has produced data showing that about 70 percent of the income in the top two individual tax brackets derive from flow-through businesses. So most of the income in those top brackets is essentially business income that would be impacted by a tax increase.

Ms. HIRONO. Thank you. Thank you, Madam Chair. I yield back.

Chairwoman VELÁZQUEZ. Mr. Buchanan.

Mr. BUCHANAN. Mr. Rosenthal, I want to mention my background has been 30 years self-employed. So I share your experience as an entrepreneur. I was chairman of the state Chamber last year in Florida a couple of years ago, but let mention I hear what you are saying. I would like to extend that to 15 years from 39 for all businesses.

But what about component depreciation and leasehold? We write off over five years' component over five years. When you took your position on the improvements for 175,000, how much of that could go in the one category over the other one? I would like to get it all to 15, but I would like to see us get 15, not just in restaurants but other businesses as well.

But I would like to just have your thoughts on that. When I open a business or something, we put it in two categories, the land at zero, 39 on the building, and five years. Most of it is whatever we can component or leasehold. So I would just be interested in your thoughts.

Mr. ROSENTHAL. Well, we play that juggling game, you know, in small business, small business entrepreneurs. We spend as much time trying to figure out how we are going to categorize things to maximize our depreciation.

However, as you know, there are restrictions on what we can use for components. For example, if we put a kitchen in, the only thing we can accelerate to the five-year level is actual equipment that is used for cooking. So we have tried to expand that to say, well, is the duct work over the stove part of that? And we have been rejected often by the IRS saying, no, that is not. It is very literally interpreted.

So we wind up with a minimum amount that we are able to put into a five-year category, and we wind up with most of our leasehold improvements carrying the full term of full 39 and a half year depreciation.

If you look at most restaurant expansions today, 15 years ago a kitchen cost $150,000 to equip a casual dining 7,500 square foot restaurant, and today we are looking at a half a million dollars for that same kitchen, the majority of which has to be depreciated over 39 and a half years. so the answer to your question is there is not enough in that lower category to offset the 39 and a half year category, and that is why I think it is important to get the accelerated depreciation.

Mr. BUCHANAN. Yes, I support you on that.

I wanted to mention, Mr. Greenblatt, on your comment one of the things I think a lot of people do no understand up here because they are not in business, a lot of small businesses pass through income, and what that means, and someone said, well, that puts more money in the small business person's pocket. It really do not. I mean, it does, but it does not, I mean, with net worth.

But the reality of it is if you make 300, you pay 150 in taxes. You buy some more inventory. By the end of the day I have seen so many business people say, "Where is my cash?" So not much of it really flows through to the owner, and then you need that money.

So when they look at raising taxes from 35 to 45 or add four and a half percent on taxes over 150,000, some of the surtax up here, that mentality, a lot of that goes right to the heart of small business. And I know a lot of people that make 500, 700, 800, but it flows back into their businesses to create jobs, buy equipment, expand. You have got to have it for the banks if you want to try to grow your business.

Has that been your experience?

Mr. GREENBLATT. Absolutely. That is the key. That is the thing that is critical that we must understand, that we are reinvesting everything back to stay competitive. We are righting China. We are fighting Japan. We are fighting Mexico. And the only way we can be competitive is by reinvesting, reinvesting.

You know, it is critical that we stay competitive, and that is only going to happen because we keep the tax rates low and we plow more money into the company.

Mr. BUCHANAN. Thank you.

That is it, Madam Chair, for me.

Chairwoman VELÁZQUEZ. Mr. Fortenberry.

Mr. FORTENBERRY. Thank you, Madam Chair.

Thank you, gentlemen, for coming today.

Just a side comment regarding Mr. Greenblatt; is that right? I am sorry. I cannot see your sign. You were talking about manufacturing. Just an anecdotal story.

A businessman I was speaking to recently was talking about the cost of manufacturing a particular item in the United States $13; in Mexico $3; in China 28 cents. And that is the disparity of what we are facing and the incentives to shift more and more manufacturing out of this country are very real because of differences of currency, because of differences of labor and environmental standards and perhaps tax code differentials as well that discourage manufacturing investment here.

And this is a very serious problem. That is not my question. My question is I like to participate in these hearings in order to try to discuss big ideas. Now, all of you have generously given of your time to come today, but we are still kind of in the framework of discussing on the margins what already is. You know, tweak this area of the tax code, simplify this, depreciate that.

I just walked out of the room to talk to a group of people who have a very legitimate concern that their depreciation schedule is not consistent with the actual life of the equipment, very legitimate.

But what are the big ideas that are out there that can start to fundamentally address the earlier problem that I talked about, encouraging a new spirit of innovation and entrepreneurship?

We have a new philosophical direction that is coming in to work for us. Mr. Rosenthal, you have got employees that are working for you right now and are looking for learning as to how to potentially get into business to compete with you one day, and do you know

what? We accept that as a way of doing business in this country, and that is the spirit of innovation and entrepreneurship that I think we do need to encourage because this is where most new jobs that help families come from in the country.

Let's reframe the question. What are the big ideas out there that can further draw an entrepreneurial spirit beyond what we traditionally think about, which is access to capital and proper education and less regulatory barriers?

One of which, and we have held many hearings in this Committee, is the problem of health care. We have tethered health care benefits generally to business because of the way the 60-year history of this has been, and it is the way it is written into the tax code. That is a possibility of untethering that linkage so that people have portability, and yet at the same time can afford to insure themselves from vulnerable circumstances.

The other is have we structured the tax code, and Dr. Lyon, perhaps you can address this, in a way that facilitates the congregation of people in one place because we depreciate real estate a particular way or assets a particular way versus allowing people to be dispersed and entering in new types of contractual arrangements from home or by telecommuting and giving incentives to do that, which is much more consistent in many ways with a lot of the new workplace philosophical paradigms that we are seeing in terms of this entrepreneurial spirit.

That may not work in all businesses where you have to have certain economies of scale, either restaurant or manufacturing, but in a lot it may, and are we impeding that progress because of certain structures that we have in the tax code?

These are the kinds of ideas that I want to try to get under and use you as experts in this field to help think constructively through, all with the vision toward enlivening and animating the spirit of entrepreneurship in this country, which we all agree is for the benefit and well-being of American families.

So who wants to take that on?

Mr. LYON. I will start, and the others can be more creative.

You ask some very challenging questions. If you look at the compliance costs facing small businesses, you certainly want to do everything possible to minimize the paper work that they are required to do in order to claim tax benefits. One of the virtues of a system like expensing is they do not have to worry about depreciation schedules.

Mr. FORTENBERRY. I read your comments on expensing right before I came.

Mr. LYON. But short of trying to eliminate burdens in that way by just allowing complete write-offs, I would say that the next best thing you can do is strive for the lowest possible rates on business income, and by doing that, it becomes less important whether something has a 15-year life or a 20-year life. The return to the business is being taxed at a lower rate. Entrepreneurs can spend their time generating income instead of trying to comply with the tax law.

Mr. FORTENBERRY. My time is done, but, gentlemen, if you will ruminate on these broad questions, we are available for input and ideas. I would appreciate your input because of your expertise.

Thank you.

Chairwoman VELÁZQUEZ. Your time has expired.

Ms. Fallin. You do not have questions?

Mr. Akin.

Mr. AKIN. Just kind of piggybacking on the last question, it would appear from even the experience of the last, say, six years that if you take a look at 2000, we are coming into a recession. In 2001 and 2002, we did some sort of feel good tax cuts, and then the first quarter of 2003, we did dividend and capital gains, and almost instantly you go from a barely over one percent GDP jump to about four. Unemployment reverses almost overnight to losing 140,000 jobs a month to gaining about 160,000 within a period of a couple of months, and you have got five or six years of a very strong economy.

And most interestingly enough to people in government, particularly the people that like to spend government money, the government revenues go up significantly. So here you have a situation where we have actually cut taxes on businesses or at least made money available to businesses through the dividends/capital gains tax cut, and it appears to be paralleling what is going on in Ireland.

You know, the Irish about 15 years, 20 years ago decided to cut their taxes on business to be some of the lowest in the entire European Union, and now everybody in Europe is trying to copy Ireland because the economy is just going like mad.

It would seem like what we are talking about here is not that complicated. What we need to do is get capital working in small businesses. That seems to be the basic principle, and instead the Fed. keeps cutting interest rates and creating liquidity. The dollar is just going down like a submarine. It seems like we have got our hand on the wrong lever and what we should be doing is, even though it is not very popular, is to just cut the dividends and capital gains, get the taxes off of business.

Somebody said it is better to tax the people than to tax the peach tree. It seems like we are just doing it the wrong way. Does anybody want to comment?

Mr. MACKEY. To comment on your question and the last gentleman's question together, I mean, I agree we need a lower compliance cost. We need to lower rates, but more importantly, I think, when you look at the global economy, we need to do whatever we can to make sure that dollars are invested in the United States of America because there are a lot of places for investors to put dollars right now, and we are truly in a global economy when it comes to investment.

There are very few barriers to investment flowing to China, to Europe, to other countries. And so we need to look at everything we can do to make sure that investment happens here, the research and development, the things that give us a competitive advantage.

If that money is not spent here, we are going to lose that competitive advantage, and unfortunately the industry that I work with closely, the wireless and telecommunications, we are saddled with a lot of tax provisions that still date back to the 1980s when computers depreciated over 30 years, and we have many, many

problems with depreciation schedules with outdated federal, state and local tax provisions that increase the cost of investing.

When I look at my business and when I look at the data on productivity and what is creating wealth in the United States, it is investments in information technology and communications that are not just helping those industries, but all of the other small and large businesses that rely on that innovation, like in my business, to be able to make money, to be able to create jobs, to be able to provide the kind of health insurance and other benefits that we provide for our workers.

So I do not know if that necessarily qualifies as thinking outside the box in the way that you were doing, sir, and I appreciate your question, but we have got to get a tax code that, number one, makes sure that investment is here and stays here so that our businesses will benefit.

Mr. AKIN. That was my only question, Madam Chair. If somebody else wants to respond, you can.

Mr. GREENBLATT. If I may, I think the two idea that you are trying to create is wonderful. If we could create a one-page tax code, one page, we would save so much money in compliance costs and being nervous that the IRS is going to do something to us and hiring accountants. Right now I could hire a full person that would make 40-something thousand dollars a year to weld or to design or to engineer as opposed to paying it to an accountant. It is insane that I am spending it that way.

In China they do not do that. In France they do not do that. So we should have a one-page document for our taxes.

Chairwoman VELÁZQUEZ. The time is expired, but, Mr. Greenblatt, before we recess, I just would like to comment on Mr. Mackey's assertion that we should have tax policies that should be rewarding companies that are creating jobs in America, not companies that are creating jobs abroad.

What are your comments on that?

Mr. GREENBLATT. I make 100 percent of everything in Baltimore City and we import nothing from China. We import nothing from the Orient. So we are 100 percent American made.

We believe that if you make the environment so good for Americans, they will never think about, you know, putting a factory in Mexico or putting a factory in Canada. So what we need to do is make it so that we are such a competitive environment that you would not consider going elsewhere.

Chairwoman VELÁZQUEZ. Okay. The Committee will stand in recess until we vote on the floor. We are going to have three votes. So it will be like 30 minutes.

[Recess.]

Chairwoman VELÁZQUEZ. Mr. Chabot.

Mr. CHABOT. Thank you.

Mr. Mackey, I will begin with you if I can.

Chairwoman VELÁZQUEZ. It was fixed by a Democrat.

[Laughter.]

Mr. CHABOT. Well, since the Democrats broke it, they ought to fix it.

[Laughter.]

Mr. CHABOT. Just kidding. We actually get along very well, as most people know that follow this Committee.

Mr. Mackey, you mentioned before H.R. 5450, and I happen to be a co-sponsor of that, which would deal with your problem of wireless phones and the reporting requirements, personal versus business and that sort of thing. Could you tell us how much time is wasted in having to comply with the existing law?

And how often in the final analysis is it really enforced in any event? So are people just spinning their wheels?

Mr. MACKEY. That is a great question. I think not a lot of time is spent enforcing it or complying with it, quite frankly, because I do not think most businesses even know they are supposed to be complying with it, and I think that the entities that have received audit notices from the IRS have spent a lot of time trying to figure out, gee, should we just basically do away with providing our employees with cell phones because the prospect of having to comply with this is so onerous that it just not worth it, which of course means that employees then lose the productivity benefit from having these hand-held devices and phones that are so critical, you know, to their ability to do their jobs.

I think if nothing is done about it and information about the provision and enforcement starts to be more widespread, then I think you are going to see a huge amount of time and effort spent by small businesses, first, to figuring out what to do and what the exposure is and trying to hire folks, you know, to calculate the back tax liability, and then secondly, sort of deciding what to do about it.

And then if they do decide to continue to provide it, I can see, you know, just for myself when I travel around the country, you know, everybody is going to have to have a policy about whether you can call your husband or wife and talk to your family when you are on the road. I mean, there is just an endless amount of time, so much time I think that companies are going to really have to rethink whether to provide the benefit at all.

So it is a very onerous burden, and should it be more enforced, it is just going to grow exponentially.

Mr. CHABOT. Okay. Thank you.

Yes, Mr. Hoops.

Mr. HOOPS. You know, when cell phones were first made listed property, they first of all weren't nearly as common as they are today, and they were much more expensive on a per unit basis. So there was probably a good reason for treating them as listed property, but now the cost of using a cell phone is so inexpensive. You do not pay by the minute anymore. You buy as many minutes as you need, and it is one flat rate so that, you know, the cost benefit of treating this as listed property is not even close to being a cost benefit in terms of the revenue generation.

So we really fully support eliminating this as listed property.

Mr. CHABOT. Mr. Hoops, let me follow up with you on a different question at this time. Yesterday, and, again, to show the bipartisan cooperation on this Committee, the Chairwoman and I together met with and addressed the Association of Equipment Distributors who were here from all over the country in this room yesterday, and we both gave a little talk, and then we answered questions.

And one of the first questions that we got was relative to LIFO that you referred to. Could you go into a little more depth relative to what the problem is and what you believe that Congress should do to address that problem?

Mr. HOOPS. Well, sure. I would be happy to. You are talking about the LIFO provision for S corporations?

Mr. CHABOT. Yes.

Mr. HOOPS. Okay. Many businesses adopt the LIFO method of computing their inventory and cost of goods sold, and just briefly the way the LIFO method works is that the costs associated with a particular sale, you match up the cost of the last inventory that you purchased with a particular sale. So if I sell something tomorrow, I would match up my cost with a product that I purchased today or the day before, not with a product that I purchased some time ago.

So for a business that has been in existence for a long period of time, what typically happens is that the inventory on their balance sheet is reported at something significantly less than fair market value because that inventory has accumulated over many years, and as costs rise the cost of replacing that inventory is much more.

The benefit of that, of course, is lower cost of goods sold and lower taxes by corporations. When a corporation goes from being a C corporation to an S corporation, the corporation no longer pays a corporate tax, but the shareholders pay an individual tax on the profits, as Mr. Greenblatt alluded to before.

The provision states that when you elect S status, that built-in gain in the inventory that had accumulated when you were C corporation has to be reported in income before you elect that status. So it's a tax on the C corporation at conversion.

That is a very expensive tax for a small business, and the truth of the matter is that if they had remained as a C corporation, they probably would never have paid that tax or they would only really pay the tax if they reduced their levels of inventory significantly.

So our suggestion is that you do not penalize a corporation that wants to elect S status by making them report that income immediately. Rather, they would report it at the time a C corporation would report it, when the inventories were reduced.

Mr. CHABOT. Thank you very much.

Dr. Lyon, you had mentioned in your testimony that it is your belief that what we should have is as clear, simple, transparent a tax system as we possibly can at the lowest possible rates and should, if possible, stay away from special incentives. I assume what you mean basically, one thing you do with that is you are further complicating the code. We are trying to help, but we are adjusting things and new forms and figuring it all out.

Could you again tell us why you believe that that is important and that is the better route to take?

Mr. LYON. Well, there are a number of reasons. One is just to question whether the special incentives themselves really make our economy more productive on the whole. It is a little like industrial planning where we think certain activities are more meritorious than others, and as we observed Japan at one time engaged in that a great deal, their economy has not done very well over the past

decade. So there is a question of whether we can really outguess the market in terms of what the best activities are.

But the other point is that simply to claim these benefits requires a lot of time spent in understanding how the rules work, showing that you are in compliance, documenting it, and especially for small businesses the cost of going through that paperwork can eat up much, if not all, of the benefit that was intended from the provision. If instead we had simply channeled that reduced tax collection through lower rates, businesses would have incentives simply to go out there and earn income in the best way that they see to do it.

Chairwoman VELÁZQUEZ. Would the gentleman yield?

Mr. CHABOT. Yes, I would be happy to yield.

Chairwoman VELÁZQUEZ. Would you say the same is true with 179 expensing and bonus depreciation?

