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SUBCOMMITTEE ON FINANCE AND TAX HEARING ON HOW THE COMPLEXITY OF THE TAX CODE HINDERS SMALL BUSINESSES

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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SUBCOMMITTEE ON FINANCE AND TAX HEARING ON HOW THE COMPLEXITY OF THE TAX CODE HINDERS SMALL BUSINESSES

Thursday, May 7, 2009

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

The Subcommittee met, pursuant to call, at 10:02 a.m., in Room 2360, Rayburn House Office Building, Hon. Kurt Schrader [chairman of the Subcommittee] presiding.

Present: Representatives Schrader, Moore, Kirkpatrick, Ellsworth, Halvorson, Buchanan, Luetkemeyer and Coffman.

Chairman SCHRADER. Well, I would like to call the first meeting of the Subcommittee on Finance and Tax to order here on May 7, 2009.

Welcome everybody in attendance, especially our guests, many of which have come a long ways. I appreciate their efforts to come here and give us a little background on small business tax simplification issues and perhaps some other points they might want to bring up.

Talk to any entrepreneur, and they will tell you the same thing: Whether it is good times or bad, the Tax Codes become a huge obstacle to any efficient business. In an effort to untangle that complexity, the current administration has recently launched a bipartisan reform panel. That group will work to overhaul the Tax Code and make sure it meets current economic standards and demands. For entrepreneurs, this is going to be extremely important.

In its current ever-expanding state, the States' tax codes, maze of write-offs, and regulations restrict small business growth, as does the Federal. Whether talking about tax to dollars or tax complexity, it is an enormous drain on small firms. This should come as no surprise. Over 3.7 million words and over 70,000 pages, the Tax Code is just a nightmare to navigate.

In an average year, individuals and companies spent close to $265 billion just doing their taxes; and small businesses paid the lion's share of that sum. In fact, entrepreneurs spend an estimated $1,304 per employee, roughly twice the amount that big companies pay. In today's hearing, we are going to examine some of these costs and look for ways in which the Tax Code can be simplified for small businesses.

When it comes to tax compliance, mounting expenses are compounded by an element of uncertainty. Many small firms struggle to determine what they owe and what they can write off, just like

we do in our daily lives. With the Tax Code changing at a rate of roughly one alteration a day, it is no wonder entrepreneurs find it very difficult to follow.

In the face of daily tinkering, undefined deadlines, expiring provisions, small firms struggle to calculate these long-term budgets. Given this uncertainty, it is next to impossible to even plan for the future. That confusion translates into postponed investments and, without a doubt, fewer new hires.

At a time when we are counting on startups to jump-start our economy, we just can't afford that sort of setback. Tax regulation should not be a stumbling block. For many entrepreneurs, they have the potential to encourage growth. In fact, small firms often make decisions based on the promise of write-offs alone. We could discuss that. For that reason, we need to be sure entrepreneurs are aware of every incentive available to them.

Just as importantly, they should know how to take advantage of these provisions. A good example of this is the home office deduction. Fifty-two percent of entrepreneurs operate out of their homes, and yet only a small handful even claim the deduction.

To address this disconnect, Representative John McHugh and I introduced the Home Office Deduction Simplification Act. That bill should go a long way, hopefully, to streamline the compliance process for entrepreneurs.

Whether it is creating a standard home office deduction or just generally modifying the Tax Code, there are ways to ease the small business burden. Of course, everyone has an opinion on how to make this happen. We will hear some today.

I am also pleased that our small business representatives, as I said before, from all over the country could join us from the Far West, the Far South and some that are here on a little more regular basis to share their wisdom. So at the very least, hopefully as a result of this hearing, we will find out ways to blunt the burden in the short term and set the stage for long-term reform as we go forward.

I would like to recognize the ranking member, Congressman Buchanan, for his opening statement now.

Mr. BUCHANAN. Thank you, Mr. Chairman Schrader, for calling this important hearing for simplifying the Tax Code for American small business.

I would also like to extend my thanks to our witnesses today, especially my constituent from my district, who have taken the time out of their schedule to provide us some important testimony today.

The present Tax Code—it is hard for me to believe, but I wanted our people to look at that—is 67,000 pages long—67,000 pages. The Internal Revenue Service says it takes an estimated 37 hours to complete the 1040 short form. The most basic tax form that—return that we have. So it should come as no surprise that a recent survey conducted by the Tax Foundation revealed that four out of five adults think the Tax Code is way too complicated and complex, while 85 percent say the system needs to be completely overhauled.

Small business are the most prolific job creators, creating 70 percent of the jobs nationwide, but small business have taken the blunt of this current recession downturn. I know my experience being involved with the Florida Chamber, the chairman of that,

about 4 or 5 years ago. In our federation, we had 137,000 businesses. Most of them were small business, 90 percent 50 employees or less. As I stated earlier, created 70 percent of the jobs.

It does concern me that the administration has proposed several tax changes or policy changes that I think will have a very, very negative impact on small business. Instead of raising taxes, we should be encouraging an environment that creates jobs and investment.

I know myself, being in business for 30 years, as someone self-employed, I can tell you most small businesses have pass-through income. So someone making 200—a lot of these small businesses might make 400, but they only take home 60 or 70. They are putting the money back in there. They are paying their taxes. Most small business are sub-S, LLCs, partnerships, sole proprietorships. And that is all pass-through income. It is a job they can't create. It is a piece of equipment they can't buy.

While Fortune 100 businesses hire an army of lawyers and accountants to find loopholes, exemptions, deductions of the Tax Code, small businesses are forced to dig deep into their pockets for help in simply just trying to comply with the law.

So I look forward to the hearing today with our witnesses, and I yield back.

Chairman SCHRADER. Thank you very much, Ranking Member Buchanan.

Well, let us move to the testimony from our witnesses. The witnesses will have 5 minutes. We have your prepared remarks. They will be included in the record.