Mr. LYON. It is a difficult angle. There are some clear benefits of Section 179 that businesses do not have to keep paper track of depreciation of the property. They write it off all at once. That is a big simplification advantage.

However, not all property qualifies for Section 179. Investment in structures or inventory do not, and so again, we are doing a bit of industrial planning in rewarding investment in equipment that does qualify for it over other investments.

Chairwoman VELÁZQUEZ. Thank you for yielding.

Mr. CHABOT. Absolutely, and reclaiming my time, Mr. Rosenthal, you are next if I can. One of the kind of common things you hear about the restaurant industry is that when new restaurants are started there is a fairly good chance that they are not going to make it, that only so many make it beyond a certain year, and that sort of thing. How much of the challenge that a new restaurateur or perhaps even somebody that has been in business for a number of years, how much of a challenge is the dealing with the paperwork that is involved, the red tape, an outside force telling you what wages you have to charge when we say minimum wage is going to be this, that, or the other thing?

And various governmental involvement in your business, how significant is that in the whole success or failure of a restaurant?

Mr. ROSENTHAL. Well, we are in a business that the mortality rate for restaurants unfortunately is very high, and there are many reasons for that, but over the last decade, and I have been doing this for over four decades, so over the last decade, the paperwork, the administrative level of trying to maintain compliance has gotten so out of hand.

I will give you an example. We have an employee, a very qualified employee who does nothing but work on I-9s, handles our I-9 compliance issues because this is a major issue today. And we pay about $50,000 a year individually in benefits for someone to do nothing but handle our I-9s. We have about 600 employees, and we like most restaurants are turning about twice a year. So we have a ton of this coming through, and we have begged for a better system, a system where we can get on line and qualify people without us having to do all of these paperwork faxing, re-faxing. This is the best example.

Additionally, you are right. All of the paperwork utilized for compliance with tip reporting has become onerous to a point that we have had to actually invest in a computer system that will insure that tips are declared properly and spread properly, and we have a human resources person that handles basically our tip employee wages, and that is all they do. So the administrative level of handling not only the paper work but the people in there and the qualified people to do these jobs.

Additionally, we are faced with and all of our businesses are operated as separate corporations for many reasons. They may have another investor or someone else in there. So they are set up separately, which means we now operate seven businesses including the property, which means we have seven federal and state tax returns, and our accounting bills have gotten to a point that we do not have a general manager making what our accountants get paid a year to handle our taxes.

So a long answer to a short question, but the answer is it has become very onerous and getting worse every day as new regs come in, health department regs, trans-fat bands, menu labeling. It goes on and on and on to a point in a narrow margin business you begin to wonder, as many operators begin to wonder, is it really worth it. Is it worth expanding?

Mr. CHABOT. Thank you very much.

And finally, Mr. Greenblatt, I think one of the main points that you emphasized was the importance of making the tax cuts that were already passed, the capital gains tax relief, the marginal rates across the board, all of the above, make them permanent. That is one of the main things that we could do.

You also talked about how many business owners are not really taking a whole lot out of the company. They are plowing it back in the business. So whereas it may look like they are rich people, wealthy people who some would argue deserve to be taxed more, in reality by plowing it back into the business, they are growing that business and hiring a whole lot of other folks, giving them a job.

Is that a fairly accurate portrayal that I just made, and would you like to expound up that?

Mr. GREENBLATT. I think you summarized it wonderfully. We are the job machine. The small business manufacturer, the small business in general is the job machine, and we are going to get us out of the recession, and as you give us more impediments, it is going to take us longer to get out of the recession.

When you tax us, we are less prone to reinvest back into the company. We are going to be less competitive, and we are going to lose more jobs to China. We are going to lose more jobs to some of these other countries.

So the way for us to get motivated and to start hiring again is to let us reinvest back into the company and grow the company, and that is our future.

Mr. CHABOT. Thank you very much.

Madam Chair, I yield back my time.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Hoops, we have talked about cell phones as listed properties. Are there any other listed properties, like automobiles, that are out of date and need to be updated?

Mr. HOOPS. I would eliminate all of the listed property rules, to be honest. That is one way to simplify the code, make life easier for small businesses and really eliminate a disparity that really should not exist.

Chairwoman VELÁZQUEZ. Okay. And my question is to you. On the first day of the 110th Congress I introduced H.R. 46, the Small Business Tax Flexibility Act. One of the provisions in that bill would give small start-ups the ability to choose the fiscal year that best fits their business cycle.

This hearing is all about modernizing the tax code to make it more small business friendly. With that in mind, why is it important for our tax code to be flexible with regards to small businesses that are in the start-up stage?

Mr. HOOPS. Well, first of all, thank you very much for introducing that bill. It is something that the AICPA has supported and believes is necessary and has really thought that for a long time. So thank you very much.

Mr. Rosenthal mentioned that most of the businesses in his industry and, in fact, most small businesses, many small businesses, too many small businesses fail in their first year of existence. Right now almost all small businesses are required to adopt a calendar year. There are a couple of problems with that.

First of all, that may not match up against the corporation's natural business year.

Second, if a new business starts up in October or November, after being in business in those first critical months, it has to stop, close its books and prepare a tax return. This would give small businesses an opportunity to have a fiscal year that matched up with their business cycle and for a new business to have an opportunity to operate for a full 12 months before it has to close its books.

As an aside, both Mr. Rosenthal and Mr. Greenblatt mentioned the fees that they are paying to accounting firms. I would personally like to thank you for that.

[Laughter.]

Mr. HOOPS. But because most of our small business clients are on a calendar year basis, there is an enormous amount of work that CPA firms have to compress in terms of serving their clients into a very short period of time.

I think that having fiscal year flexibility would allow CPAs to devote more time to smaller, new businesses at a time of year when they are not so incredibly busy. So that is another important part of this provision.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Rosenthal, I know that Jasper's has been business for over 25 years, and I wanted to get your thoughts on the recent stimulus package that includes tax rebate. In 2001, Congress passed similar legislation that sent out tax rebate checks to millions of Americans. At that time, did your industry or restaurants see a significant boost in revenues?

And do you anticipate higher volumes of business when the checks start arriving in May?

Mr. ROSENTHAL. Well, we are all hopeful, but that is a question which we have been pondering because the last time that happened, we did not face some of the issues we are facing today, and that is at the current rate it probably would fill up someone's tank maybe two or three times, and I do not know if they are going to have any money left to spend in restaurants.

So I am not overly optimistic that we are going to see that trickle down. The real problem—

Chairwoman VELÁZQUEZ. But in 2001, you did see that?

Mr. ROSENTHAL. It did help. It did help at that time.

Chairwoman VELÁZQUEZ. Mr. Mackey, the R&D tax credit obviously is of great importance to your industry. Traditionally, that credit has been mainly utilized by larger companies.

How, in your view, could the credit be modernized or simplified to make it more attractive for small businesses or more friendly?

Mr. MACKEY. Well, as I mentioned before, I mean, when you think about the wireless industry, you are thinking about big businesses, but I do think there are a lot of smaller companies that are able to use the R&D credit. My firm, for instance, we do not use it because we end up outsourcing a lot of the development of software and things like that to other companies which I assume are using the credit. So we benefit indirectly.

I do think that perhaps more small businesses are able to take advantage of the credit than some people may generally realize, and even if they do not take advantage of it directly, indirectly they are able to benefit from the new products that are being developed by small businesses that do take advantage of the credit.

Chairwoman VELÁZQUEZ. Thank you.

Mr. Hoops, how would the changes that you discuss make small businesses more competitive? And do you believe that these reforms could encourage greater small business formation?

Mr. HOOPS. Yes, I do believe it would encourage greater small business formation. I think the changes that we discussed, most of which are relatively minor and simple to fix, would go an enormous way, would make enormous strides towards making it easier for small businesses to comply with the tax law and to put their time and efforts to earning more profits.

One of the other members was looking for the big idea. I have been in this business now for over 30 years, and in those 30 years everyone is always looking for the big idea, but my experience and judgment tells me that there really is no big idea and that we would make a lot more progress, especially in a down economy, by focusing on fixing the hundreds of things that could be fixed relatively simply in the current tax code to make it more efficient and easier to comply with for small businesses.

Chairwoman VELÁZQUEZ. Thank you.

Dr. Lyon, in light of the budget deficit, the tax gap is a major concern for the federal government and has received a lot of increased attention, given the budget deficit. One of the drivers of the gap is the increasing complexity. How would updating the tax code potentially reduce the tax gap?

Mr. LYON. Thank you, Madam Chairwoman.

The actual studies have not been able to determine whether complexity drives noncompliance. I think there is a lot of common sense that when it takes more time to compute your taxes, businesses that have many other valuable things to do with their scarce time and resources may find it more valuable to generate income instead of devoting resources to the compliance costs.

And so I do think as we simplify the tax laws and especially lower rates, it makes it much easier, less painful to report income and the tax gap would go down.

Chairwoman VELÁZQUEZ. Thank you.

Yes, Mr. Hoops.

Mr. HOOPS. I think that there is no tax code simplification that could ever cure the tax gap when it comes to simply not reporting the income that everyone knows should be reported, and sadly for the small business owners, sadly the evidence is irrefutable that when you have increased reporting, you have increased compliance.

But also I would say based upon my experience and practice and just dealing with my neighbors is that when there is a perception that the tax code is extraordinarily complex and unfairly favors some groups over the other, that people are even less enthused about paying the taxes that they should pay.

So I think that that tax code in some cases contributes directly to the tax gap with its complexity and certainly in other cases indirectly to the tax gap.

Chairwoman VELÁZQUEZ. Thank you.

Mr. CHABOT. Would the gentle lady yield?

Chairwoman VELÁZQUEZ. Sure.

Mr. CHABOT. Yes I thank the gentle lady for yielding.

The term "the tax gap" was one that sort of came up a few years ago, and some—certainly not the Chairwoman because she does everything right—but some people have used that term—

Chairwoman VELÁZQUEZ. Make sure that is reflected in the record.

Mr. CHABOT. That is right.

[Laughter.]

Mr. CHABOT. But some people, I think, have used that term because they think that the problem is Congress has been spending this much and we have been taxing this much. So we are spending more than we in. So there is sort of this idea out there that there is a gap between what we spend and what we bring in in taxes, and some people are not paying their fair share of their taxes. If we can just get them, we can keep spending this extraordinary amount of money that we are spending up here.

And the bottom line is we just spend too much in Congress. That has been true under Democratic control now and it was true certainly when Republicans were in control as well.

So it is just a term that sort of has political implications. Certainly those that are not paying their taxes are not being fair to those that are, but I think the IRS and others try as hard as they can to make people comply with the tax code, and I just would not want to leave that impression out there that all we have to do is try harder or simplify the code, which I do think we ought to simplify, but then we will have more money. Then we can keep spending all of this exorbitant money, you know.

We need to get control of spending.

Chairwoman VELÁZQUEZ. Yes, it really grew during this last eight years.

Anyway, any more questions?

[Laughter.]

Mr. CHABOT. Including this eighth year, too. So I have no other questions.

Chairwoman VELÁZQUEZ. Okay. So let me take this opportunity again to thank all of you for your participation and insights, and we will continue to work.

Today we release this report that I will encourage you to read and to make any comments that you might want, and I ask unanimous consent that members will have five days to submit a statement and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned. Thank you.

[Whereupon, at 12:36 p.m., the Committee meeting was adjourned.]

NYDIA M. VELAZQUEZ, New York
Chairwoman

STEVE CHABOT, Ohio
Ranking Member

Congress of the United States
U.S. House of Representatives
Committee on Small Business
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STATEMENT
Of the Honorable Nydia M. Velazquez, Chairwoman
United States House of Representatives, Committee on Small Business
Full Committee Hearing: "*Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy*"
April 10, 2008

As we approach April 15th, millions of Americans are preparing to meet the tax filing deadline. Individuals and businesses are busy working through tax forms and schedules to determine what they owe the IRS. For entrepreneurs, however, the tax code has become an obstacle to success, rather than a means of encouraging the expansion of their firms.

Today's hearing will look at ways U.S. tax policy can be improved to provide immediate relief for these leaders of U.S. economic activity. While the most recent Economic Stimulus Package was focused on rebate checks—which aim to boost consumer spending—more can and must be done to foster sustainable economic growth.

The tax code is often used to influence and encourage individual and business decisions. In fact, the Internal Revenue Code is filled with numerous preferences—deductions, credits, or favorable tax rates—that boost investment in business, savings for retirement, and homeownership. However, in numerous ways, the tax code is stacked against the average small business owner.

Despite a number of changes in the past ten years, there continue to be an abundant of inequities and unnecessary complexities in our tax laws. While fundamental reform may be years away, there is an opportunity to modernize some of the more antiquated provisions, which raise major obstacles and are particularly harmful to entrepreneurs.

Today's hearing will focus on those aspects of the code that can—and should be—updated or simplified without delay. In conjunction with this hearing, the Committee will also release a report outlining those reforms that would help small businesses weather the economic downturn and put us on the path to recovery.

In its review of the nation's tax laws and their impact on entrepreneurs, the Committee found that a number of provisions fail to adequately reflect the changing economy. Tax policies simply have not kept up with the shift to a service-based economy and lack adequate recognition of the role technology plays.

Furthermore, home-based businesses are unnecessarily hampered by paperwork burdens, and, depreciation schedules don't reflect the realities of the equipment and buildings that are part of today's small companies. Last, but not least, there are provisions in existing law that shift investment away from small firms.

The report outlines reforms for each of these problems while reflecting a need to update the tax code to spur innovation and growth. Given that the last major reform of the tax code took place in 1986, it is clear these changes are long overdue.

Today, we will hear from business owners who can provide us with additional insights into how the tax code is affecting this important sector of the economy. From what we already know, the facts are not encouraging. While small firms are America's chief job creators, just last week, we learned that 80,000 more jobs were lost in March. We must take action to stop these trends and instead of losing jobs make sure we are creating them.

I believe there exists an opportunity for this Committee and Congress to implement some immediate reforms. Doing so will have immediate benefits for small businesses. It will also ensure the nation's long-term economic growth.

U.S. House of Representatives

SMALL BUSINESS COMMITTEE

Thursday, April 10, 2008

Representative Steve Chabot, Republican Leader

Opening Statement of Ranking Member Steve Chabot

Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy

Good morning. Thank you for being here as we examine ways to simplify the tax code for small businesses. I want to thank you, Madam Chair, for recognizing this pressing issue and for calling this timely hearing.

April 15th is right around the corner, and it is this time of year that we all become more attuned to the tax burden placed upon us by our federal and state governments. Small business owners feel this burden profoundly as the question, "How will this affect my tax bill?" echoes all year long in each decision they make.

The complexity and uncertainty of the tax code limits small businesses' growth, slows job creation, and puts a damper on our economy. In many respects, the tax code makes decisions for entrepreneurs and, all too often, those decisions are to not upgrade equipment, offer health insurance, or make other key investments.

According to the non-partisan Tax Foundation, Tax Freedom Day – the day that we begin to work for ourselves as opposed to working to pay taxes – falls on April 23rd. That means we work 113 days of each year to pay Uncle Sam before we earn a single dollar for ourselves. That's unacceptable.

In 2001 and 2003, Congress passed legislation to cut taxes for all Americans. Unfortunately, these cuts – including the infamous death tax which affects several of our family-owned small businesses – are set expire in 2011. Higher taxes, particularly on capital, cause the level of private investment to fall – a devastating blow to the many small businesses who rely on private investors for their livelihood. Before it sunsets, I want to see Congress make this tax relief permanent. It is not just the added benefit of paying lower taxes, but the certainty that comes with it. Small businesses are always better off when they can plan for the future, and having stable and predictable bills is a big part of that.

The complexity of our tax code is staggering. At over 54,000 pages, the code is a morass of laws and regulations that has bloated to unmanageable proportions. For small businesses just starting out, it can be especially difficult to know exactly what to do and when to do it. Small businesses simply do not have the technical expertise and, in many cases, the financial ability to hire accountants to help them understand what deductions and benefits they might be eligible for.

There is also a huge disparity in the way in which smaller firms compare with larger ones when it comes to tax compliance. In 2001, the Small Business Administrations Office of Advocacy released a report on the regulatory costs faced by small firms that contained an estimate of the paperwork compliance costs. The report showed that small businesses with fewer than 20 employees spend over $1200 per employee to comply with tax paperwork, recordkeeping, and reporting requirements – more than double their larger competitors. Sounder, simpler tax policies would benefit both the government and small business owners by improving compliance and lowering costs.

A local veterinarian near my district in Cincinnati found out the hard way just how complex the tax code is. Last April, the practice passed an employee wage threshold that required it to change how its 941 forms were deposited. Of course, the IRS didn't notify the vet until August. She contacted her CPA and followed his advice, but the next letter from the IRS was a fine. After sending a letter citing, as she put it, "ignorance as first time business owners," she received not guidance, but a new penalty bill, bringing her fees to more than $2,400. That's a lot – and often too much – for a small business to absorb. Her biggest argument was that she used the IRS's Electronic Federal Tax Payment System and didn't see why there wasn't a system built in to alert users to things like passing into a new threshold. Most of all, she just wanted to know why things couldn't be simpler. We're here today because that is a fair question that deserves an answer.

I am looking forward to hearing from our panel their recommendations for simplifying and modernizing the tax code. Outdated provisions simply do not reflect real world experiences and the way business is done domestically and globally.

Again, thank you Madam Chair for calling this hearing. I look forward to working with you to help our colleagues on the Ways and Means Committee provide real tax relief, simplification and certainty to our small businesses. I yield back.

Statement of Rep. Jason Altmire
Committee on Small Business Hearing
"Modernizing the Tax Code: Updating the Internal Revenue Code
to Help Small Businesses Stimulate the Economy"
April 10, 2008

Thank you, Madam Chairwoman, for holding today's hearing to discuss how we can modernize the tax code to help small businesses stimulate the economy. It is clear that changes to our tax code are long overdue. The last major reform of the tax code took place over twenty years ago, and today our antiquated tax code has become an obstacle for small businesses.

Despite a number of changes over the past decade, including new deductions, credits or favorable tax rates, the tax code still hinders the potential expansion of small businesses because of numerous inequities and complexities. While an overhaul of our tax code may still be years away, there are steps that we can take now to help small businesses. One way we can do that is by changing the depreciate schedule from 39 ½ years to 15 years for restaurants. I have cosponsored legislation that would change the depreciation schedule to reflect the realities and needs of today's businesses.

I look forward to hearing the suggestions of today's witnesses on other ways we can update the tax code to spur economic growth. Small businesses are our nation's number one employer, and it is imperative that we arm them with the resources they need to continue to be an engine of job growth.

Madam Chair, thank you again for holding this important hearing today. I yield back the balance of my time.

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Written Testimony of

Scott Mackey
Economist / Partner, Kimbell Sherman Ellis LLP

Before the Small Business Committee
U.S. House of Representatives

April 10, 2008

Chairwoman Velázquez, Representative Chabot, and members of the Committee, thank you for this opportunity to testify on several issues that the Committee may consider in "Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy." I don't have to tell members of this committee how important small businesses are to the US economy, and how important federal and state tax policies are to the success of small businesses.

My name is Scott Mackey and I am an economist and partner at Kimbell Sherman Ellis LLP. Our firm has grown from 10 employees in 2006 to 22 today, and this growth is directly attributable to advances in communications networks and information technology. We provide state legislative bill tracking services to dozens of companies and trade associations. High-speed communications networks – both wireless and wireline – are the lifeblood of our business, and without the advances in technology over the past 5-10 years, we simply would not be in this business today.

I also provide consulting services to the six largest wireless communications providers on state and local tax policy. This coalition of wireless providers – which includes Alltel, AT&T, Sprint, T-Mobile USA, US Cellular, and Verizon Wireless – seeks to accomplish two major objectives in state legislatures: 1) the reduction or elimination of excessive and discriminatory taxes imposed upon wireless consumers; and 2) the promotion of state and local tax policies that encourage investment in wireless networks.

So I appear today both as a small business owner directly impacted by the federal tax policies I will discuss today, as well as on behalf of CTIA – The Wireless Association® and its member companies. And while few people may think of wireless providers as "small businesses," having just returned from the CTIA trade show last week, I was struck by the number of small

businesses that are rolling out new products and services that are delivered to consumers over wireless networks.

Today, I will discuss two specific issues in the federal tax code that are very important to small businesses that rely on wireless services. I will also briefly touch on federal legislation that would help provide relief from excessive state and local taxes to millions of consumers and small businesses that use wireless service.

- First, we would respectfully request that Congress pass H.R. 5450 introduced by Representatives Johnson and Pomeroy remove cellular phones from the listed property classification. This is a classification that no longer has a place in today's economy, where small businesses are very reliant on wireless services to be effective and efficient in the daily operation of their business.

- Second, at a time when state and local economic development experts are touting broadband as critical to economic competitiveness, extension of the Research & Development credit will help spur continued innovation and advancements in broadband network technologies as well as continued development of applications that work over wireless networks.

- Third, while not directly related to updating the Internal Revenue Code, Congress should support a moratorium on new discriminatory state and local taxes on wireless services, consumers and providers. Currently wireless consumers, including small businesses, already pay **almost double** the rate of taxes on wireless services than the rate imposed on other goods and services. This ban would preclude additional excessive taxes from being added to the consumer's costs for these services.

1) Support and pass H.R. 5450 introduced by Rep. Johnson and Pomeroy to remove cellular phones from the listed property classification.

Cellular phones were included in the "listed property" class (IRC § 280(F)) in 1989 at a time when cellular phones and the cost of such services were very expensive and were primarily restricted to being an executive perk. As listed property, every employee using a phone provided by their employer must maintain a detailed phone log. The log must document every call made and distinguish those that are business calls from personal calls. To substantiate a call was for business use, the employee must identify the date, time and business purpose of the call. Failure to maintain the detailed call log will render the entire monthly service as a taxable fringe benefit to the employee. Subsequently, the employer will be assessed additional payroll taxes and penalties for having failed to comply with these requirements.

In today's wireless world, the cost to use such services has declined dramatically over the years and many businesses utilize this vital technology on a daily basis to help promote productivity and efficiencies within their business. These services are even more critical to many small businesses. As a former Congressional staffer, I know first hand that the work day does not stop

at 5:00 pm for Members of Congress and their staffs. Can you imagine keeping a detailed record of every e-mail or phone call received on your wireless device? In today's economy, the distinction between "work" and "leisure" is not always clear.

Not only that, but today's wireless pricing plans do not lend themselves to neat accounting of "work" and "non-work" calls. Price plans that include unlimited calling, unlimited emails, and free nights and weekends make it nearly impossible to assign monetary values to specific calls.

Unfortunately, the Internal Revenue Service (IRS) has recently become more aggressive in auditing businesses for this issue. This is particularly true among nonprofit and tax exempt entities where payroll audits are more common. However, the classification of cellular phones as listed property is a concern for all businesses. The practical effect is that many businesses have stopped subscribing to multi-line business accounts and provide their employees with a taxable allowance to sign up for wireless services that will be used for business purposes. Is that really the right answer? Taxing employees for the value of an expense required for business does not seem fair to me.

That is why the wireless industry, advocating on behalf of consumers, respectfully requests that Congress support and pass H.R. 5450 to remove cellular phones from the listed property classification. This will eliminate an unnecessary and outdated impediment to allowing small businesses to utilize wireless technology to be more productive and efficient in managing the day to day operations of their business.

2) Extend the Research & Development (R&D) credit to help spur continued innovation and advancements in broadband technologies as well as continued development of applications that work over wireless networks.

Technology and innovation have been at the cornerstone of our migration to the service economy that we all benefit from today. Finding ways to develop, improve and expand on technology is critical to the efficiencies and effectiveness we need for our economy to be successful and to continue to grow. Providing an incentive through the R&D credit is essential to encouraging continued investment in innovation and change. This is particularly true in developing and improving upon existing broadband technologies, making them more efficient and reducing the costs to deploy such technologies. Incentives, such as the R&D credit, have helped promote the rapid development of high speed broadband networks and the web-based applications that use these networks. The constant change in broadband technologies has benefited the entire US economy by improving the productivity of American businesses and by lowering prices for such services to consumers through competition.

For example, a recent study by the international technology consulting firm *Ovum and Indepen* found that as much as 80% of the productivity growth in the entire economy in 2003 and 2004 was due to just two sectors: communications and information technology.[1]

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[1] Lewin, David and Roger Entner. Impact of the US Wireless Telecom Industry on the US Economy , Ovum and Indepen, Boston, MA, September 2005.

Economists strongly discourage policymakers from imposing taxes on investment and instead encourage them to find ways to promote such investment. However, in the case of investments in the communications networks that make up the backbone of the Internet, tax policies that discourage investment are especially problematic because of the "network benefits" investments in the advanced communications infrastructure yield. Network benefits are the economic benefits provided by additional infrastructure investments – benefits that extend beyond the direct impact on the affected industry and enhance growth throughout the entire economy based upon the other businesses that utilize these networks.

The data is clear: investments that increase the speed and reach of communications networks improve the productivity of the businesses that use these networks to conduct their business every day. For this reason, tax policies that have the effect of reducing investment in communications networks have negative consequences that extend far beyond the providers directly hit with the new taxes. Letting the R&D credit expire would increase the tax cost of investing in the development of new and innovative technologies for communication networks and slow innovations in productivity-enhancing communications and information technologies.

Much has been written in the last few years about the investments that our economic competitors in China, India, and other nations are making in their communications networks and applications that run over these networks. The competitors recognize that broadband networks are crucial components of a successful strategy to compete in a global economy.

Congressional approval of an extension of the R&D credit would send a clear signal to the markets that long-term investment decisions will not be undermined by increasing the tax cost of investing in developing new technologies. Such a strong, pro-investment signal from the Congress would help ensure that these investments – which have had such an important role in US economic growth and productivity over the last decade – will continue to be encouraged and rewarded. It will send a signal to the markets to invest here, not abroad.

3) Support the moratorium on precluding new discriminatory taxes on wireless services, consumers and providers.

While not directly related to the Internal Revenue Code, another way that Congress can help reduce the total tax burden for small businesses is to support the Cell Phone Tax Moratorium. This legislation would preclude any ***new discriminatory*** state and local taxes from being imposed upon wireless services, consumers and providers for a specified period of time. Much of the testimony provided below comes from a report that I authored, recently published in *State Tax Notes, February 18, 2008,* discussing the tax burden imposed upon the wireless industry and its consumers.

Wireless consumers are subject to a growing number of industry-specific discriminatory taxes and fees on their service. Some states and localities are looking to expand these taxes – many of which originated during a time when the telecommunications industry was characterized by regulated monopolies – even though the wireless marketplace is highly competitive. The wireless industry is characterized by intense price competition and innovative new products and

services that have led to dramatic declines in per minute prices and rapid growth in both the number of wireless subscribers and the number of minutes used. Accordingly, these services and their consumers should be taxed like any other competitive goods or services.

A new analysis of the taxes and fees imposed upon wireless services shows that the overall federal, state and local tax burden averages 15.19% compared to the 7.07% imposed upon other competitive goods and services. That represents a tax burden that is more than double the burden imposed upon other goods and services, substantially increasing the cost to provide such services. This additional cost hits the small businesses that are utilizing wireless services in the day to day operation of their business even harder.

Even though economists and policymakers agree that there is no rational economic basis for excessive taxation of the industry and its consumers, wireless consumers continue to pay excessive and burdensome state and local taxes on their wireless service. Some state and local policymakers continue to impose excessive taxes on wireless service because they have imposed excessive taxes on telecommunications services for decades. Rather than reducing excessive taxes on local landline phone companies and their customers, which would reduce existing state and local revenues, some policymakers claim that they have "leveled the playing field" by expanding discriminatory taxes to wireless services.

Supporting the wireless tax moratorium would put a halt to this practice and allow the industry to continue to work with state and local policymakers to continue to pursue the tax reform needed to ensure that all communication services and their consumers are taxed like any other competitive goods and services.

In summary, thousands of small businesses that rely on wireless services to improve their productivity and profitability would benefit if Congress passed H.R. 5450 to remedy the "listed property" issue; extended the expiring R&D tax credit; and adopted a moratorium on new discriminatory state and local taxes on wireless services.

Madame Chair and members of the Committee, thank you again for the opportunity to testify and provide my insight on the importance of these issues to America's small businesses.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

WRITTEN TESTIMONY (FOR THE RECORD) BEFORE

THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

HEARING ENTITLED

MODERNIZING THE TAX CODE:
HOW UPDATING THE INTERNAL REVENUE CODE
CAN BETTER SERVE SMALL BUSINESS

APRIL 10, 2008

AICPA WRITTEN TESTIMONY BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

The American Institute of Certified Public Accountants thanks the House Small Business Committee for inviting us to submit comments on an upcoming hearing on modernizing the tax code. The AICPA is the national, professional organization of certified public accountants comprised of more than 350,000 members. Our members advise clients on federal, state, and international tax matters, and prepare income and other tax returns for millions of Americans. They provide services to individuals, not-for-profit organizations, large and medium-sized businesses, as well as America's small businesses. It is from this broad base of experience that we offer our comments today.

This hearing will address an important issue for small businesses and the individuals that operate those businesses. Some main goals of modernization should be to foster economic growth, to lessen the enormous paperwork and compliance burden on smaller businesses, and to neutralize the tax code as much as possible with regard to various types of business entities. The AICPA has developed a series of Tax Policy Concept Statements that we recommend be consulted when evaluating legislative proposals. For your assistance in this regard, we have attached a copy of the first summary statement entitled *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*.

The suggestions below are some of the ways the AICPA believes the above goals could be met.

I. S Corporation Issues

A. SE TAX – Over the last several years, several proposals have been made to treat S corporation shareholder/employees as partners for purposes of employment taxes. Such proposals would cause shareholders to report varying degrees of income as taxable under the Self-Employment Contributions Act (SECA) and would require the payment of quarterly estimated taxes. Currently, shareholders who perform services for the corporation are treated as employees and have income and employment taxes withheld from their earnings like any other employee of a corporation. The earnings not attributable to services are subject to income taxation when earned, whether or not distributed, but are not subject to employment taxes, because the Federal Insurance Contributions Act (FICA) and SECA are intended to only tax earnings from labor.

We believe the S corporation framework works quite well with respect to employment taxes. An August 2006 TIGTA report indicated that 43 percent of S corporation audits for the year 2005 resulted in no adjustments.[1] That means almost half of audited S corporation returns were not challenged on the shareholder's reporting of employment taxes and of the audit changes made, it is unclear how many, if any, were challenged on this issue. There have been a few published cases showing that S corporation shareholders have grievously failed to report wages when they clearly should have, but a few publicized cases does not indicate

[1] See *Filing Characteristics and Examination Results for Partnerships and S Corporations* at http://www.treas.gov/tigta/auditreports/2006reports/200630114fr.html.

widespread misunderstanding or abuse. Our experience tells us that the opposite is true; most taxpayers are advised properly on the issue and are in compliance. Results and analysis of the IRS' National Research Project study of 5,000 S corporation audits, to the extent they focused on this issue, should hopefully provide further, useful insights. Generalized assumptions about noncompliance should not be made to the detriment of a majority of compliant taxpayers.

To improve and simplify compliance, Congress should endeavor to bring the partnership regime closer to the S corporation model and have partnerships utilize the FICA and W-2 system of reporting (see suggestion II.C. below). The self-employment and estimated tax payment system fosters lower compliance levels due to complexity and reliance on the individual taxpayer. S corporation shareholders should not be brought into such a system. S corporation elections continue to be made in large numbers, in large part, not to avoid employment taxes, but because Subchapter S is still perceived to be a simpler operational entity than LLCs and offers many benefits that are right for some taxpayers. For those in the minority that are abusing the system, increased audits should be used to reduce this problem.

B. REPEAL LIFO RECAPTURE TAX – C corporations in certain industries such as automobile dealerships, fine jewelry stores and others often account for their inventory using last-in-first-out (LIFO) inventory methods as specified in sections 472 through 474.[2] The LIFO method often reduces taxable income in current years because the later costs of inventory are usually higher than such costs from earlier years (layers). When a C corporation that uses the LIFO inventory method makes an S election, it is required to pay tax on the difference between the inventory values under the LIFO and FIFO methods (the LIFO reserve). This difference is the accumulated amount for the aggregate number of years that the corporation has been using LIFO and can be significant.

The LIFO recapture tax under section 1363(d) is often the most significant hurdle faced by a corporation desiring to make an S election and, therefore, should be repealed. In many cases, this tax makes the election cost-prohibitive. The LIFO recapture tax was enacted in 1987 in response to concerns that a taxpayer using the LIFO method of accounting, upon conversion to S corporation status, would avoid corporate level tax on LIFO layers established while the corporation was a C corporation. While this is a legitimate policy concern, requiring inclusion of the LIFO reserve into income upon conversion to S status is unwarranted because the section 1374 built-in-gains tax (BIG) addresses that situation by taxing those layers, to the extent they are invaded, within ten years of conversion.

Even more importantly, S corporations don't avoid invading LIFO layers for the ten-year period simply to avoid the BIG tax. Generally, for non-tax business reasons, neither S nor C corporations invade their LIFO reserves within ten years. In fact, they often go decades before doing so. In other words, if a corporation remains a C corporation, it will not likely pay any corporate level tax on LIFO layers; the only reason any corporate level tax is generally paid on LIFO layers is when an S election is made. S corporations should not have this dark shadow cast over them -- certainly not beyond the ten-year BIG period -- simply

[2] Section 474, Simplified dollar-value LIFO method for certain small businesses, is specifically used by businesses with less than $5,000,000 of average annual gross receipts in the preceding three years.

because they are following conventional business practice in utilizing the LIFO method of inventory maintenance.