You will have 5 minutes, basically, to summarize your testimony. The timer begins when the green light goes on, 1 minute of time remaining is the yellow light, and the red light means I have got to interrupt you if you are still talking. So I apologize for that up front. We are trying to get to everybody and allow for good questions to hopefully get us some good policy.

Chairman SCHRADER. The first witness today will be Ms. Christine Chin Ryan. She is President and Founder of Synergy Consulting, Incorporated, located in Portland, Oregon. She is also the first woman and Asian American to serve as chairperson of the Governor's Small Business Council. She is here to testify on behalf of the Oregon Small Business for Responsible Leadership group. It is a nonpartisan advocacy organization committed to the creation, promotion, and preservation of small business in Oregon. She is a good friend and a good friend of small business.

Ms. Ryan.

STATEMENT OF CHRISTINE CHIN RYAN

Ms. CHIN RYAN. Thank you, Chairman Schrader and members of the Committee. For the record, I am Christine Chin Ryan; and I have been a small business owner since 1988.

First, I want to give you some statistics on small businesses in Oregon. Small businesses' definition is 100 employees or less and account for 51 percent of the private-sector employees in Oregon. Ninety-eight percent of the approximately 112,203 employer firms in Oregon are small businesses. The 20- to 49-size class provides the largest number of small business jobs, around 203,339. The

source is the Oregon Employment Department for the Oregon Economic and Development Department.

The main issues addressed in the written testimony that affect small business owners are the complexity of the Tax Code, the true cost of Social Security, and the AMT. Most small business owners need to hire a tax professional because of the complexity of the Tax Code. The time spent on keeping records to make sure they are in compliance with the law is extremely time consuming for small businesses and takes away from the day-to-day operations.

I spend approximately $10,000 to $15,000 a year for my CPA and bookkeeper services. This money can be spent on capital costs towards hiring a part-time employee.

The Tax Code is written in Congress, the regulations are written by IRS, and the Tax Court cases memorandum interrupts the law. This has contributed to the complexity.

In addition, the IRS generated revenue procedures, revenue ruling, circulars, and on and on. Originally, some forms were only 2 to 3 pages, example, form 990 and 5500. Now there are 9 to 11 pages, plus schedules. Originally, the tax rates were high and the Code was simpler.

The government needs money to operate. When the tax rates were lowered, then the amount of money the government got was less. In order to increase tax revenue, the government put in rules to limit the deductions, thereby increasing taxable income and tax revenues and adding to complexity. As a result, the past 3 to 4 decades, the complexity of the Code rules have been compounded.

I have two examples in my written testimony that I will not go through because of time limitations.

The next one is the true cost of Social Security. The true cost of Social Security also adds to complexity. Currently, sole proprietorships automatically have to pay 15 percent of income up to $100,000 into Social Security and Medicare before any itemized deductions and then pay tax on that income again at the regular tax rate.

Why does this affect small businesses? 15.3 percent is a significant percentage to operating capital. The income is taxed again, and this takes away from the small business owner's ability to plan for retirement.

Another issue is the alternative minimum tax, AMT, which adds another level of complexity. The AMT was originally established to ensure that wealthy individuals paid enough taxes. However, it has not been indexed to inflation. Many individuals fall into AMT. This is due to the adjustments for taxes, excess medical deductions, and miscellaneous itemized deductions which include a deduction for unreimbursed business expenses.

Another example not in my written testimony that Chairman Schrader mentioned is the home office deduction. Standardizing home office deduction would be huge for small businesses. Currently, the home office deductions are complex. It depends on the square footage you use in your home for your business, and that percentage is used to calculate other expenses. So it will make it a lot easier for home business; and thank you, Chairman Schrader, for doing this.

This testimony was not intended to be how much we know about the Tax Code as written in my written testimony but to identify the complexity and frustration for small business owners. It has become apparent to us that most businesses, large and small, recognize their civic responsibility and are willing to pay their fair share for their business footprint. I would like to underscore the word ″fair″, as a fair Tax Code ensures participation, rather than encourages searching for intricate ways to pay as little as the law allows.

Thank you.

Chairman SCHRADER. Thank you very much. Good testimony.

[The statement of Ms. Chin Ryan is included in the appendix at page 32.]

Chairman SCHRADER. Well, our next witness is Mr. Blackledge. He is the President of Blackledge Furniture in Corvallis, Oregon. Founded in 1901, Blackledge Furniture is Corvallis' oldest and largest home furnishing center.

Mr. Blackledge has served as the regional tax advisory chair to the SBA Office of Advocacy and has chaired the U.S. Chamber of Commerce Small Business Council on Tax Policy; and I know from his work in Oregon, an avid proponent of simplification of tax law across the spectrum.

Mr. Blackledge.

STATEMENT OF ERIC BLACKLEDGE

Mr. BLACKLEDGE. Thank you, Chairman Schrader and Ranking Member Buchanan, for inviting me to talk today about simplification of the Tax Code.

There have been many suggestions to simplify the tax system by completely changing our tax structure to a consumption tax, a value-added tax or a flat income-based tax, but the potential negative economic impacts of the transition make such a major systemic change unlikely in the near future. I will therefore limit my comments to eight key principles for good tax legislation that could make the current tax system simpler and easier for small businesses and all taxpayers to comply with.

I will also suggest priorities for legislation that implements these principles. The details for each proposal are included in my written testimony. Many of these proposals have been supported by Committee members and the Congress in the past, and I hope you will continue to support their passage in this Congress.

Principle number one is to remove outdated and unnecessary recordkeeping burdens that don't significantly impact tax revenues. The top priority would be removal of the outdated ″listed property″ recordkeeping requirements and deduction limiting on business cell phones and computers.

Principle number two, periodically update all dollar limitations and rate break points in the Tax Code by a single and standardized inflation factor. This could be done with a one-time adjustment for inflation that has occurred since each provision's adoption or last change, and the addition of a standard inflation adjustment provision for all dollar limits in the Code that do not have a greater specific adjustment. Examples of this with provisions needing modernization are the badly outdated $25 business gift limitation and the very poorly written luxury automobile depreciation limitation.

Principle number three, as much as possible, take tax considerations out of the issues involved in choosing a business entity by applying the same equitable rules and offering comparable tax advantages to all forms of business organization. A top priority is the equal and simple deductibility of group health insurance for all small businesses at the entity level. Another priority would be removing the inequitable limitations on small businesses other than C Corporations offering a cafeteria benefit plan to their employees. And a third priority would be to correct the inequitable impact for the personal alternative minimum tax on the business income of pass-through entities such as S Corporations and partnerships which are impacted at a much lower level than is true of C Corporations.

Principle number four, do not create new tax expenditure benefits and then take them away from any taxpayers through complicated phaseouts, limitations, adjustments, recapture or a lack of matching exemptions in the alternative minimum tax provisions. A prime example is the ineffectiveness now of Section 1202 small business stock, which is largely negated by the AMT impact.

Principle five, reduce cost recovery periods and complex recordkeeping for all small business equipment purchases and facility improvements. Keep the current section 179 small business expensing provisions, which are a key factor in helping small businesses survive and grow, but recognize that the changing needs of small businesses now would call for the inclusion of nonstructural real property improvements under Section 179 property.

Principle number six, provide alternative simple provisions in the Tax Code that provide equitable tax deduction benefits to small businesses without excessive administrative requirements and costs that often become a barrier to small businesses using a tax benefit. A high priority would be passage, as has been mentioned, of a simple home office deduction and a change of the outdated and unrealistic requirements for physical customer presence and exclusive use that prevents most small businesses from deducting their home office.

Principle number seven, reduce the burden on taxpayers to create complex legal arrangements to preserve family businesses for their children. It is important this year that we finally enact the provisions in the recent budget reconciliation for a permanent unified gift and estate tax exclusion of $3.5 million per individual and a maximum tax rate of 45 percent, while still maintaining the current Code provisions intended to help family farms and businesses survive generation transfers.

Principle number eight, and perhaps the most important one, is that it is important for Congress to regularly evaluate the actual impacts of the tax system and the financial and regulatory environment on the ability of small businesses to succeed and grow. The Congress and administration should seek broad-based input from small businesses about the problems that they face and the ideas they can develop for improving the small business economy by authorizing a National Small Business Summit on Economic Recovery for 2010.

If we are going to rebuild a growing and sustainable economy, government needs to better understand and address the unique

needs of the small business community, particularly in the area of taxation and regulation.

This year marks the beginning of a new presidency, with many new leaders in the administration and in Federal agencies and in the Congress. For these leaders to be effective in helping rebuild the small business economy, they need to better understand its needs. Yet it has been over 14 years since the Federal Government last sought broad-based and balanced input on the problems affecting small businesses through the 1995 White House Conference on Small Business.

To implement a restart of this summit process, I ask that the House Small Business Committee add a provision to an SBA reauthorization bill matching the provision that currently exists in the Senate reauthorization bill which would authorize a National Small Business Summit on Economic Recovery in 2010.

Thank you very much, and I would be happy to answer any questions later.

Chairman SCHRADER. Very good. Thank you, Mr. Blackledge.

[The statement of Mr. Blackledge is included in the appendix at page 36.]

Chairman SCHRADER. Well, our next witness is no stranger to this body, Mr. Keith Hall. He serves as a National Tax Advisor for the National Association for the Self-Employed.

As owner of his own accounting firm, Mr. Hall has been involved in providing consulting and tax services to small businesses for the last 10 years. The National Association for the Self-Employed was founded in 1981 and represents hundreds of thousands of entrepreneurs and micro businesses.

We welcome you to the hearing.

STATEMENT OF KEITH HALL

Mr. HALL. Thank you. Mr. Chairman, Ranking Member Buchanan, members of the Committee, thank you so much for holding this hearing and mostly thank you for the chance to be here myself.

Again, my name is Keith Hall; and I am a small business owner. I have a small accounting practice in Dallas. I am here on behalf of myself but also on behalf of the National Association for the Self-Employed, which represents 250,000 members and over 500,000 workers.

These are micro business owners from all 50 States, all ages, all races, all sexes, any other demographic that you want to name. But all of them have one thing in common. They all struggle with their tax return. Most don't like to do their tax return, but they know they have to deal with it. Everyone does.

The IRS is the one government agency that all micro business owners must deal with at some level; and, quite frankly, most of them are a bit intimidated, maybe even a little bit scared of the big bad IRS. That is not because the IRS intends to be intimidating or scary but because the Code is so complicated. I understand there are three times as many words in the Internal Revenue Code as there are in the Bible. There are not a lot of books out there that are longer or more pervasive than the Bible, but apparently the Internal Revenue Code is one of those.

Again, the fear is not because of the IRS itself but because of the Code.

I feel that the IRS has done a great job in helping small businesses with their Web site, with access to education. They have done a lot of good things to help us, and they have been successful. But still the IRS—

Ranking Member Buchanan mentioned that there is 37 hours to fill out a 1040, but the IRS says that it takes 57 hours to fill out a Schedule C with a 1040. For a small business owner, that is over one workweek. That is roughly 2 percent of their work year. That doesn't sound like a lot. But if we could all have a 2 percent growth in our 401(k) plan or 2 percent growth in the economy, we would be really happy with that. So that is a big chunk of their work.

Now, in my opinion, the answer is pretty simple. But, apparently, simple can be complicated, which is also complicated. For micro business owners, simplifying the Code is the right answer for them in growing their business. But it is also the answer for the tax gap as well, $353 billion in taxes that should be paid that aren't. I believe a big chunk of that is because people just don't know how to do the taxes the way they should.