C. STING TAX – If a profitable C corporation[3] makes an S election, it must then be careful not to earn too much income from royalties, rents, dividends, interest or annuities. If it earns more than 25 percent of these types of passive income, it is required to pay a 35 percent tax on the net amount. If it does so three years in a row, its S election is terminated. Excessive passive investment income (PII) should not terminate an S election; section 1362(d)(3) should, therefore, be repealed. S corporations are already penalized with a tax at the highest corporate rate for having such income in any given year. If PII as a terminating event is not repealed, then, at a minimum, the three-year limit should be lengthened to at least five years and/or the 25 percent threshold in sections 1362(d)(3) and 1375(a)(2) should be raised, like in the case of personal holding company (PHC) income, to 60 percent. PII and PHC income of section 543(a) are virtually identical. Additionally, the tax rate imposed on PII should not be the highest corporate rate, but, again, like in the case of PHCs, should be 15 percent as imposed under section 541. Both the PII and PHC statutes have a common legislative history and purpose.

D. CHARITABLE CONTRIBUTIONS – The temporary provisions recently enacted in the Pension Protection Act of 2006 (section 1203(a)) and the Technical Corrections Act of 2007 (section 3(b)), but now expired, should be extended permanently. These provisions allow S corporation shareholders to much more fully deduct their pro rata share of the fair market value of charitable contributions made by the S corporation while reducing their S corporation stock basis by only their pro rata share of the contribution's adjusted basis. While shareholders' basis still remains a limitation on current deductibility as drafted under the expired provision, a far greater portion of the charitable contribution is allowed as the appreciation inherent in the contributed property no longer affects (reduces) that basis. An even better way to draft this provision would be to increase shareholder basis by the fair market value of the contributed property (and then reduce it again by the same amount when the deduction is taken), resulting in a zero net reduction of basis and thus guaranteeing a full fair market value deduction in the current year, regardless of basis limitations. This latter treatment would more closely resemble the treatment of charitable contributions in the partnership context.

E. NRAs – Nonresident alien individuals (NRAs) should be allowed as S corporation shareholders and/or as potential current beneficiaries (PCBs) of electing small business trusts. NRAs are able to contribute capital to an S corporation and participate in the benefits and obligations of an S corporation as long as the S corporation is aware that such result can be obtained indirectly and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships. The operating partnerships, in turn, permit NRAs to hold ownership interests and thus NRAs indirectly receive passthrough items from the S corporation's operations. If NRAs were permitted to be direct owners of S corporations, they would be subject to withholding just as NRA partners and there would be no revenue loss at the individual level. Such direct ownership benefits should not be

[3] The C corporation must have accumulated earnings and profits at the time it makes an S election in order to be subject to the tax on excessive passive investment income.

available only to the sophisticated taxpayer. The smaller, struggling S corporations, particularly those in border states, should be free to raise capital from these individuals.

NRAs should also be permitted to be potential current beneficiaries of electing small business trusts, a type of trust that is a permitted S corporation shareholder and that pays tax at the highest corporate rate, regardless of who its beneficiaries or potential current beneficiaries are. Since PCBs are each treated as a shareholder, current law requires that they not be NRAs to avoid terminating the S election. Changing this rule would promote family tax planning for owners of S corporations who have spouses and other family members who are NRAs.

F. CHARITABLE CONTRIBUTION AND FOREIGN TAX CREDIT CARRYOVERS SHOULD NET BIG TAX – Currently, code section 1374 allows net operating loss carryforwards arising under section 38 in a C year to reduce the net recognized built-in-gain of a newly converted S corporation and general business credit carryforwards to reduce the newly converted S corporation's built-in-gain (BIG) tax dollar for dollar. We believe charitable contributions made during a C year should also carryforward to reduce such corporate level gain. Similarly, since the foreign tax credit is not included in the laundry list of general business credits, it has escaped favorable treatment in the S corporation conversion context. We believe foreign tax credit carryovers from C years should also be allowed to offset the BIG tax.

G. PTTP - When an S corporation's election terminates, a period called the post-termination transition period (PTTP) begins and governs issues such as suspended losses, deductions, distributions, and more. Generally the PTTP begins immediately after the S election terminates and continues for one year. A PTTP may begin and end beyond the one year period if a later audit results in a redetermination of tax for an S year. In our opinion, a 120-day PTTP should also begin when a taxpayer files an amended return after the S period ends. We believe the method of redetermination of tax, whether by the IRS or by the taxpayer, should be immaterial in deciding whether a former S corporation should be permitted to obtain the benefits of a PTTP.

II. Partnership Issues

A. HUSBAND & WIFE JOINT VENTURES – The husband and wife joint venture election under section 761(f) should be clarified to cover state law partnerships and limited liability companies. While assisting spouses in obtaining social security credits for work performed in a husband-wife business is to be commended, many husband-wife partnerships will not be able to take advantage of this benefit and potential simplification solely because they created a general partnership or limited liability company under the rules (typically based on the Revised Uniform Partnership Act or the Uniform Limited Liability Company Act) of a state that governs those entities. The current law requires a technical correction because, as currently interpreted by the IRS[4] to say that the only businesses that qualify for this election are those that are not owned and operated in the name of a state law entity such as a general

[4] See http://www.irs.gov/businesses/small/article/0,,id=127576,00.html

or limited partnership or a limited liability company, it severely limits the number of husband-wife partnerships able to report their shares of the business on their Form 1040.

B. TECHNICAL TERMINATION RETURN DUE DATES - Technical terminations of partnerships require the filing of two short-year returns on two separate dates. To simplify administration and alleviate confusion over filing dates, we recommend that both short year returns be due on the same date, i.e. the later date that currently relates to the date the partnership return would have been due had it not technically terminated.

C. PARTNERS SHOULD RECEIVE FORM W-2 – Revenue Ruling 69-184 interprets the definition of employee found in section 3121(d) stating that remuneration for services to a partnership by a partner is not wages. Nevertheless, partnerships that treat partners as employees for purposes of income and employment tax withholding are not compromising revenue collections for the government and do so because they find it easier than reporting their earnings as partners. Partners also find it easier to have these taxes withheld than to estimate and pay their taxes quarterly. Individual general partners should be permitted to receive a Form W-2 for their guaranteed payments for services and to be treated as employees for purposes of income and employment tax withholding related to such payments. Such a rule would simplify reporting for many partnerships and partners and have a positive impact on the tax gap by improving compliance through required employer withholding. It would also match the law to this common, harmless practice. In addition, partnerships that want to reward existing employees with a small partnership interest would now be able to maintain that employee's status on payroll and the employee would be able to continue receiving familiar paychecks like they have always received. Switching a lifelong employee to a Schedule K-1/estimated tax arrangement would be confusing and complicated in this situation. We therefore anticipate that partnerships would more readily offer small partnership interests to encourage loyalty from valued employees if they were permitted to treat partners as employees for this purpose.

D. TAX-FREE CONTRIBUTIONS OF CAPITAL TO A PARTNERSHIP – Section 118 currently permits an exclusion from gross income for contributions to the capital of a corporation. When the contributor is an existing shareholder, the effect on basis is as follows: the shareholder's basis is increased by the amount of the contribution; the corporation's basis in the contributed property equals, under section 362(a), the shareholder's carryover basis plus gain recognized by the contributing shareholder on the transfer, if any. When the contributor is a non shareholder, the basis to the corporation of the contributed property is, under section 362(c), as follows: if the property is other than money, the property's basis is zero; if the contribution consists of money, the basis of any property purchased with that money during the 12 months following the contribution is reduced pro rata. Partnerships are utilized in today's business world much like corporations were in 1954 when this rule was codified. As long as similar basis rules are enacted under subchapter K (along with rules to prevent abuse upon distribution to partners of section 118 property contributed by non-partners), there is no theoretical reason section 118 should not be expanded to apply to partnerships. Section 118 would benefit small partnerships, for example, as municipalities are often looking to provide monetary incentives to construction companies to build in their jurisdictions. When this opportunity arises, different construction

firms should not have to alter their competitive bids for these projects based on their organizational form. A corporation should not be in a better position to receive a tax-free incentive than a limited liability company.

III. Taxpayer-Tax Practitioner Parity Issue - Section 6694 Legislative Proposals

The penalty provisions in section 6694 of the Internal Revenue Code regarding tax return preparers were amended in May 2007 as part of the Iraq war funding legislation. Included in the changes made to section 6694 was an increase in the tax return reporting standard a preparer has to satisfy with respect to undisclosed, non-tax shelter items. Previously, a preparer could sign a return taking a position with respect to such an item if there was a "realistic possibility" it would be sustained on its merits. Now, a preparer can sign a return taking a position only if there is a "reasonable belief that more likely than not" it would be sustained on its merits. This is a major change in tax policy, but was not the subject of a hearing, was not based on a recommendation from Treasury, and came as a surprise even to the IRS.

This change in standard impacts several fundamental policies related to the representation of taxpayers and causes serious problems, not only for tax return preparers, but also for taxpayers and the government. Of particular concern is the fact that the reporting standard for preparers is now higher than the reporting standard for their taxpayer-clients (which remained at "substantial authority"), creating the potential for conflicts of interest between preparers and their clients. The conflict exists because the tax preparer, in order to escape from penalty liability imposed if the IRS doesn't agree with the position taken, must have the client make a disclosure that the client would not be required to make if they were not using professional assistance. This potential for conflict of interest could discourage small business owners from seeking the assistance of tax advisors (or encourage the use of less scrupulous tax advisors who are willing to sign returns that do not satisfy the higher standard now applicable to preparers.) Tax preparers should be able to act as advocates for their clients.

H.R. 4318 and a similar proposal in the Administration's Fiscal Year 2009 Revenue Proposals would remedy these problems by equalizing the tax return reporting standards applicable to preparers and taxpayers for non-tax shelter items at "substantial authority," which is the standard that currently applies to taxpayers.

IV. Estate Tax Issues

The priority list of suggested reforms below focus on the complexity of the current system, taxpayer planning and compliance burdens, ease of administration, and revenue constraints.

A. GENERATION-SKIPPING TRANSFER TAX - The technical modifications to the generation-skipping transfer tax (GSTT) rules enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) should be made permanent. These technical modifications provide relief from several GSTT "traps" that existed under previous law. However, as with other provisions of EGTRRA, these changes will sunset on December 31, 2010, unless action is taken to make them permanent.

B. ESTATE TAX EXEMPTION - The applicable exclusion (exemption) amount should be increased in order to eliminate filing and tax burdens for 90 to 95 percent of estates. We also suggest indexing the exemption for inflation.

C. STEP-UP - The full step-up in basis to fair market value for inherited assets should be retained. This would avoid the complexities of carryover basis.

D. UNIFORM EXEMPTION – A uniform exemption amount for estate, gift, and generation-skipping transfer tax purposes should be created. We emphasize the need for all three exemptions to be uniform in order to simplify planning for individuals.

E. STATE TAX CREDITS - The reinstatement of the full state estate tax credit, or provision of another mechanism (such as a surtax) would allow states to uniformly "piggyback" on the federal estate tax. To avoid diminishing tax revenues, many states have decoupled from the federal estate tax and enacted their own estate tax regimes, resulting in unnecessary complexity and uncertainty in both planning and administration.

F. ESTATE TAX RATE - The top estate tax rate should be made no higher than the maximum individual income tax rate. We note that there have been some proposals in the past that have included a rate structure with a very limited number of tax brackets and a large gap between brackets. For example, such a system might provide for only two brackets, say 15 percent and 30 percent, with estates over a certain size paying the higher bracket (30 percent in this example), and estates below that number paying the lower bracket (e.g., 15 percent). In such a proposal, there may be significant uncertainty in the planning process for married couples with significant estates. For example, taxpayers may have to consider if estate tax should be paid at the death of the first spouse to die at a 15 percent rate compared to an alternative of paying the tax in the future but at a higher rate. In addition, this type of "cliff" taxation leaves too much room for disparity among similarly situated taxpayers, where one receives estate planning advice and pays significantly less tax when compared to the individual who does not receive such advice.

V. Alternative Minimum Tax Issues

Due to the complexity, the increasing impact on unintended taxpayers, and compliance problems, the AICPA supports repealing both the individual and corporate AMT. However, we recognize that simply eliminating the AMT would cause a large loss of tax revenue.

If repeal is not possible, we urge Congress to consider, with respect to the individual AMT, the following alternative solutions, which we believe would reduce or eliminate most of the complexity and unfair impact of the AMT as currently imposed.

A. Increase and index for inflation the AMT brackets and exemption amounts, and eliminate phase-outs.

B. Eliminate the standard deduction and personal and dependency exemptions as adjustments to regular taxable income in calculating AMT.

C. Eliminate miscellaneous itemized deductions as an adjustment to regular income tax so that middle income taxpayers are able to deduct such items as employee business expenses for AMT.

D. Eliminate the AMT medical expense adjustment so that middle income taxpayers are allowed the same amount of medical expenses for both regular tax and AMT.

E. Eliminate state and local income and other taxes as an adjustment.

F. Allow tax credits enacted to promote important public goals – such as the low-income tax credit, tuition tax credits, etc. – to be credited against AMT liabilities.

G. Exempt all taxpayers with regular tax AGIs under $100,000 from AMT.

H. Have only one AMT tax rate and set that rate to below the third lowest regular tax rate of 25 percent.

I. Require that AMT's impact on future tax legislation be reported with the revenue estimates for proposed legislation, i.e., whether the intended tax benefits of any change are negated by the AMT regime.

J. Allow a minimum tax credit for *all* AMT, not just AMT attributable to deferral preferences, in order to place the individual AMT on parity with the corporate AMT.

K. Liberalize the capital loss limitation rules when calculating AMT associated with incentive stock option (ISO) transactions (e.g., specifically allow a negative basis adjustment for ISO differences to be ordinary rather than capital loss).

L. Eliminate the definition of "qualified housing interest" and allow all deductible residence interest as a deduction for AMT.

M. Exclude AMT from the estimated tax penalty.

VI. Fiscal Year Flexibility

An entrepreneur's first year in business is the most difficult. The Small Business Tax Flexibility Act (S. 270 and contained in H.R. 46 sponsored by Chairwoman Velazquez) would permit small start-ups to choose the fiscal year that best fits their business cycle and give entrepreneurs one 12-month year to concentrate on getting the business up and running before they must close their books and deal with their first tax return. It also helps their cash flow, one of the most critical areas for start up businesses. Starting a business is capital intensive. Being able to defer the payment of taxes allows the business more time to stabilize its cash flow. These start-ups would

also benefit from the extra attention their CPAs could give them, including being available to give business advice during the January to April tax "busy season."

CPAs and their clients would also benefit from spreading tax preparation work over more of the year. Now, CPAs and other return preparers must squeeze in all their tax preparation and audit work for partnerships, S corporations and individuals as well as calendar year C corporations and trusts, between January 1 and April 15 of each year. As a consequence, CPA firms must hire a significant portion of their staffs to work just during the first few months of the year. The effect of such hire-and-fire policies is destructive for recruiting, retention and training efforts. Further, the 70-hour workweeks typically required for these months are decidedly anti-family.

VII. Other Proposed Legislation Helping Small Business

CELL PHONES – The AICPA supports H.R. 5450, *the MOBILE Cell Phone Act of 2008* and its companion bill S. 2668 which would reclassify cell phones and personal digital assistants (PDAs) from listed property (under section 280F(d)(4)(v)) to that of business property. Such a reclassification would update the tax treatment of cell phones and PDAs by (1) eliminating the onerous substantiation requirements on taxpayers, including small business owners, (2) removing such taxpayers from being subject to penalties and taxes for not meeting the substantiation requirements under audit, and (3) reducing the possibility of tax preparers being subject to unnecessary penalties.

According to a 2004 NFIB Small Business Poll, 78% of small-business owners use a cell phone for business purposes.

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The AICPA appreciates the opportunity to present these options for modernizing the Internal Revenue Code and would be pleased to discuss or clarify them with Members or staff of the House Committee on Small Business at any time.

Testimony of

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Before the
Committee on Small Business
U.S. House of Representatives

Tax Reform and Small Business

April 10, 2008

* Principal, PricewaterhouseCoopers LLP. Employment is shown for identification purposes only. The views expressed do not necessarily represent those of PricewaterhouseCoopers or its principals and partners.

I. Introduction

I thank the Committee for the opportunity to testify this morning on the appropriate design of the tax system as it applies to business, with particular attention to the application of the tax system to small business both in the context of the current economic slowdown and, forward looking, to promote long-term economic growth.

While the design of temporary tax stimulus to the economy may differ from the structure of a permanent tax system, I believe the long-run growth of the U.S. economy and small businesses is best promoted by providing for a simple, transparent business tax system with the lowest possible rates.