I believe most people want to do the right thing and will do the right thing. They just don't know which line to put the right thing on, and I think that is where simplifying the Tax Code comes into play.

Now, everybody recognizes that. I think the administration has a new tax force working on tax simplification. We are here today meeting for it. So I think we are heading in the right direction, and I believe we are on the right track.

There are three bills right now that you guys are working on: One, H.R. 946, the Plain Language Act. Its sole purpose is to simplify language in all government forms and publications. We strongly support that bill. Just making the forms easier to read will be a good first step.

Second is H.R. 1562, as Chairman Schrader had mentioned. That is the Home Office Deduction Simplification Act. It basically provides a $1,500 standard home office deduction.

Ranking Member Buchanan also mentioned that only a handful of people who qualify for the home office deduction actually take the home office deduction. Now, the very purpose of that rule is to make the playing field level, because big businesses clearly deduct their facility expense. But some of the small guys don't just because it is so complicated.

Again, on that form, the home office deduction form, 14 different times appears the phrase ″see instructions″. That is very difficult.

Now the NASE has done a survey with its members back in 2008. You mentioned only a handful of people claim the deduction. Of the people who qualify for the home office deduction, only 27 percent actually take the deduction, and that is because it is so complicated. That is just not fair.

A third bill is H.R. 1470, which is Tax Equity for Our Nation's Self-Employed Act; and that basically just moves the self-employed health insurance deduction over to Schedule C. Mr. Blackledge mentioned that, taking the deduction at the entity level. That just

levels the playing field and removes a significant complexity in the Tax Code.

The last thing I will mention is we need some continued work, I believe, and the NASE supports a continued clarification on the definition of independent contractors. Lots of small businesses really struggle with whether they have an employee or have an independent contractor. There is a 20-point checklist that the IRS gives us. Each of those points is very difficult. Even if you answer all 20 of those questions, you are still not sure you get to the right answer. So additional work on that clarification would be very useful.

Again, thank you very much for everything you guys do; and thanks for the chance to be here.

Chairman SCHRADER. Thank you much, Mr. Hall. Good testimony again.

[The statement of Mr. Hall is included in the appendix at page 52.]

Chairman SCHRADER. For our last witness, I will defer to Ranking Member Buchanan to introduce him.

Mr. BUCHANAN. Thank you, Mr. Chairman.

It is a pleasure—we have a gentleman from one of our local firms, a constituent in my district, Stan Stathis to the Committee today. We appreciate you coming.

He is a certified public accountant with CPA Associates in Bradenton, Florida. They are one of the larger regional firms in the area, highly regarded and respected certified financial planner. He also does a lot of personal financial planning, specialist in terms of small business, an expert in financial planning and consulting. He does all different types of small businesses and some larger businesses, including construction, manufacturing, real estate, medical, legal, and agriculture.

I want to welcome you today to the Subcommittee and look forward to hearing your testimony.

STATEMENT OF STAM STATHIS

Mr. STATHIS. Thank you, Ranking Member Buchanan and Chairman Schrader and Committee members.

Name my is Stan Stathis. As you heard, I am a partner in the firm of CPA Associates located in Bradenton, Florida. It is my honor and pleasure to come before you today to testify.

During the span of my career, I have gone from posting manual books to the computer age. As you have heard, you have many thousands of pages in the Internal Revenue Code. When I first started, we had two small books. We could carry the entire Internal Revenue Code basically around in our hand. The regulations were three separate books. So you literally could walk in and place on your table a stack of books about this high.

I have no idea how large that would be now. I don't want to know. I have it on my computer, and I can access it in a much more expedient manner.

You would think that with the advent of the computer age that you could have more quickly and accurately prepared information. The problem that we have found is that you are only as good—the information is only as good as the people who input the information. So that if you put a lot of garbage in, you get a lot of garbage

out; and you just produced a very easily readable piece of garbage. So we have had a large change in the way we report information, but we don't have the knowledge that has gone along with it.

I spend hundreds of hours every year reading material just to keep abreast of the current tax law and trying to understand currently what is going on; and it is darn well near impossible for me, let alone a small business owner, to be able to keep up and not run afoul of the Tax Code.

So what have they done? With the added complexity of preparing an accurate tax return, many small business owners have either been forced to hire a competent professional to aid them in preparing their tax return, at considerable expense, I might add, or go it on their own and hope they don't prepare a return with too many inaccuracies.

However, incorrect preparation of tax returns is not the only risk the business owner faces. The Internal Revenue Code as currently written has very complex and in some cases arcane rules for the uninformed small business owner.

If there is one thing I want you to take away from what I am going to talk about on some of these issues is that if you could sit in my seat and feel the anger and frustration from the small business owner and the anger at how much they have to pay me a lot of times to come in and fix things to make sure that they are not running afoul of the Internal Revenue Code, If you could do that, this Code would be changed tomorrow. It is just way too complex, and it has way too many rules.

I have identified 13 different areas in my testimony that I thought were pertinent; and we will start with the first one, which was choice of entity.

Choice of entity, what you have there is you have LLCs, you have corporations, you have S Corporations. One of the things we could do there is even out the playing field on what the benefits are to make sure that we have more consistency. One of the things you would also like to do is allow partners and sole proprietors to participate in the system so they could pay their taxes on a regular basis.

Capital formation, as you heard, most owners plow their money right back into the business. They don't understand how come they owe so much in taxes, and that is because they are putting their money back into the business.

Shareholder health insurance for deduction on the return. It is passed out for S Corporations, and it is deductible in a full corporation, and then you have sole proprietor rules. These things should be evened back and put into the business. We don't need to just change paper here on things like that.

Shareholder loans to an S Corporation, they need to be part of basis for losses.

Inadvertent S Corporation terminations, we need have much more relaxed rules in being able to maintain your S Corporation.

Listed property record keeping is way too onerous for most people. I mean, the cell phone, I understand we had bills introduced a number of times to get that corrected.

We have automobile records that have been mentioned, business gifts and promotion, home office deductions. I could go on hours

about that. Unless you get rid of the exclusivity of use provision in there, you are going to have problems.

Fiscal year flexibility to go to other than a counter year, fixed asset addition, retirement plans, they all need reform to be equalized among the different kinds of entities.

I would also like to say my spouse is a small business owner, and I spend hours preparing her own tax return, which is included in ours. It is a Schedule C, and it is difficult to do every year. And I have her maintain automobile records, and I have had her tell me that other attorneys laugh at her when they see her out in the car writing down the mileage. Because I won't go without having those records kept on a contemporaneous basis.

So it is very difficult for a small business to keep those kind of records; and if anybody has any question, I would be more than happy to answer them. Thank you.

Chairman SCHRADER. Thank you very much, Mr. Stathis. Excellent testimony.

[The statement of Mr. Stathis is included in the appendix at page 59.]

Chairman SCHRADER. Let us move into some questions of our witnesses, and I guess I will start off.

Let us start with Mr. Blackledge. You have referenced the National Small Business Summit. Could you elaborate on that? And is there any precedence for that before?

Mr. BLACKLEDGE. Yes, actually, there have been three small business—they were called White House Conferences on Small Business in the past, the last one being in 1995. But it has been 14 years now since that last summit, and a lot has changed for the world of small business in that time. The Tax Code has changed. The regulatory environment has changed.

What is particularly important now is that the world of the economy has changed with the result of our current recession. Businesses are radically impacted by the recession. Many of them are failing, and there are many things that government could do and has been trying to do to help small businesses. But, at the moment, it is flying blind, because it doesn't really understand what is happening in the small business community and isn't getting as much input directly from small businesses as it could.

That would be the purpose of a White House Small Business Summit on Economic Recovery, would be to let small businesses actually, just as we are today, talk to the Congress, talk to the administration, talk to Federal administrators and the agencies about what needs to be done to help small business. It would allow the Congress to spend the money that it spends to assist small business more wisely and would also certainly improve the small business economy.

Chairman SCHRADER. Thank you.

Mr. Hall, your organization represents millions of home-based businesses. In your view—could you elaborate a little bit more? You testified on it somewhat already. Why they are not taking this home office deduction? How complicated is that, really?

Mr. HALL. I think it is very complicated.

Again, the form itself has—I think I mentioned in my testimony has "see instructions" 14 different times. There is a publication,

Publication 957, that is designed to help complete one form. So there is an entire publication that you can read. I think the publication is 57 pages. That 57 pages goes along with the one-page form. So I think it is very complicated.

I think there is also this fear of the IRS that I talked about as well. There is this—I heard at the library or heard at the water cooler that if I take the home office deduction there is a better chance I am going to get audited. So it is that fear of not putting the right thing on the right line that just becomes more and more cumbersome, and they choose to just forego the deduction. And I think that clearly is not what the intent of the Internal Revenue Code was for, nor was that deduction to discourage taking that deduction. It was designed to recognize their facility's expenses there at their house and should be recognized on their tax return.

I think that is the best thing about the standard deduction. You know, let the scoring work out so that it can be revenue neutral. If $1,500 is not the right number, $1,400 might be the right number. But whatever number should recognize the cost of operating a business out of that office in the home. There ought to be a deduction for that.

Chairman SCHRADER. So Congressman McHugh and I have introduced that simplification act, H.R. 1509. Would you hazard a guess as to how many more small businesses might take advantage of the home office deduction if that bill is enacted?

Mr. HALL. It would be difficult to say, but, depending on which paper you read, there are 20 million small businesses out there. I think that the IRS estimates there will be 23 million tax returns with a Schedule C attached to it. If only 27 percent of those, which is what the NASE survey indicates, only a fourth of those people actually take the home office deduction, just using those numbers there, that is another 15 million small business owners out there that would benefit from that bill and that standard deduction.

Chairman SCHRADER. I appreciate the comments on the tax neutrality, too. That is very, very good.

Ms. Ryan—Chin Ryan. I will get it correct. Sorry, Christine—the Tax Code is pretty darn complex. You alluded to having professionals prepare tax returns. A lot of small business folks can hardly do that on their own. What has been your experience since you have been in business starting and now at this point in time and where do you think we need to be heading for many small businessmen and women?

Mr. BLACKLEDGE. When I first started, I knew infrastructure was very important, so I hired a consultant to help me with my financials. So that has enabled me to set everything in place that I currently use now.

I used to be an 8(a) firm through SBA, so I had four different entities to account for in my accounting system, not only through the SBA but also through the IRS and Federal Government contracts. There are some allowable and unallowable costs. And then my banks for a credit line, which was required for an 8(a) firm, for my 8(a) application is when I get a contract, how will I be able to meet payroll and expenses before I get my first payment.

So I had all these different entities to report to, especially the Federal Government, what was not allowed as expenses or not. So

I pretty much had to have infrastructure. So I hired a consultant, and through the SBA also they have had consultants to help me. So, fortunately, I had help and I had the vision to know that infrastructure is very important. But it does cost me.

I at one point had 31 employees in the 1990s through the tech boom, and I needed that infrastructure. So I have also been audited by the IRS because they thought I was a professional services corporation, therefore, higher tax bracket. I passed with flying colors. I have been audited by the Federal Government internal audit group, passed with flying colors. So, fortunately, I have no issues. Every penny is accounted for.

But as Chair of the Governor's Small Business Council and the Oregon Small Business Responsible Leadership, many small businesses around the State don't have the advantages I did, do not really understand that infrastructure is very important.

I have had friends who started businesses that really couldn't even go to the banks for loans because their financials were not in order, and it is because a lot of them really didn't graduate with an MBA. They are entrepreneurs. They had the creativity. They were either technical folks that started the business. And, like many of us, we learned the hard way; and we then, of course—what you hear a lot—we started loaning ourselves money to start the business.