Private business drives the $14 trillion U.S. economy, providing in 2007 approximately 115 million jobs and $1.5 trillion in investment to raise future living standards. Small business plays a vital role within the private economy. In 2005, businesses with less than 500 employees represented 99.7 percent of all firms, and accounted for half of all private employment and 45 percent of all private payrolls.[1] Internal Revenue Service data based on receipt size (rather than employment) show that businesses, including sole proprietorships, with less than $50 million in receipts accounted for 99.9 percent of all businesses, 31 percent of total receipts, and 37 percent of business payrolls in 2003.[2] While showing a substantial role of small businesses in the economy, these data also show that the relatively small number of large businesses also provide a leading role in economic activity in the United States; firms earning $50 million or more in annual receipts represent just 0.1 percent of all businesses yet generate 69 percent of total receipts and 63 percent of business payrolls.

Given the important role of both small and large businesses to the economy, there is a general consensus among most economists that special tax assistance based on size of business is unwarranted in the absence of market failures. Recent papers reaching this conclusion include those by former Congressional Budget Office Director Douglas Holtz-Eakin, University of Michigan Business School and Economics Professor Joel Slemrod, and former Clinton Administration Deputy Assistant Secretary of Treasury Eric Toder.[3] The basic rationale expressed in these papers is that in the absence of taxation the market economy would lead to a distribution of small and large firms in the economy that generates the most economic output. In the presence of taxes, the tax system should therefore aim for equal treatment of small and large firms, so as to maximize economic output for a given level of business taxation.

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[1] U.S. Small Business Administration, Office of Advocacy, "Employer Firms, Establishments, Employment, and Annual Payroll Small Firm Size Classes, 2005," http://www.sba.gov/advo/research/data.html

[2] Kelly Luttrell, Patrice Treubert, and Michael Parisi, "Integrated Business Data, 2003," Statistics of Income, Internal Revenue Service, http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html

[3] See, Douglas Holtz-Eakin, "Should Small Businesses Be Tax-Favored?" *National Tax Journal*, Vol. XLVII, No. 3, September 1995, pp. 387-395; Joel Slemrod, "Small Business and the Tax System," in *The Crisis in Tax Administration* (eds., Henry J. Aaron and Joel Slemrod), Brookings Institution, 2004, pp. 69-123; and Eric Toder, "Does the Federal Income Tax Favor Small Business?" in National Tax Association, *Proceedings of the 100th Annual Conference, 2007* (available at http://www.urban.org/publications/411606.html)

This "level playing field" argument is persuasive to most economists. Firms operating under a tax system providing a level playing field can best replicate the competitive outcome that would occur in an economy without taxes.

One complicating factor, noted by Slemrod (2004), is that the very presence of a tax system may impose an inordinate compliance burden on small business relative to large business. While to some this may justify the use of special incentives to offset these compliance burdens, a best practice would be to design the tax system to impose the lowest possible compliance burdens, everything else equal. Special tax incentives intended to offset compliance burdens can themselves complicate the tax system; further, compliance costs of claiming these tax incentives may offset a significant amount of their benefit, especially for small businesses. In addition, if overall business tax collections are held fixed, special incentives ultimately may be paid for by higher tax rates that have additional distorting consequences on the operations of businesses.

II. Legal Forms of Business Operations

Small businesses operate in a wide range of legal forms -- including sole proprietorships, partnerships, S corporations, and C corporations -- and operate in a wide range of economic sectors. **Table 1** presents aggregate IRS data on businesses classified by size of business receipts for C-corporations, S-corporations, partnerships, and non-farm sole proprietorships for tax year 2003.[4] Sole proprietorships, S-corporations, and partnerships are pass-through entities subject to a single level of tax on the business owner. C-corporations are taxable at the entity level and the equity return is taxable to shareholders as dividends or capital gains.[5]

The overwhelming number of businesses in these data were operated as sole proprietorships: 19.7 million sole proprietorships, constituting 72 percent of the 27.5 million total businesses in 2003. Next most prevalent were S-corporations (3.3 million businesses, or 12 percent of total businesses) and partnerships (2.4 million, or 9 percent of total businesses). The least prevalent form of business was C-corporations (2.1 million businesses, or 7 percent of total businesses).

Larger businesses are more likely to operate as C-corporations than smaller businesses. Among the largest corporations (those with business receipts of $50 million or greater), C-corporations were the most prevalent (constituting 52 percent of all businesses with business receipts of $50 million or greater), followed by S-corporations (30 percent of all businesses with business receipts of $50 million or greater), partnerships (17 percent of all businesses with business receipts of $50 million or greater), and sole proprietorships (less than 1 percent of all businesses with business receipts of $50 million or greater).

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[4] Additional IRS integrated business data are available at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html

[5] Currently dividends and long-term capital gains are taxed at a maximum rate of 15 percent for individuals as a result of temporary provisions enacted in 2003. The dividends tax rate is scheduled to increase to a maximum rate of 39.6 percent and the maximum long-term capital gains tax rate is scheduled to increase to 20 percent beginning in 2011.

Table 1.--Number of Businesses, Total Receipts, Net Income (less Deficit), and Salaries and Wages, by Form of Business and Business Receipt Size, Tax Year 2003

[All figures are estimates based on samples--money amounts are in thousands of dollars]

Form of business, item	Total	under $25,000	$25,000 under $100,000	$100,000 under $250,000	$250,000 under $500,000	$500,000 under $1,000,000	$1,000,000 under $2,500,000	$2,500,000 under $5,000,000	$5,000,000 under $10,000,000	$10,000,000 under $50,000,000	$50,000,000 or more
All businesses											
Number of businesses	27,486,691	15,872,235	5,521,119	2,578,962	1,331,692	932,914	686,257	263,211	143,693	124,568	32,040
Total receipts	24,461,950,768	171,850,677	283,643,212	399,675,771	466,753,866	650,698,469	1,064,907,945	918,729,000	995,285,415	2,583,604,931	16,926,801,481
Salaries and wages	2,389,996,593	13,835,571	12,420,821	40,735,142	65,026,979	102,127,201	151,872,220	123,510,264	120,362,165	264,299,581	1,495,806,649
Net income (less deficit)	1,353,802,117	-23,427,608	75,630,471	79,225,921	55,733,253	51,703,038	54,086,095	41,991,902	47,086,139	133,379,079	838,393,827
C corporations											
Number of businesses	2,059,631	450,597	307,399	328,012	268,188	247,385	229,634	103,484	57,788	50,628	16,516
Total receipts	16,457,008,327	31,386,821	20,967,927	58,311,445	100,910,587	180,167,017	373,712,629	370,007,131	410,398,180	1,060,140,824	13,851,005,765
Salaries and wages	1,599,662,967	5,911,201	2,153,003	7,678,722	14,770,133	28,087,167	54,797,775	46,855,558	50,980,009	114,828,385	1,273,601,013
Net income (less deficit)	608,414,019	-14,450,726	-3,092,854	-3,055,026	-3,905,490	-3,211,426	-4,719,570	-2,862,986	2,930,957	27,459,611	613,321,529
S corporations											
Number of businesses	3,341,606	829,112	561,043	601,851	451,424	375,165	291,775	107,685	60,895	52,898	9,757
Total receipts	4,232,565,964	12,854,180	34,707,120	101,156,434	164,133,276	268,746,940	453,325,584	380,630,873	424,509,024	1,115,580,928	1,276,921,604
Salaries and wages	449,732,962	2,693,180	2,241,561	11,108,682	23,540,794	43,368,279	61,680,182	54,161,344	48,364,801	105,627,726	96,946,412
Net income (less deficit)	213,681,780	10,414,073	3,251,698	9,177,254	12,154,281	16,306,001	25,688,763	21,831,927	17,631,789	45,809,116	51,416,878
Partnerships											
Number of businesses	2,375,375	1,284,396	397,461	262,423	147,948	110,698	89,675	36,829	20,925	19,416	5,603
Total receipts	2,722,174,031	34,844,097	13,089,999	28,078,848	41,095,591	66,570,786	128,217,169	117,247,715	133,678,247	379,353,241	1,779,998,339
Salaries and wages	244,927,745	4,237,840	881,925	3,246,966	5,225,898	9,925,742	20,120,293	17,110,418	18,315,986	41,756,140	124,106,537
Net income (less deficit)	301,398,218	-36,718,902	1,944,464	11,573,255	11,790,856	14,183,975	21,169,546	19,915,489	24,962,215	58,934,127	173,643,193
Nonfarm sole proprietorships											
Number of businesses	19,710,079	13,308,130	4,255,216	1,386,675	464,131	199,666	75,173	15,213	4,085	1,626	164
Total receipts	1,050,202,446	92,765,579	214,878,166	212,129,044	160,614,412	135,213,726	109,652,563	50,843,281	26,699,964	28,529,938	18,875,774
Salaries and wages	95,672,919	993,350	7,144,332	18,700,772	21,490,154	20,746,013	15,273,970	5,382,943	2,701,369	2,087,330	1,152,687
Net income (less deficit)	230,308,100	17,327,947	73,527,163	61,530,438	35,693,606	24,424,487	11,947,356	3,107,472	1,561,178	1,176,225	12,227

Source: IRS Integrated Business Data available at http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html

Profitability of C-corporations varies considerably across size of business. C-corporations with business receipts of less than $5 million in aggregate had *negative* net income in 2003. In contrast, C-corporations with business receipts of $50 million or more comprised less than 1 percent of all C-corporations, yet received 84 percent of all C-corporation receipts and accounted for more than 100 percent of all net income of C-corporations (exceeding 100 percent due to net losses among smaller C-corporations).

III. Advantages and Disadvantages in the Tax Code Applicable to Small Businesses

A wide range of tax advantages and tax disadvantages exist for small business. While not attempting to provide a complete inventory, this section outlines several features of the tax system that differentially impact small and larger businesses. Guenther (2008) provides an analysis of additional tax provisions benefiting small business, including accounting rules and tax incentives for private equity investments in small companies.[6]

Double tax on C-corporation income

Because smaller businesses can more easily operate as pass-through entities -- that is, sole proprietorships, partnerships, or S-corporations -- subject to only a single level of taxation, the double tax on equity earnings of C-corporations may represent an implicit tax advantage to small business operating in pass-through form.[7]

There are certain factors, however, that limit the scope of this advantage for small pass-through entities (or limit the disadvantage faced by C-corporations). Importantly, dividends paid to tax-exempt shareholders (such as pension funds) by C-corporations are not taxable. As a result, not all equity earnings of C-corporations are subject to double taxation. Small pass-through entities may be unable to access equity financing from tax-exempt institutional investors and, furthermore, income from partnerships and S-corporations paid to a tax-exempt owner is subject to tax as unrelated business income.

Many economists and tax attorneys believe an integrated tax structure with a single level of taxation for all businesses would be preferable to the current double tax on C-corporation earnings.[8] Elimination of the double tax on corporate earnings, everything else equal, would reduce total business tax collections. If total business tax collections were to be held unchanged, other offsetting business increases would be required that could differentially impact small and large businesses.

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[6] Gary Guenther, "Small Business Tax Benefits: Overview and Economic Rationales," CRS Report for Congress, Congressional Research Service, RL32254, March 3, 2008.

[7] C-corporations are subject to a graduated corporate income tax schedule, beginning at a 15 percent tax rate on the first $50,000 of income and 25% on the next $25,000 of income. At higher levels of income, the benefit of these lower rates is taken away through higher marginal rates that reach 39 percent. For corporations with income exceeding $18.3 million, the applicable tax rate is 35 percent.

[8] See, for example, Department of the Treasury, "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once" (January 1992); R. Glenn Hubbard, "Corporate Tax Integration: A View from the Treasury Department," *Journal of Economic Perspectives*, Vol. 7, No. 1, Winter 1993, pp. 115-132; and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 124.

Small Business Expensing (section 179)

As a result of the Economic Stimulus Act of 2008, signed into law on February 13, 2008, businesses may immediately deduct as an expense rather than depreciate over a period of years the cost of up to $250,000 of qualifying property placed in service in 2008. The amount of qualifying property that may be expensed is reduced by the amount of investment in excess of $800,000, which serves to limit the expensing benefit to smaller businesses. Qualifying property is generally equipment and computer software.

Prior to the enactment of the Stimulus Act, businesses could deduct only the first $128,000 of qualifying property in 2008. The amount eligible for expensing was reduced for investment in excess of $510,000. These dollar values, indexed for inflation, are set to apply in 2009 and 2010. The amount of property eligible for expensing is scheduled to decline to $25,000 beginning in 2011 (as temporary provisions enacted in recent years expire).[9]

Expensing reduces the cost of acquiring qualifying property since the immediate deduction of the acquisition cost confers greater tax savings in present value than a deduction of the same dollar amount spread over a period of years. In addition, many small businesses may face financing constraints so that the enhanced cash-flow from expensing may increase the ability of the business to undertake new investment. As a result, expensing is thought to increase capital investment by small businesses. The temporary increase in expensing in 2008 may also accelerate the purchase of investments by businesses from future years.

Because productivity, wages and living standards are closely tied to increases in capital investment, policies that increase investment are desirable. Conventional economic analysis generally concludes that expensing is an effective stimulus to business investment relative to a rate reduction because the benefit of expensing is directed only at newly purchased capital goods whereas a rate reduction also benefits previously acquired assets. The tax savings accruing to income from previously acquired assets, while providing a cash-flow benefit, is not generally considered to provide as significant of an investment stimulus as a direct tax reduction on the purchase of new capital.[10] This is especially true for a temporary incentive because the income generated from new investment may arise largely in periods in which the temporary rate reduction is no longer in effect.

Expensing, however, does nothing to reduce the tax burden on entrepreneurial effort that generates returns in excess of the opportunity cost of capital. These and all other cash flows of the business remain subject to the statutory tax rate applying to business income. In contrast, a rate reduction may encourage additional entrepreneurial effort that can boost production from existing and new tangible capital, as well as from intangible capital. There is also evidence of a significant investment response by small businesses from permanent reductions in the tax rate applying to business income.[11]

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[9] The Economic Stimulus Act of 2008 also permits all businesses to expense 50 percent of the cost of qualifying investments placed in service in 2008 (so-called "bonus depreciation"). There is no dollar limitation on the amount of property qualifying for bonus depreciation.

[10] See, for example, analyses of alternative business tax reform proposals comparing expensing and rate reduction in Department of the Treasury, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century," December 20, 2007.

[11] See Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment" (January 1998). NBER Working Paper No. W6374.

Alternative Minimum Tax

Small C-corporations are exempt from the corporate alternative minimum tax (AMT). For this purpose a small corporation is defined as one with average gross receipts less than $7.5 million for all three-year periods beginning after 1993 and before the current taxable year. For the first three-year period, average gross receipts must be less than $5 million. No corporate AMT applies in the first year of a corporation's existence. There is no exception from the individual AMT for businesses operating as sole proprietorships, partnerships, or S-corporations.

Some pass-through business owners believe the individual AMT creates disproportionate burdens on pass-through entities by not permitting a deduction for state and local income taxes on business income, while permitting such a deduction at the entity level under the corporate AMT. Of course, individual shareholders in C-corporations are also not permitted under the individual AMT to deduct state and local income taxes on business income taxed to individuals as dividends or capital gains.

Because C-corporations are subject to a double tax, it is unclear whether these differences between the corporate AMT and the individual AMT create disparate tax burdens for pass-through businesses relative to C-corporations. Elsewhere, I have written that the corporate AMT is difficult to justify on either efficiency or equity grounds.[12] Some tax reform proposals would repeal both the corporate and individual AMT.[13]

Wage versus Capital Income

In contrast to incorporated businesses (including S-corporations) and certain partnerships, all of the return to sole proprietorships is taxable as wage income rather than at least in part as capital income. Wage income, in addition to being taxable under the income tax, is also taxable under Social Security and Medicare self-employment taxes. In 2008, the Social Security (OASDI) self-employment tax is 12.4 percent on the first $102,000 of self-employment income. The Medicare (HI) self-employment tax is 2.9 percent on all self-employment income. One-half of self-employment tax is deductible from the computation of taxable income for income tax purposes. For many sole proprietorships, some of the income earned by the business is a return on capital investments in excess of what would normally be paid as wages and salary of the business owner. When this return is taxed as wages, it is taxed at a higher rate than if it were able to be identified as capital income. This extra tax disadvantages sole proprietorships and other entities that do not distinguish a portion of earnings as capital income.

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[12] Andrew B. Lyon, *Cracking the Code: Making Sense of the Corporate Alternative Minimum Tax* (Brookings Institution), 1997.

[13] See for example, President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, November 2005, which would repeal the corporate and individual AMT (although it would deny the deduction for state and local income taxes for both individuals and businesses). House Ways and Means Chairman Charles Rangel introduced a bill, H.R. 3970, in October 2007 which would repeal the individual AMT, but not the corporate AMT.

Deductible Expenses

Toder (2007) states that small business owners may be more able to represent personal expenses (such as home office expenses or automobile use) as deductible business expenses compared to larger businesses. In the other direction, strict rules on the deduction for home offices may prevent some business owners from claiming expenses that are legitimately tied to the operation of a business. The varying willingness of business owners to claim deductions for certain business expenses may create a tax disadvantage to some owners and a tax advantage to other owners. At low tax rates business owners may be more willing to sacrifice these deductions than at higher tax rates.

Tax Compliance

Recent IRS estimates of non-compliance suggest that small business fails to report a significant amount of taxable income. Non-compliance by small business is estimated to be significantly greater than for large businesses. IRS research is unable to determine conclusively whether the extent of non-compliance is tied to tax complexity or the absence of other controls, such as independently audited financial records to satisfy external investors or reduced IRS examination rates (audits) of smaller businesses.

Based on a random examination of returns for tax year 2001 conducted under the National Research Program of the IRS, the IRS calculated that net under-reporting of business income from pass-through entities, including sole proprietorships, was 43 percent.[14] Under-reporting of non-farm sole proprietorships was estimated at 57 percent, and under-reporting of farm income was estimated at 72 percent. In contrast, IRS estimates that wage income of all taxpayers was under-reported by only 1 percent. Based on older compliance estimates, the under-reporting rate of large C-corporations (assets exceeding $10 million) is approximately 14 percent. **Table 2** shows the estimated tax gap, i.e., the reduction in tax payments before enforcement actions, and the net under-reporting rate for various forms of business income and non-business income.

As noted by Slemrod (2004) and Toder (2007), non-compliance does not necessarily benefit small business owners. When non-compliance in a sector is significant, competition may bid down prices facing consumers in that sector and reduce the return to business owners. However, a compliant business owner is at a competitive disadvantage when operating in a business sector in which non-compliance is prevalent.

[14] Internal Revenue Service, "IRS Updates Tax Gap Estimates," IR-2006-28, Feb. 14, 2006, available at: http://www.irs.gov/newsroom/article/0,,id=154496,00.html and "Tax Gap Figures," available at: http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf

Table 2.—Under-reporting Estimates, Selected Items for Individuals and Corporations

Type of Income	Tax Gap ($ billions)	Under-reporting Percentage
Total Individual Under-reporting Gap	**197**	**18%**
Individual business income	**109**	**43%**
non-farm sole proprietor	68	57%
farm income	6	72%
rents & royalties	13	51%
partnership, S corp, estate and trust	22	18%
Individual non-business income	**56**	**4%**
wages,salaries, tips	10	1%
interest income	2	4%
dividend income	1	4%
capital gains	11	12%
Total Corporate Under-reporting Gap	**30**	**15%**
small corporations (assets less than $10 million)	5	29%
large and medium corps (assets > $10 million)	25	14%

Source: IRS, "Tax Gap Figures," (2006). Under-reporting percentages for corporations computed by Toder (2007).

Tax compliance may be affected by the probability of IRS audit. The proportion of returns audited, i.e., the audit coverage rate, for individuals reporting business income is significantly lower than for large corporations, although generally higher than individuals without business income (**Table 3**). However, even if small businesses report a significantly smaller percentage of their income than larger businesses, it may be inefficient to redirect IRS audits to smaller businesses given the smaller amount of income earned by small businesses.

Table 3.— Selected IRS Audit Coverage Rates

Type of Return	Audit Coverage Rate (2007)
Individuals	
Individuals with business income reporting total gross receipts greater than $25,000	2.8%
All individuals	0.9%
S-Corporations	
1120S Corporations	1.3%
C-Corporations	
Assets less than $10 million	0.9%
Assets between $10 million and $250 million	13.9%
Assets greater than $250 million	27.2%

Source: Internal Revenue Service Data Book 2007 (March 2008), Table 9.

Compliance Costs

Slemrod (2005) estimates the federal tax system imposes a total compliance burden of $135 billion, of which $85 billion represents compliance costs imposed on individual taxpayers, $40 billion represents compliance costs imposed on businesses other than sole proprietorships, and $10 billion represents the cost of the Internal Revenue Service.[15]

The compliance cost of the tax system to small business may be quite high. Small businesses may fail to claim all tax benefits to which they are entitled due to complexity and recordkeeping costs.

[15] Joel Slemrod, testimony to the House Ways and Means Committee, June 8, 2005.

In a study for the IRS, DeLuca et al. (2007) provide estimates of compliance costs for small businesses other than sole proprietorships for tax year 2003.[16] The estimates are derived from a survey of small business taxpayers representative of the nearly 7.2 million partnerships, S-corporations, and C-corporations with assets less than $10 million.

The IRS study estimates that these businesses spent between 1.7 billion and 1.8 billion hours on tax compliance and incurred out-of-pocket expenses of between $15 billion and $16 billion. If the time spent on tax compliance is valued at $40 per hour (an annual salary of $83,200), the total compliance cost to small businesses is between $83 billion and $90 billion, or an average burden of about $12,000 per small business. This estimate significantly exceeds Slemrod's estimate of business compliance costs.

Table 4 shows that compliance costs (including time costs valued at $40 per hour and out-of-pocket expenses) are a significant cost to small businesses relative to gross receipts. For the smallest businesses (total receipts less than $10,000) compliance costs exceed revenue. Even for businesses with receipts between $100,000 and $500,000, compliance costs are about 5 percent of total receipts. For low margin businesses, these compliance costs can represent a significant percentage of net income and, for many businesses, can exceed net income.

From these estimates, it is apparent that compliance costs represent a very significant implicit tax on small business income.

Table 4.— Total Compliance Costs as a Percentage of Total Receipts

	Number of businesses (thousands)	Time and money burden as a percentage of receipts
All small businesses	7,243	1.4%
Total Receipts		
0 or less	895	n.a.
Less than $10,000	815	217.7%
$10,000-$20,000	303	47.0%
$20,000-$50,000	677	26.2%
$50,000-$100,000	715	14.8%
$100,000-$500,000	2,029	4.7%
$500,000-$1 million	705	1.9%
Over $1 million	1,104	0.5%

Source: DeLuca et al. (2007), Table 12 (average of low and high reported values, valuing time at $40 per hour)

[16] Donald DeLuca, Scott Silmar, John Guyton, Wu-Lang Lee, and John O'Hare, "Aggregate Estimates of Small Business Taxpayer Compliance Burden," Proceedings of the 2007 IRS Research Conference, available at http://www.irs.gov/taxstats/article/0,,id=174701,00.html.

IV. Conclusion

Let me leave you with some final thoughts on the design of the tax system.

It is vital for the future standard of living of Americans to have a tax system that promotes the long-term growth of the economy. Entrepreneurship, innovation, and capital investment play a key role in economic growth, and small businesses are an important contributor to these factors.

Economists generally believe that a low rate, transparent tax system that does not distinguish businesses based on their size is the best way to maximize the productive capacity of the economy.

It may appear counterintuitive, but tax incentives come at an economic cost. Among these costs are the compliance burdens created by special incentives, which hit small businesses the hardest. Compliance costs are a form of inefficiency in the economy. The time and out-of-pocket expenses that businesses spend in navigating complex tax rules produce no economic benefit for society. A simpler tax system would allow these business resources to be channeled into more productive activities that add to the future growth of the economy and increase the standard of living of all Americans.

REPRESENTING, EDUCATING AND PROMOTING THE RESTAURANT INDUSTRY

Written Testimony

of

Fred Rosenthal
President, Jasper's Restaurants

for the hearing

Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy

before the

U.S. House of Representatives
Committee on Small Business

on behalf of the

National Restaurant Association

Thursday, April 10, 2008

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Chairwoman Velazquez, Ranking member Chabot, members of the House Committee on Small Business; thank you for the opportunity to testify before you today of behalf of the National Restaurant Association. My name is Fred Rosenthal of Bethesda, Maryland and I am the President of Jasper's Restaurants.

I have been a part of the restaurant industry for more than 40 years. I trained with many of New York's top caterers while attending New York University's School of Business for hotel and restaurant management. After graduation, I joined a new catering company in Baltimore, MD and for the next 15 years helped grow that operation to include seven banquet facilities, the largest accommodating 1500 guests. The company also expanded into contract feeding – winning several key contracts in Baltimore. After selling my interest in this catering venture, I joined Mr. Berk Motley and Mr. Patrick Noonan, opening the original Jasper's Restaurant in Greenbelt, MD in 1981. I am the principle of the entities that operate the three existing Jasper's Restaurants in Greenbelt, Crofton and Largo, and the Jasper's American Grille which opened in 2007. I am immediate past Chairman of the Board of the Restaurant Association of Maryland and continue to remain actively involved with the industry and small business issues.

I am proud to be a part of an industry that plays such a significant role in this nation's economy. There are 945,000 restaurant/foodservice outlets in this country. Seven out of ten restaurants are single-unit operators. The restaurant industry is an industry of small businesses.

This year the restaurant industry is estimated to generate $558 billion in sales, with an overall economic impact of $1.3 trillion. Every dollar spent dining out generates $2.34 in business for other industries.

We are the nation's second largest employer outside the government, employing more than 13.1 million people, representing more than 9 percent of the job-base. We are truly the cornerstone of this nation's economy.

On any given day 133 million individuals are patrons of a food establishment. Given the industry's contributions to the economy, we strongly urge the committee to include reforms to restaurant building depreciation schedules among those tax items considered to help spur this struggling economy. Depreciation schedules must also be broadly re-examined during the larger tax reform debate over the next several years.

Depreciation Schedules Must Be Updated To Help Stimulate the Economy

Depreciation schedules for commercial real estate, including restaurant buildings, have not been significantly revised since they were established. It is time to take another look at these schedules so that they more accurately reflect the life of the property. According to the tax code, commercial real estate generally has a 39 1/2-year depreciable life for the original building and for any subsequent renovations or improvements to the building. Restaurants have gained some temporary relief through tax extenders packages but nothing that provides reliable relief that will encourage longer term investment and planning.

Restaurants operate on industry average margins of four to six percent and every penny counts, especially for small businesses and independent restaurateurs. Depreciating property over a shorter amount of time has a direct impact on a restaurant's bottom line by allowing a restaurateur the immediate cash flow to reinvest in their business.

Changes have been made that allow certain industries that directly compete with restaurants to benefit from shorter schedules. These schedules range from seven years for food outlets located in amusement parks to 15 years for gas stations/convenience stores. This favorable depreciation schedule has allowed convenience stores to expand and improve their foodservice options – a direct competitor to quick service restaurant operators.

Legislative History of Accelerated Restaurant Depreciation

The economic stimulus package passed in the 107th Congress, allowed for 30 percent bonus depreciation for certain assets, (such as assets depreciated over a 20 year schedule or less). As part of the 9/11 economic stimulus package, this provision was expanded to include any leasehold improvements (currently depreciated over a 39 ? year schedule). However, owner-occupied properties were not included.

The American Jobs Creation Act of 2004 established that restaurants could depreciate qualified restaurant building improvement costs over 15 years for property in place by the end of 2005. This provision applied to both leased and owner-occupied buildings. The Tax Relief and Health Care Act of 2006 extended the existing provision through the end of 2007.

The Minimum Wage/Small Business Tax Relief bill (H.R. 2) that passed the Senate on February 1, 2007 contained a provision which would have extended the improvement piece through March 31, 2008, and would also have added 15-year depreciation for new restaurant construction from the date of enactment through March 31, 2008. A subsequent Senate Finance Committee package included the extension of qualified leasehold and restaurant improvements through December 31, 2008 and added new construction from the date of enactment through

December 31, 2008. However, all depreciation provisions were removed from the final package that was enacted into law.

As of January 1, 2008 all schedules reverted back to 39 1/2 years, including improvements made to restaurant structures both leased and owner-occupied. When Congress passed and the President signed the Economic Stimulus Act of 2008, the legislation included a bonus depreciation tax provision as well as increased Sec. 179 small business expensing. However, the restaurant industry can not take advantage of the bonus depreciation provision for even the improvements we had previously because the provision only applies to property on a 20 year or less depreciation schedule. As a result, the positive impact of the economic stimulus package was not as great as it could have been for the restaurant industry and our communities.

There are currently two bills in the 110th Congress which address accelerated restaurant depreciation for new construction and improvements. H.R. 3622, championed by Congressmen Kendrick Meek (D-FL-17th) and Patrick Tiberi (R-OH-12th), would make permanent a 15 year depreciation schedule for newly constructed restaurants as well as restaurant improvements. The bill currently enjoys the bipartisan support with 113 cosponsors, including 10 members of this committee. Senators Kay Bailey Hutchison (R-TX) and Jon Kyl (R-AZ) introduced companion legislation, S. 2170, that also has bipartisan support.

Restaurant Building Depreciation

The National Restaurant Association believes the depreciation changes that have been made in the past for certain industries and the exclusion of the new restaurant construction provision have placed certain businesses at an economic disadvantage. The tax code should not pick win-

ners and losers in the restaurant industry; it should allow a level playing field on which all can compete.

Within the retail industry, restaurants have a unique case for accelerated depreciation schedules. As mentioned earlier, 133 million individuals are patrons of the industry on a daily basis. Restaurants must constantly make changes to keep up with the daily structural and cosmetic wear and tear caused by customers and employees. Restaurants get more customer traffic than other commercial businesses. Many are open 24 hours a day, seven days a week. This heavy use accelerates deterioration of a restaurant building's entrance, lobbies, flooring, restrooms, and interior walls. Restaurant building structures therefore experience a daily human "assault" unlike that borne by any other types of buildings in the retail industry.

Most restaurants remodel and update their building structures every six to eight years – a much shorter timeframe than is reflected in the current depreciation schedule. Many of these refurbishments are not treated as improvements under the tax code, but as new construction because these remodeling projects require changes to structural walls. Thus, creating layer upon layer of depreciation schedules for every periodic update or new construction.

Also, many franchise agreements contractually require the evaluation of the location, and quality and configuration of the restaurant structures routinely. Franchisees are small business owners and they bear the cost of updating their buildings or completing scrape and build projects, which are often written into their agreements. While these scrape and build projects may be considered renovations in their agreements, the tax code treats these as new construction.

The above-mentioned renovations and structural improvements made to restaurants every six to eight years come at an average cost of $250,000 --$400,000. This year alone the restaurant industry is expected to spend in excess of $5.5 billion on capital expenditures for building construction and renovations. The restaurant industry is projected to spend over $70 billion over the next ten years for building construction and renovations. These more-than-modest expenditures in turn have a significant economic impact on businesses performing these renovations. Like the restaurant industry, growth in the construction industry will reverberate throughout the economy. According to the Bureau of Economic Analysis, every dollar spent in the construction industry generates an additional $2.39 in spending in the rest of the economy, while every $1 million spent in the construction industry creates more than 28 jobs in the overall economy.

If there is any question whether shortened deprecation schedules would spur economic activity consider the fact that after Congress enacted the restaurant improvement provisions in 2004, the restaurant industry spent more than $7.4 billion on new structures and building improvements in 2005 – a 42 percent increase over the $5.2 billion spent in 2004 (according to the U.S. Census Bureau).

The additional spending – fueled by a shorter depreciation schedule – created thousands of jobs in construction-related industries across the country. With more predictability we anticipate that these spending numbers will grow as restaurateurs have the ability to plan new construction and improvement projects farther out than one or two years.

We urge the members of this committee to consider this information as evidence of the need to keep the restaurant industry strong in order to help keep the nation's overall economy strong.

Over the years, the House Small Business Committee has been a staunch advocate for tax relief for the country's small businesses, including restaurants. We encourage the committee to continue to support such efforts, we ask the members that haven't already done so, to lend their names to H.R. 3622 and ask that any reforms to the tax code be done with the goal of leveling the playing fields for businesses, not further exploiting them or playing favorites.

If this is done, it will free up valuable resources to allow restaurants to do their part to reinvigorate this nation's economy.

Thank you.

Enclosures

Freshly prepared foods boost bottom lines for convenience stores

BY LISA JENNINGS

Long gone are the days when dinner from a convenience store meant little more than a microwaved frozen burrito and a soda.

Across the country, C-store chains are adding more in the way of freshly prepared foods — in ways that are competing directly with quick-service restaurants.

For most C-stores, customers come for gas, cigarettes or other retail items. The smell of a freshly baked pizza or the convenience of a carryout chicken dinner is likely to cause customers to add to their purchases, retailers reason. And because such fresh foods typically are higher-margin items, C-stores are seeing a significant boost to their bottom lines.

Segment leader 7-Eleven, a global chain with 32,312 units, for example, has been adding fresh-food offerings for several years. About 4,700 units in larger U.S. markets offer sandwiches, salads, fresh fruits and baked goods that are delivered daily from commissary kitchens. Earlier this year, the Dallas-based company installed new high-speed ovens in 111 Utah stores to test a new hot-foods menu that will add freshly baked pizzas, chicken wings, churros and cinnamon rolls to the lineup.

Ankeny, Iowa-based Casey's General Store, which is operator or franchisor of more than 1,430 namesake units in nine Midwestern states, is also building foodservice operations with higher gross-profit margins in mind.