So I think that is the majority, small businesses out there. Even though it has improved, there is a lot—at least in Oregon, there is a lot of free consultations that are very inexpensive through the SBDCs and through the targeted service providers and so on in the community colleges. But there are still a lot out there that do not know these services are available and do start off on a shoestring.

Thank you.

Chairman SCHRADER. Thank you very much.

I was one of those 30 years ago when I did my own taxes and started my own business, because I felt I could do that. I hazard to guess, as a budding veterinarian coming out of veterinarian college right now, I would not be starting my own business in large part because of some of the rules and regulations we now have upon us that are so onerous.

I am going to switch over to Ranking Member Buchanan and let him ask some questions.

Mr. BUCHANAN. Thank you, Mr. Chairman.

Ms. Chin Ryan, let me ask you, Mr. Stathis said something about people being angry and upset, a lot of small business, that passion about taxes being as complex as they seem to be or they are. What is your sense of that, I mean, when you are dealing with a lot of different small business people?

Ms. CHIN RYAN. First, as myself, when I first started and my accountant and the CPA tried to explain to me some of the accounting rules, I pretty much told them that this is not for me, it is way over my head, and whatever you say is fine with me. You just give me direction.

So I still remember that from almost 20 years ago, and I think small businesses feel the same way. I don't think anything has changed. And I just think it is too complicated. I gave some examples with solutions.

By the way, one of my steering committee members was a CPA that helped me prepare my testimony, and he could have gone on and on and on, and I just said, let us hold it. So it is still very complicated. I just think it needs to be simplified in all aspects. I don't think it has really gotten any better.

I don't know if I answered your question.

Mr. BUCHANAN. Yeah. The other thing that—the chairman and I were having lunch yesterday, talking about different things. But, you know, you look at, of course, States like Oregon, a great State, California. But now—this is a little off of tax simplification, but it is one of my big passions.

As we are looking at taxes being 39 percent or so, 40 percent Federal, a State like Oregon—California I know is 10 plus percent, maybe as high as 15. So if someone starts out, takes the risk, puts up their house, all these—your personal guarantees, where is the incentive anymore for someone to do all this? Then they have got to pay property taxes and all—assuming you have got property taxes now—other taxes on top of that.

And it is one thing if you are making less than 100, but I know people that end up being when they become successful, they start making 3 or 4 or 500. They need that capital to reinvest for jobs. And that is the big thing I think we need today for small business.

What is the sentiment out there, just out of curiosity? Someone said when they get successful and big, they move to another State or something. But what do you sense of that? Because a lot of that is pass-through income. Is that a factor or are people concerned about that?

It is one thing when we were at 33 and now we are at 40, 39. Now you add 13, 12 on top of that. Where is the incentive to take the risk and all the personal guarantees and everything? I think it is going completely in the wrong direction. I really feel like it hurts small business. But that is just my opinion.

Ms. CHIN RYAN. I think most small businesses that are what you call true entrepreneurs that start up that do not have the formal education like an MBA, I don't think they think about that. I certainly didn't. And we go into it because it is a chance to be your own boss, be creative, make decisions based on what you think is right or good for the company. And I think we think about that first, less about the negative aspects of your businesses.

Personally, I felt after about 10, 15 years, I still had the—how do you say—the spirit of being a business owner. Now that wears you down as time goes by. But I—you just don't think about it. When you started—and most of us were younger then—you are fearless. You are going to succeed. You have that mentality. Until it really hits you, that is when you start being mature and seeing what the responsibilities are and the decisions that you have to make.

So I don't really see a lot of that changing, except for those who have gone on to higher education and who have, like you say, MBAs, who have formal training in marketing plans, business plans that can then take it to more of a structured type of approach, which is a little different than lot of the entrepreneurs that start off based on passion.

Mr. BUCHANAN. I think you are right on that. Probably especially at startup, you are not thinking about that. You are thinking about surviving.

Mr. Blackledge, your company is in Oregon, a more mature, generational family business, I assume. Does that affect businesses that are out there that are more mature and starting to make some money? Is that a big issue or not?

Mr. BLACKLEDGE. Clearly, it does. Frustration with the level of taxation is obviously an issue.

In Oregon, we have a problem with that, just as you have in Florida. The State right next to us has no income tax. And one of the problems that we encounter in Oregon since Oregon has adopted—although at the moment we are disconnected from the Federal Tax Code. We normally follow the Federal Tax Code. As a result, a lot of businesses who are successful leave the State of Oregon, unfortunately, and move to Washington to escape that high level. We have about a 9 percent income tax rate in the State of Oregon. So the level of taxation is important.

But one of the other issues that Ms. Ryan was talking about, that is, the frustration of small businesses is important, too. When you go back to the tax gap, some of it results from just the complexity of the Code and the fact that businesses just can't completely comply with it. Even IRS staff people designed to help taxpayers fail 25 percent of the time to get the right answer to tax questions based on GAO audits.

But some of it also is just frustration with the Tax Code in the sense that when the Code becomes so outdated and illogical, issues like having to report cell phone use and computer use, for example, when businesses know that there is no additional cost for the personal use of it, or the outdated limitations on many of the deductions, businesses have a tendency to rebel.

Business people are very practical people; and when the Tax Code gets so out of sync with the reality of the world today, business people rebel and sometimes fail to properly pay the taxes as they should. And, unfortunately, even though those items may be forgivable, once that process starts, it gets much easier for them to make the next decision not to comply with the Tax Code and the next one after that. So it is really important that Congress keep the Tax Code fair and logical.

Mr. BUCHANAN. Thank you.

Mr. Hall, the self-employed, did you say how many folks are in that group?

Mr. HALL. Two hundred and fifty thousand members, about half a million workers.