What began with from-scratch pizzas in 1984 has grown to a menu of sandwiches, pork and chicken fritters, chicken tenders, hamburgers and hot dogs, doughnuts, biscuits, pastries, and more.

According to the company's annual report, non-gas items accounted for 30 percent of sales but resulted in 75 percent of gross profits from retail sales. Gross profit margins from prepared foods averaged about 62 percent over the past three years, compared with margins from gas sales averaging 5 percent.

Casey's net sales for prepared foods and fountain items totaled in excess of $260 million for the fiscal year ended April 30.

"The additional fountain choices contributed to this category's excellent performance in fiscal 2007, but the real star was our proprietary prepared food program," said Robert Myers, president and chief executive of Casey's. "We kept the warmers full of the right product at the right time of day and were rewarded with another year of impressive gross-profit improvement."

Altoona, Pa.-based Sheetz Corp., with approximately 330 stores throughout the Mid-Atlantic region, recently broke ground on a new $36 million production facility called Sheetz Bros. Kitchen that company officials hope will improve efficiencies and allow the chain to build on its already booming foodservice program.

Sheetz offers a full line of in-store prepared foods, from deli sandwiches and burgers to salads and wraps.

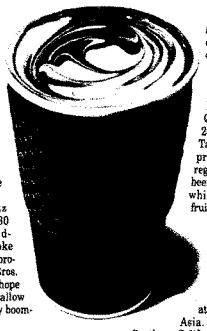
JOE MODLIN/CITY

7-Eleven recently installed high-speed ovens in 111 Utah stores to test a new hot-foods menu.

The new commissary will enable the company to add new premade foodservice items, said president Stan Sheetz. However, company officials had not yet determined what might be added to the menu.

The second-largest C-store operator in North America — Alimentation Couche-Tard Inc., based in Laval, Quebec — owns the Circle K brand, with more than 2,000 U.S. locations, as well as the Mac's and Couche-Tard stores in Canada, for a total of nearly 5,000 outlets.

About 300 stores under the three brand names include quick-service restaurants operated by brand partners such as Subway, Dunkin' Donuts, Blimpie, Noble Roman's and Quiznos Sub, according to the company's 2006 annual report. Alimentation Couche-Tard is also testing the development of proprietary foodservice offerings based on regional preferences. Breakfast items have been well-received in Canada, for example, while West Coast customers prefer fresh fruits, sushi and Chinese food.



Altoona, Pa.-based Sheetz offers a full line of beverages and prepared foods, including coffee, deli sandwiches and salads.

Among the fast-growing rivals to the Second 100 convenience players is Famima!!, a Japan-based brand with 12 stores in Los Angeles. Famima Corp., the U.S. subsidiary based in Torrance, Calif., is owned by Tokyo-based FamilyMart Group, which operates more than 13,000 convenience stores in Asia. The group plans to have 20 stores in Southern California before the end of 2007 and to begin opening units in New York by 2009.

In Los Angeles, the Famima concept is so foodservice-focused that the stores may be more accurately described as quick-service restaurants where guests can also buy shampoo and a gallon of milk.

Famima commissaries deliver freshly prepared dishes ranging from roasted-garlic tomato soup and sushi to pad thai noodles and chicken-artichoke paninis that can be grilled in the stores. Instead of the C-store staple of hot dogs, Famima offers hot steamed Chinese buns at the checkout counter, as well as exotic pastries and specialty coffees.

Freshly prepared foods at Famima stores account for about 40 percent of sales, said Shiro Inoue, Famima Corp.'s president and chief executive. He predicts the chain will see $50 million in revenue in fiscal 2007, if all the planned stores open on schedule. ■

ljenning@nrn.com

CONVENIENCE STORE CHAINS RANKED BY U.S. SYSTEMWIDE SALES

LATEST-YEAR RANK	PREC.-YEAR RANK	CHAIN	FISCAL YEAR END	U.S. SYSTEMWIDE FOODSERVICE SALES* (BY FISCAL YEAR, IN MILLIONS) LATEST	PRECEDING	PRIOR
1	1	Sheetz	Sept. '06	$280.0	$268.0	$249.7
2	2	Casey's General Stores	April '07	262.0	232.0	208.0
3	3	Circle K	June '07	249.0	239.0	232.7
		TOTALS:		$801.0	$739.0	$690.4

*Actual results, estimates or projections. Source: NRN Research

CONVENIENCE STORE CHAINS RANKED BY GROWTH IN U.S. SYSTEMWIDE SALES (Year-to-year percentage change)

LATEST-YEAR RANK	PREC.-YEAR RANK	CHAIN	FISCAL YEAR END	LATEST* VS. PRECEDING	PRECEDING* VS. PRIOR
1	1	Casey's General Stores	April '07	12.93	11.54
2	2	Sheetz	Sept. '06	8.21	7.33
3	3	Circle K	June '07	4.18	2.71
		AVERAGE:		8.44	7.19

*Actual results, estimates or projections. Source: NRN Research

CONVENIENCE STORE CHAINS RANKED BY NUMBER OF U.S. UNITS

LATEST-YEAR RANK	PREC.-YEAR RANK	CHAIN	FISCAL YEAR END	YEAR-END NUMBER OF UNITS* LATEST	PRECEDING	PRIOR
1	1	Circle K	June '07	2,250	2,149	2,105
2	2	Casey's General Stores	April '07	1,431	1,413	1,358
3	3	Sheetz	Sept. '06	328	317	302
		TOTALS:		4,009	3,879	3,765

*Actual results, estimates or projections. Source: NRN Research

CONVENIENCE STORE CHAINS RANKED BY GROWTH IN NUMBER OF U.S. UNITS (Year-to-year percentage change)

LATEST-YEAR RANK	PREC.-YEAR RANK	CHAIN	FISCAL YEAR END	LATEST* VS. PRECEDING	PRECEDING* VS. PRIOR
1	3	Circle K	June '07	4.70	2.09
2	1	Sheetz	Sept. '06	3.47	4.97
3	2	Casey's General Stores	April '07	1.27	4.05
		AVERAGE:		3.15	3.70

*Actual results, estimates or projections. Source: NRN Research

REPRESENTING THE RESTAURANT INDUSTRY
The Cornerstone of the Economy, Career Opportunities and Community Involvement

October 18, 2007

The Honorable xxxx
U.S. House of Representatives
XXX House Office Building
Washington, DC 20515

Dear Representative XXX:

On behalf of the nation's 935,000 restaurant locations nationwide and our 53 state restaurant association partners, **I urge you to cosponsor H.R. 3622, the accelerated restaurant depreciation bill.**

Recently introduced by Congressmen Kendrick Meek (D-FL-17th) and Patrick Tiberi (R-OH- 12th), the legislation would allow accelerated depreciation schedules for newly constructed restaurant properties as well as improvements made to restaurant properties. The legislation would allow the cost of the construction and/or improvements to be written off over a 15-year period rather than the current 39 ½ year schedule. As most agree, the 39 ½ year schedule is outdated and does not reflect the true "life" of a restaurant building which experiences a daily assault by customers and employees lasting up to 18-24 hours a day, unlike most other retail buildings.

From quick service to fine dining, every sector of the industry supports an accelerated depreciation schedule. Some of our toughest competition in the marketplace enjoy seven or fifteen year schedules themselves, and we continue to be at a competitive disadvantage. In addition, there is inconsistency within the restaurant industry where those who lease their properties can use an accelerated 15-year schedule for improvements.

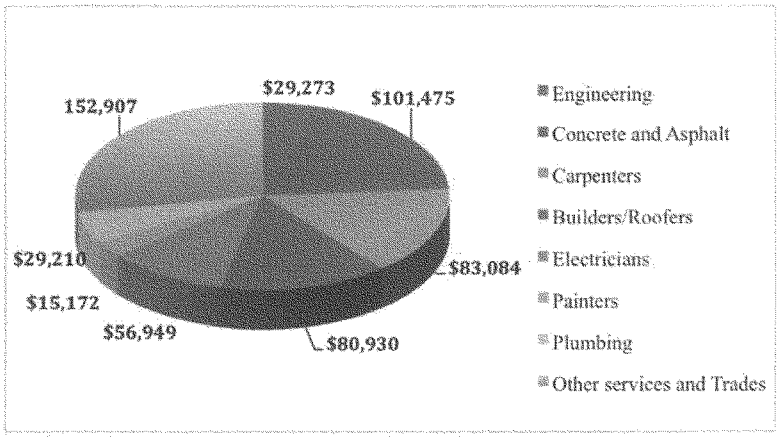
I ask you to bring fairness, consistency and uniformity to the tax code by cosponsoring H.R. 3622 and allowing restaurateurs to write off new construction and improvements to their buildings over a 15 year schedule. If you need additional information, please contact Michelle Reinke, Director, Legislative Affairs at mreinke@dineout.org or 202-331-5900.

Sincerely,

John Gay
Senior Vice President
Government Affairs and Public Policy

1200 SEVENTEENTH STREET, NW • WASHINGTON, DC 20036-3097
TEL: 202.331.5900 • FAX: 202.331.2429 • WWW.RESTAURANT.ORG

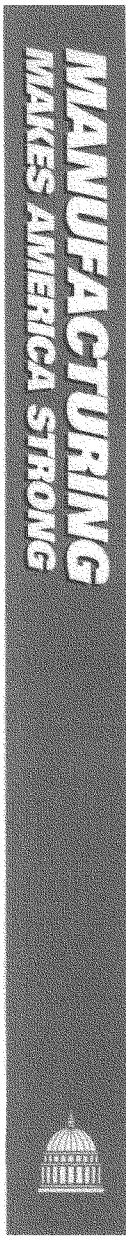
Pizza Hut Restaurant Franchisee Construction Cost Estimate



Total Capital Expenditure = $549,000

This is an example of just some of the costs associated with constructing a new Pizza Hut restaurant. It is based on an actual restaurant built in the Midwest in 2005. Costs can be significantly higher in some locations.

The vast majority of this expense represents ***direct local economic stimulus****.*



Testimony

of Drew Greenblatt
Marlin Steel Wire Products

on behalf of the National Association of Manufacturers

before the Small Business Committee

U.S. House of Representatives

Hearing on Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy

April 10, 2008

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Testimony of
Drew Greenblatt
President and Owner
Marlin Steel Wire Products
Baltimore, MD

On Behalf of the
National Association of Manufacturers

Before the
House Small Business Committee

Hearing on
"Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy"

April 10, 2008

Good morning, Chairwoman Velazquez, Ranking Member Chabot and members of the Committee. My name is Drew Greenblatt. I am the President and owner of Marlin Steel Wire Products in Baltimore, MD. Marlin was founded in 1968. We manufacture wire baskets, hooks and wire forms. We also have the capability to produce a wide range of custom products for our customers. Our products are used in industrial, aerospace, automotive and medical industries by clients like Caterpillar, Boeing and Toyota. Thank you for the opportunity to appear today on behalf of Marlin Steel Wire and the National Association of Manufacturers.

The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. I was pleased to learn of the subject of today's hearing—updating the Internal Revenue Code to help small businesses stimulate the economy. The NAM's Tax Policy agenda is designed to promote U.S. jobs and competitiveness and ensure continued economic growth. I'd like to touch on a few items of specific concern to my business and to small and medium-sized manufacturers across the country. Specifically, making the income tax cuts permanent, providing a permanent and strengthened R&D credit, and repealing the 3 percent withholding requirement on government contracts.

Because Marlin Steel is organized as an S-corporation, we pay taxes at the individual rate. Many manufacturers like us are in the same boat. In fact, about 50 percent of NAM's members are similarly organized, as "flow through" companies, meaning they pay individual rates. For us, the legislation passed in 2001 and 2003 that lowered the top individual tax rate to 35 percent has been extremely beneficial. Lower tax rates mean we have more money after taxes to expand our operations and create new jobs. When enough manufacturers expand, we fuel economic growth, and that translates into higher government tax receipts and lower federal deficits. It's paradoxical but true that lower tax RATES mean higher tax REVENUES. Conversely, letting the Bush tax rate cuts expire, effectively raising taxes in 2011, will mean cutbacks at a time when the economy may well be in a downturn.

There has been a lot of talk recently about not only raising the individual income tax rates, but also placing a surtax on folks in the upper brackets. Many folks in Congress think this means that they're raising taxes only on the wealthy. But, I'm here today to remind you that these rate increases will strike at the heart of small businesses. My tax return includes all of my business income even though we have never paid a dividend. We pour every penny of profit back into the company, to grow. So this so-called profit that the IRS is taxing me on is not cash in my pocket; it's money that I'm keeping in my company so we can buy another welding machine to make baskets like these. If my taxes go up, I will have less money to buy that welding machine and hire that welder off the streets of Baltimore. So the toll will be paid not only by manufacturers like me, but also the company that makes the welding machine and the unemployed fellow collecting unemployment benefits. Wouldn't we be better off if I'm buying new equipment and hiring young kids whom I pay double the minimum wage? Wouldn't the tax revenues go up and the unemployment benefit load on us go down if we follow that path?

The R&D tax credit is also instrumental to the US maintaining its competitive edge. As the primary innovators in the United States, manufacturers clearly understand that research and development drives new product development and increased productivity. R&D is how we stay fresh and competitive. I can't compete with other countries when it comes to wages, so I have to win on innovation.

Chairwoman Velazquez, let me give you a concrete example. Travers Tool, one of the excellent companies in your Congressional District, buys this basket from me. They resell it worldwide. No one is going to get rich on this one basket model. Travers needs a steady flow of fresh ideas – new products that are competitive and different. We use this R&D tax credit to do our Thomas Edison imitation, to be different and innovative by coming up with new products for Travers to sell. Travers appreciates this because their clients demand fresh products. This tax credit helps Marlin stay innovative and contributes to jobs in your district.

Unfortunately, because of the temporary nature of the credit, it's been an on-again, off-again tool for us. The fact that we're never certain when or if the credit will be extended makes it extremely hard for my business to plan ahead. Should we hire another engineer? Should I buy an AutoCAD design system? As of right now, the credit has expired. Because Congress failed to act, we've now been hit with a big tax increase. Making the credit permanent would end the years of speculating and waiting for congressional action. It would give my business the certainty we need to plan ahead and put us on par with many of our trading partners who already have the advantage of a permanent credit.

My company also does business with the government. I want to thank this committee for working hard to open government contracting opportunities for small and medium-sized businesses. But, there is a looming change to the tax code that will be disastrous to those of us who work with the government. In 2011, the government will be required to withhold 3 percent of all contract payments to companies. Most of our profit margins are already less than 3 percent. If this law is allowed to go into effect, we will stop bidding altogether. The result will be the undoing of years of hard work by small businesses trying to cultivate the biggest customer of all, the federal government. I pay my taxes and work hard to be a good corporate citizen – is

it right that our company would be penalized like this and that the government would have fewer vendors willing to bid for its work? I hope Congress will look long and hard at the negative consequences of this law and repeal it before it goes into effect.

The reality is that taxes are too high and vastly too complicated. Temporary and expiring provisions make life extremely difficult for small companies like mine. The alternative minimum tax means my taxes have to be figured twice – essentially doubling my tax preparation costs. We pay 1 percent of our sales just on accounting fees alone. If you simplify the forms to a three-page document instead of this 60-page document that I filled out last year with the help of my accountant, I would save so much on accountants' fees that I could hire another welder at $15/hour. I hold two life insurance policies to protect my sons from facing the estate tax down the road. All of these costs are just wasted dollars – money that could have been used to hire another employee or buy more welders. I've figured out that I could buy four more welding machines with just the money I spend on accounting alone.

In conclusion, tax relief enacted since 2001 for families and businesses has played an important role in stimulating economic growth and job creation. Making this tax relief permanent will provide an insurance policy for continued and durable economic growth. Lower tax rates and a permanent R&D credit are necessary tools to ensure that U.S. companies can thrive and compete in the international arena and attract and keep manufacturers in the United States. Simplifying the code by repealing the 3 percent withholding, consolidating the alternative minimum tax with the existing tax structure, and repealing the estate tax will go a long way toward helping small businesses like mine add jobs and increase productivity.

I want to again thank the committee for the opportunity to be here today and talk about the tax code and its impact on Marlin Steel Wire. I'm happy to answer any of your questions.

TelCoa
The Telework Coalition
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Washington, DC 20002
202.266.0046
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Statement of Nicole Belson Goluboff, Esq.

and

The Telework Coalition

Submitted to the House Committee on Small Business

For Inclusion in the Record of the Hearing

Concerning Small Business Tax Reform

Scheduled for

April 10, 2008

I am Nicole Belson Goluboff, a lawyer and advocate for telecommuting, or "telework." My work involves extensive

writing on the legal consequences of telework for both employers and employees, including tax consequences. I am the author of *The Law of Telecommuting* (ALI-ABA 2001 with 2004 Supplement) and *Telecommuting for Lawyers* (ABA 1998).

I serve on the Advisory Board of the Telework Coalition (TelCoa), an organization that promotes telework through research, education, technology and legislation. I make this statement together with Chuck Wilsker, TelCoa's President and Chief Executive Officer. The statement includes both my views and the views of TelCoa.

We thank the House Committee on Small Business for the opportunity to offer this written statement concerning tax reforms to benefit small businesses. We make this statement to urge the Committee to support measures that will enable small businesses to increase their reliance on telework and maximize its many advantages. We believe that one tax reform that is crucial to the ability of small businesses to broaden their use of telework is enactment of the Telecommuter Tax Fairness Act of 2007 (H.R. 1360; S. 785), and we urge the Committee to press for rapid passage of this legislation.

We also urge the adoption of certain changes to the Internal Revenue Code that would facilitate telework. These changes include, among others, a simplification of the home office deduction and the inclusion of employer-provided telework

tools in the list of fringe benefits excludable from employees' gross income.

I. The Benefits of Telework for Small Businesses

A. Cost Savings

Telework enables small businesses to compete successfully in a global market by significantly lowering their costs. It can, for example, reduce real estate and energy costs: Because telecommuters spend less time at their employer's central office, the business needs to lease, secure, heat, air condition and light less commercial space.

Similarly, telework can help small businesses save on travel related expenses, including, among others, fuel costs. Such savings are possible when telecommuters' home offices are closer than the central office to customer or client sites and when the telecommuters replace face-to-face meetings with teleconferences and videoconferences.

Telework enables small businesses to reduce recruitment costs while attracting the most qualified applicants from the broadest geographic area. These applicants may include people who live too far away to make a daily commute, workers with dependent care responsibilities, older Americans, handicapped Americans, military spouses forced to relocate frequently and the technologically savvy alternative-seekers of Generation Y. Further, the very flexibility that encourages applicants to join

the company also inspires them to stay, helping small businesses minimize turnover costs.

B. Increased Productivity

Telework can increase the productivity of small businesses.[1] It enables remote workers to avoid the frequent distractions and interruptions that typically occur in an office.[2] It also enables them to use time they previously spent commuting to get more work done or to meet the non-work responsibilities that might otherwise disrupt their work day.[3]

Telework also improves productivity by reducing regional traffic congestion. Small businesses can make and receive deliveries faster - and arrive at customer sites sooner - when fewer commuters are on the road. We note, too, that, as businesses rely on telework to help ease congestion, they also reduce fuel consumption, air pollution and greenhouse gas emissions,[4] and they lower the cost of maintaining and expanding the transportation infrastructure in their communities.

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[1] *Cf.* "Telework Under the Microscope - A Report on the National Science Foundation's Telework Program," Mar. 11, 2008 ("NSF Study"), p. 7, available at www.teleworkexchange.com (reporting that, at the National Science Foundation, 67% of employees who telework perceive that telework increases productivity).

[2] *Cf. id.* (reporting that 77% of National Science Foundation employees who telework perceive less frequent interruptions as a benefit of telework).

[3] According to the NSF Study, the average National Science Foundation teleworker saves 62 hours a year in commuting time. *Id.* at 13.

[4] *Cf.* www.sun.com/aboutsun/workplace/eco/res.jsp (reporting that teleworkers at Sun Microsystems each save over 125 gallons of gasoline and

C. Business Continuity

Small businesses can be harder hit than big ones by emergencies and other events that render the central office either unusable or inaccessible - like a terror threat, catastrophic storm, bridge collapse, flu pandemic or transit strike. One reason is that, even if a major disruption precludes only a small number of employees from working at the office, in a small business, that number could represent a substantial proportion of the workforce. However, when a firm's employees are experienced telecommuters, unusual circumstances do not interfere with the firm's capacity to continue operating normally.

II. The Telecommuter Tax Fairness Act

A. The Convenience of the Employer Rule

The Telecommuter Tax Fairness Act (H.R. 1360) would remove a powerful disincentive to telework and, thereby, make it much easier for small businesses to exploit the benefits of telework identified in section I.

Specifically, the Telecommuter Tax Fairness Act is intended to remedy the ill effects of a state tax rule known as the "convenience of the employer" rule. A number of states maintain

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2000 pounds of vehicular carbon dioxide emissions annually); NSF Study at 13 (reporting that the average National Science Foundation teleworker saves approximately 1750 pounds of emissions a year).

this rule.[5] New York has applied the rule with particular aggression.

Under New York's convenience of the employer rule,[6] for example, if a nonresident is employed by a small business in New York and works partly within New York and partly from his out-of-state home, New York may force him to treat the days he works at home as if they are days he works in New York and to pay New York tax on the income he earns on those days.

However, the telecommuter's state of residence may (much more logically) treat the days the telecommuter works at home as home state days, rather than New York days, and it may also tax the income earned on those days.[7] Because the employee's telework days may be treated inconsistently by the two states, the employee is threatened with double taxation.

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[5] *See, e.g.,* 20 NYCRR § 132.18(a); Delaware Schedule W (Apportionment Worksheet); 61 Pa. Code § 109.8.

[6] 20 NYCRR § 132.18(a)("If a nonresident employee … performs services for his employer both within and without New York State, his income derived from New York State sources includes that proportion of his total compensation for services rendered as an employee which the total number of working days employed within New York State bears to the total number of working days employed both within and without New York State…. However, any allowance claimed for days worked outside New York State must be based upon the performance of services which of necessity, as distinguished from convenience, obligate the employee to out-of-state duties in the service of his employer").

[7] *See, e.g.,* Edward A. Zelinsky, "Employer Convenience, Telecommuting, and the Constitution: The Empire State Really Strikes Back," *State Tax Notes,* May 8, 2006, p. 451.

Even if a telecommuter's home state offers him a credit for taxes he pays New York on the income he earns at home, the telecommuter remains at risk. If New York taxes the income he earns at home at a higher rate than the telecommuter's home state, the telecommuter must pay the higher New York rate on his non-New York income. As a result, he is still penalized for telecommuting.[8]

B. The Harm of the Convenience Rule to Small Businesses

Because the convenience of the employer rule punishes nonresidents who work from home for employers located in other states, it discourages the practice. It deters current nonresident employees of a small business from telecommuting across state lines, and it deters nonresident job applicants who require workplace flexibility from accepting a position with the firm. Thus, the rule frustrates small businesses trying to grow and retain a distributed workforce.

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[8] The telecommuter's state of residence is also penalized. If the state gives the telecommuter a credit, it effectively forfeits its tax revenue to New York, subsidizing public services in New York when the telecommuter typically uses the services in the residence state. *See* Raymond J. Keating, "The Tax Man and Telecommuting," Feb. 21, 2008, ("Small Business & Entrepreneurship Council Commentary"), available at www.sbsc.org/news/display.cfm?ID=2594. New York's aggressive insistence on exacting revenue that belongs to other states is especially troubling given that many states across the country are now struggling to address their own budget shortfalls. *See* Jennifer Steinhauer, "As the Economy Falters, So Do State Budgets," *The New York Times,* Mar. 17, 2008. Further, whether the telecommuter receives a credit or is double taxed, the convenience rule can drive up his total state tax liability considerably. As a result, the telecommuter's budget for spending in his home state shrinks.

The convenience of the employer rule also creates undue payroll burdens for small businesses. These businesses may not know, for example, for which state they are required to withhold taxes on the income a telecommuter earns at home: Must they withhold for the telecommuter's home state, the state where the business is located or both? Making this determination can be time-consuming and expensive.

If, for example, a New York company is unaware that an out-of-state telecommuter could owe taxes in New York - and New York advises the company that the company has unmet withholding obligations for a telecommuter only after the employee has been telecommuting for several years - the administrative burden of addressing the state's claim may be totally overwhelming. Consider the case of a small business recently described in *The New York Times*:

> One small manufacturer on Long Island has been battling the New York State Department of Taxation and Finance for two years, after payroll auditors ruled that the company's president, who moved to Florida in 2002, owed back taxes on all his income since then….
>
> The company's treasurer … says she has spent a lot of time collecting [credit card] receipts, A.T.M. records and other evidence of the president's whereabouts to minimize his tax bill.
>
> "We were totally blindsided," the treasurer said. "We are a very small company. We can't afford all this."
>
> The company, which makes aerospace equipment, plans to move to Florida or the Carolinas as a result of the

> tax status of the company's president, she said. Most of the 52 employees are hourly workers who will not move with the company, she added.[9]

Because of the hardships the convenience rule causes for small businesses, the Small Business & Entrepreneurship Council has called for federal intervention, strongly endorsing H.R. 1360 - the Telecommuter Tax Fairness Act. According to the Council, H.R. 1360 "would eliminate this patent case of tax unfairness towards telecommuters and small businesses."[10]

C. A Federal Solution

The Telecommuter Tax Fairness Act would prohibit a state from taxing the income earned by a nonresident employee for any period when he is "physically present in another State."[11] It would impose a strict standard for determining whether a telecommuter is "physically present" in a state, barring a state from applying a convenience of the employer rule and forcing telecommuters to pretend that out-of-state days are in-state

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[9] David S. Joachim, "Telecommuters Cry 'Ouch' to the Tax Gods," *The New York Times,* Special Section on Small Business, Feb. 20, 2008.

[10] Letter dated February 27, 2008 from Karen Kerrigan, President and CEO, Small Business & Entrepreneurship Council to U.S. House Representative Christopher Shays, available at http://www.sbecouncil.org/legaction/display.cfm?ID=2603.

[11] H.R. 1360, section 2(a), adding section 127(a) to chapter 4 of title 4 of the United States Code.

days.[12] The bill would clarify that days worked at home are allocable to, and taxable by, the home state - not the employer's state.

In so doing, the bill would ease both the confusion interstate telecommuters currently face concerning where they owe taxes on the income they earn at home and the confusion the small businesses employing them face about where they have to withhold. It would protect these telecommuters from either double or excessive taxation for their choice to telework and make telework a more affordable work option for them.

By significantly simplifying tax compliance for both telecommuters and small businesses - and by abolishing a strong tax disincentive to telecommute for employees - the Telecommuter Tax Fairness Act would empower small businesses to maximize the bottom line benefits of telework. According to the Small Business & Entrepreneurship Council, the Telecommuter Tax Fairness Act is "an obvious solution to a costly tax overreach by some states. Congress should act immediately in the name of fairness and common sense."[13]

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[12] H.R. 1360, section 2(a), adding section 127(b) to chapter 4 of title 4 of the United States Code.

[13] Small Business & Entrepreneurship Council Commentary.

III. Other Tax Reforms Necessary to Help Small Businesses Increase Their Use of Telework

A. Standard Home Office Deduction

Internal Revenue Code ("Code") § 280A(c)(1) allows a taxpayer to take a home office deduction if he uses part of his home exclusively and regularly (1) as the principal place of business for his trade or business; (2) as a place of business where he meets with customers, patients or clients; or (3) "in connection with [his] trade or business" when his home office is located in a separate structure not attached to his home.

The complex requirements to qualify for and calculate the home office deduction can make taking the deduction difficult. For example, a "member poll conducted by the National Association for the Self-Employed (NASE) in 2005 found that complexity and burden of the home office deduction paperwork and fear of an IRS audit discourages business owners from receiving the deduction on federal tax returns."[14] According to the NASE, a majority of the group's members "'operate out of a home office, but fewer than half elect to take the deduction.'"[15]

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[14] "IRS Taxpayer Advocate Calls for Simplified Home Office Deduction," Jan. 18, 2008, available at www.rtoonline.com/Content/Article/Jan08/HomeOfficeDeductionSimplification54123412011808.asp.

[15] *Id.*

Employees who want to take the deduction - as opposed to home-based business owners - have to meet the same requirements home-based business owners do, as well as some additional requirements. One of the extra conditions is that the home office must be for the convenience of the employer:[16] "If the use of the home office is merely appropriate and helpful," the employee "cannot deduct expenses for the business use of" his home.[17] Thus, according to the Internal Revenue Service, if a telecommuter's employer provides her with an office and does not require her to work at home, the telecommuter does not meet the convenience of the employer test and cannot claim the home office deduction.[18]

Because telecommuting employees must meet the same complex requirements that home-based business owners must meet - as well as the convenience of the employer test - the deduction may be unusable for many of them, too. Simplifying the deduction for employees would make it easier and less expensive for them to telecommute.

As we discussed in Section II, facilitating telework for employees can help small businesses increase the number of

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[16] Internal Revenue Code § 280A(c)(1).

[17] Internal Revenue Service Publication 587 ("Business Use of Your Home") ("IRS Pub. 587"), p. 3.

[18] IRS Pub. 587, p. 5 (Example 4).

telecommuters they employ. Thus, in addition to benefiting home-based small business owners in their capacity as deduction -seekers, a simplified home office deduction would benefit small business owners in their capacity as employers looking to hire off-site workers. Further, a simplified deduction would aid small businesses operating from traditional offices that want to employ more telecommuters.

To simplify the deduction for the benefit of home-based business owners, office-based small business owners and telecommuters, Congress should amend the Code to offer taxpayers the option of taking a standard home office deduction.[19]

Further, employees who would prefer to take the deduction currently offered instead of the standard deduction should be permitted to do so regardless of whether their employers require them to work remotely. If an employer considers a telework arrangement sufficiently valuable to approve it, then the fact that the arrangement is "merely appropriate and helpful"[20] - rather than impossible for the employer to do without - should not bar the telecommuter from taking the deduction.

B. Excluding Employer-Provided Telework Tools From Employees' Gross Income

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[19] *Cf.* The Parents' Tax Relief Act of 2007, H.R. 1421, section 5.

[20] IRS Pub. 587, p. 3.

Code § 132 specifies certain fringe benefits excludable from gross income. Congress should amend this section to specify that the value of equipment and services an employer provides an employee to facilitate telework is excludable from the employee's gross income. The exclusion should be available whether the equipment and services are to be used for part-time telework, full-time telework or telework for a limited period in response to an emergency.[21]

C. Tax Credits

The Code should be amended to offer tax credits to small businesses implementing telework. For example, it should offer such businesses credits for purchasing the equipment and services necessary to facilitate remote work.[22]

In addition to providing a credit designed to reduce telework-related costs, the Code should offer small businesses a credit designed to encourage them to make the telework option available to as many of their employees as possible. For

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[21] *Cf.* H.R. 1421, section 8. (This legislation would amend Code § 132 to exclude from gross income any computer and related equipment and services an employer provides to an employee if such computer and related equipment and services "are necessary for the employee to perform work for the employer from the employee's home, and … the employee makes substantial business use of the equipment in the performance of work for the employer." The bill defines "substantial business use" to include "standby use for periods when work from home may be required by the employer such as during work closures caused by the threat of terrorism, inclement weather, or natural disasters").

[22] *Cf.* The Gasoline Affordability and Security Act, S. 1868, section 301 (109th Cong.)(amending subpart B of part IV of subchapter A of chapter 1 of the Code by providing a credit for certain telework expenses to either the employer or the teleworker, depending on who paid or incurred the expenses).

example, the Code could offer businesses a credit for each employee who spends at least a specified percentage of his work time telecommuting.[23]

Further, the Code should provide tax credits to telecommuters who must purchase for themselves the equipment and services they need to work off-site.[24]

Finally, the Code should provide incentives to businesses of all sizes to expand broadband access in both rural and urban areas that currently lack access or are underserved. Broadening such access will further enlarge the applicant pool from which small businesses can hire their ideal workforce.

IV. Conclusion

Telecommuting offers small businesses numerous advantages, including cost savings, improved recruitment efforts, lower turnover, increased productivity and business continuity in the event of an emergency.

The Telecommuter Tax Fairness Act would strengthen the capacity of small businesses to maximize these advantages by abolishing a potent deterrent to telework - the state imposed penalty tax on interstate telework. By discouraging current

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[23] *Cf.* H.R. 1421, section 7 (amending subpart D of part IV of subchapter A of chapter 1 of the Code to provide a credit equal to 40% of the wages (up to a maximum of $6000 of wages) attributable to service an employee renders during the first year in which she renders at least 40% of her service from home).

[24] *Cf.* S. 1868, section 301 (109th Cong.).

employees and job applicants from telecommuting, this telework tax threatens the ability of small businesses to grow and retain a decentralized workforce. The tax also saddles small businesses with payroll obligations so onerous that the businesses may be forced to leave their home states. The Telecommuter Tax Fairness Act is a tax reform crucial to enabling small businesses to use telework to compete successfully in a global economy.

In addition to passing the Telecommuter Tax Fairness Act, Congress should amend certain provisions of the Internal Revenue Code to help small businesses maximize the benefits of telework. The Code should allow telecommuters (as well as home-based business owners) to choose between taking the current home office deduction and taking a standard home office deduction. Further, for those employees who would prefer to take the current deduction, the Code should eliminate the convenience of the employer test. The Code should also include employer-provided telework equipment and services in the list of fringe benefits excludable from employees' gross income.

The Code should offer telework incentives in the form of tax credits to both small businesses and their employees. In addition, it should offer incentives to businesses of all sizes

to aid the growth of telework by expanding broadband access in areas where access is currently inadequate.

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