Mr. BUCHANAN. And you brought up a lot of different things, but if you distill it down to one or two of the top things we could do in terms of simplifying the Tax Code, what would they be? And I am sure there are 10 things, but if you were to say one, two, or three or something like that just off the top—

Mr. HALL. One, because the bill is pending, which is the home office deduction, I think that makes a big difference. That makes an immediate help.

Maybe the more pervasive of the issues I talked about was clarification of the worker status, independent contractor versus employee, and what we were just talking about here.

Back in the day, I started my career with Peat Marwick, which is a giant accounting firm. And I have been through a lot of Presidential elections and congressional elections and everybody always talks about creating jobs. And I know when I decided to start my accounting practice, I was thinking about that. A little bit naive again. We won't talk about how long ago that was. But about creating jobs.

And my firm supports four families. There are four jobs that I created, and I am very proud of that, and I think that is the incentive to start businesses. And I think that back in the day that was always the incentive to start business.

That has changed a little bit. Back in March, I did a tax seminar in connection with the SBA's Small Business Development Centers; and I spoke to 62 small businesses. And during that seminar, we would ask a question and there were 16 of those 62 that had just started their new business within the last 30 days. And most of those had started that business not because they wanted to go out and create a job or because they had a great idea. It is because they had been laid off.

And they didn't choose self-employment. They became self-employed, and they spent a day with me trying to figure out how to run their business and not let the Tax Code get in the way of them creating jobs. And not knowing the difference between an employee or an independent contractor, my real fear for that complexity is that they choose not to hire the person. And choosing not to hire the person when you have the economic base to create a job, if you choose not to create a job just because the Tax Code is complicated, now we truly have cost all of us money based on just that choice. So that would be very important.

Mr. BUCHANAN. The sense is today—and I want to pick up one point—is that a lot of these kids are coming out of some of the top schools, there is not job opportunities, so they will probably have the next guy, the next Microsoft and all that. You are going to see a lot of people—but we have got to make sure we have incentives for the people willing to take the risks, create the jobs, go out and guarantee notes.

Because a lot of these businesses—I have seen the U.S. Chamber put out 20 years ago, 100 people go in business; in 5 years, there is only 90 that are—there is only 10 left or 8 left. So they are taking big risks to create jobs to help move the economy forward.

Let me just—Mr. Stathis, one of the things that in tax simplification also got mentioned was fairness. I know like in our businesses or friends that have businesses, they will have a building or something and they write the building off 39 years. But the CPAs will come and say, look, you can take component depreciation, take it over 5, but that is going to cost you 5 grand. It is more complicated. You have got to get involved. But the small businessperson that is starting out can't afford that.

But yet if you don't have the documentation—so I am just thinking about things like that, again, where small businesses don't have the same advantage. These are not loopholes. They are just

legal. But because they don't have the lawyers and the CPAs, they can't have the same advantages as businesses a little bit larger.

What is your thought on that?

Mr. STATHIS. What you are talking about is a cost segregation study that is done on a building and its components in order to write it off over a shorter period of time; and, hopefully, we usually show that you save the money in income taxes to pay for it. The small business owner who is uninformed who goes into business and doesn't get the proper advice will not be able to take advantage of those things.

When I deal with most small business people, they are risk takers. I once had a very wealthy individual sit down with me; and he said, you could never do what I do, and I could never do what you do. And I asked him why. And he said, you are a wage slave. You take wages. You don't want to take the risk of not having a paycheck.

Well, I do take that risk now with owning my business. But at the time I was just a salaried employee.

He, on the other hand, said he could lose everything every day. He was always rolling the dice. He was always taking risks. And that is what made him an entrepreneur.

And the older I have gotten, the more I have gotten to appreciate that, that small business owners will cut corners. They will be ignorant of the law. One of the sayings in our office is ignorance is cheap. Because if you know what the law is and you have got to comply with it, you have to spend the hours and time and get it right. Because if you don't and you get caught, then you have a problem. And that is what most people hire like a CPA for or another financial advisor that is helping them with their business, is to keep them from running afoul of these arcane rules is what I want to call them.

Going back to the home and the office deduction, I have a former agent in my office; and he said a home in the office deduction is like taking candy from the baby. Very few people are able to actually meet all the rules that are in place in order to have a home office deduction. And the fear of that that has been permeated through the public is why it is not taken. Because most people feel that it is an audit flag. And it is an audit flag. Just plain and simple, it is an audit flag. You put it on your return, and chances are you are going to have an audit.

And it should be legitimate business reasons to have it, and you shouldn't have to have exclusive use of that for business use. I mean, you use your business 8 hours a day. Sometimes, like I am in there maybe 15, 17 hours. But why should you have to maintain that office for 24 hours as an office in your home?

I mean, people can't afford to have all that space go to waste. So if they keep storing personal items in there, that would be a reason to disallow it as an office if you have got personal items stored in there.

I have known people that have legitimate reasons for having home office businesses, and in our society today many people are employed at home. That is where they work. You talk to them, and they are at home. That is where they are. That is where their busi-

ness is located. And I have even seen some of those not take the deduction.

So when you are looking at the small business owner and what they have to comply with as far as regulations are concerned, most of them are going to take the risk and say, I am not going to know what that law is and I am just going to go ahead; and if I get caught, then I will work on it. And it is a shame that they get put in that position, and they shouldn't be put that position. They should be able to simply understand what the law is and simply comply with it.

Mr. BUCHANAN. Can you expound just a little bit more on the frustration and anger? What are the top one or two things you see—because you guys deal with a lot of small businesses—in terms of tax simplification that outrages people the most in the small business community that—over the last 5 or 10 years or whatever? I know there is probably a lot, but can you distill it down to two or three that really come to mind for you?

Mr. STATHIS. I will give you the major one. The major one is that they come in and they look down at the return and they go, I made how much and I owe how much? They are incredulous at the number. Because they go, I didn't take that home. They equate income with cash. Okay? So if they don't have the cash, they didn't make it.

And if you are sitting there and you are looking at a K-1 say from your business and it says you made half a million dollars, well, $350,000 went back into the inventory, went back to pay debts, went to purchase other pieces of equipment. And then by the time you pay taxes on the other $150,000, you are back down to where you are making a hundred. If you are paying State taxes, it is even lower. So it much less than you really think.

People that are entrepreneurs are always constantly taking that money and putting it back into their business. So they get very angry and frustrated when they are saying, where am I going to come up with this money? I don't have it. It is in the business. So then they are put in a position where they have to go borrow money to pay the taxes, and that gets them frustrated.

The second part that I see a lot of anger with is Social Security tax. You can actually have a profit on a Schedule C, have no taxes, no income taxes, yet have substantial taxes for self-employment tax; and that is very hard to explain also to individuals, alternative minimum tax.

That one, when that pops on there and I am going down my sheet in explaining it to them, well, this is the alternative minimum tax. What is that? Well, what the government giveth the government taketh away. So you get a deduction here, but because you got too many deductions now we are put in a position to have to pay taxes for that. So you actually lost that for this year.

That is another one that really just rankles them immensely. Probably when I sit there and explain to them that they can't take a deduction for something that they think is a legitimate deduction, they get angry at that.

Gifts are an item. Currently, when I sit there and say—they come in and say, well, I want to give some Christmas gifts out to some of my friends that are referral sources to my business; and

I tell them, well, you are limited to $25. And they go $25? You can't buy anything for $25. What am I supposed to give them, movie tickets?

Really, you should be looking at what the promotional value of those items are. Because, really, you are promoting your business. You are promoting yourself. You are promoting being able to get more business from them. And that should be a legitimate expense. I don't advocate giving away lavish gifts, but there should be the ability there to do that. And you have a hard time explaining that.

I think that probably the other thing is when I start getting into record keeping, talk about cell phones, cell phone usage, personal use, it is de minimis. It has no business being listed property.

Telling them they have to keep records for their automobile log, and I am calling them on the phone, what was your beginning mileage, what was your ending mileage, you know, how much was business, how much was personal. When I start going into that and they go, I don't know. You got that last year. My bookkeeper has it.

And that is another point that should be brought up. When you are in a large business, it is very easy to maintain the proper records because you have an accounting department. You have people that are responsible for saying, hey, give me those expense slips, give me your records. And there is a real threat of not getting your money back because you are an employee in the business and you don't get paid if you don't give them the proper records.

But when you are the owner and you look at yourself, yeah, give me the records and you stick your head around the other corner, no, sir, what are you going to do? Fire yourself? It is not going to help. And the self-discipline part is there.

And then when they come in and they are talking to me and I say, we have to have this. My other accountant didn't want that. Why do you need it? I say, well, I am trying to keep you out of trouble.

And so it really gets down to—like I said, ignorance can be cheap. Because if you don't require certain things, it is more expensive. Because then I have to spend the time chasing this stuff down and making sure they are in compliance.

Mr. BUCHANAN. One thing you are saying is that as a CPA you also have to have a little expertise in anger management?

Mr. STATHIS. Yes, sir.

Mr. BUCHANAN. I yield back. Thank you.

Chairman SCHRADER. Thank you. Good discussion.

Well, let us recognize the gentlelady from Arizona, Mrs. Kirkpatrick.

Mrs. KIRKPATRICK. Thank you, Chairman Schrader. Excellent panel, excellent.

Chairman, like you, I established my own law firm, and so I went through the business formation myself, and I was a managing partner. So I have dealt with all of these issues. I understand.

But also part of my law practice was advising clients on business formation, and it is so difficult when you are comparing the various entities to really come up with a clear picture of what is best.

I also found out—I practiced in a small town—that it was hard to find bookkeepers and that the level of advice from accountants

varied and not—and they were all competent, but it is just that it is hard to understand the Tax Code. So you talk about these provisions, but interpretation can vary.

I have three questions. The first one is about retirement plans. We haven't really talked about that. And of course that is part of what you look at in setting up the small business. I think the last time I counted there were more than 20 IRA plans to consider.

So I guess my question is for the entire panel. If you could just maybe touch on your thoughts about what we could do to help small businesses with retirement planning. Maybe, Mr. Stathis, start with you.

Mr. STATHIS. Well, you know, the major thing that you see with retirement plans is a structure that they are set up for in order to get various benefits back to the owner. We went from a period of time back in the late 1970s and early 1980s when we had very complex plans being written in order to skew benefits to the owner, and we went to very simple plans and we did away with a lot of the skewing that went on. And now we are going back again the other way, where there is a lot of complexities that are involved.

The cost of maintaining these different plans is horrendous for the small business owner. A lot of small business owners will get talked into putting in plans, and they will drop them after a couple of year, simply because it costs so much to maintain them. Not only for the benefits that are going to the employee but also the benefits that they are not getting because they are putting the cash into there and they are having to maintain them and do tax returns.

There needs to be a lot fewer plans, and they need to be more level across the playing field as to the benefits that are available to not only the employee but to the owner. So I would say that when you are looking at plans, the fewer, the better.

And I know my actuarial friends are going to be screaming at me for that. But, really, they are way out of control; and it is hard to explain them. I am not an expert in them. I don't pretend to. When a client of mine wants to go that way, I go and send them to people that are experts in that arena. But, really, it is just—I think personally it is out of hand.

Mrs. KIRKPATRICK. Any other thoughts?

Mr. HALL. I know we are supposed to be simplifying things today, so I am going to take the opposite opinion.

Part of the difference, though, with the NASE, we have so many micro business owners, mom and pop shops. I think the retirement plan options is a prototype for simplification that the IRS and Congress have done a great job with over the last 4 or 5 years.

Because, just taking one example, self-employed pension plans, SEP accounts, are as easy to set up as opening a bank account. If you know where your Edward Jones office is or your Charles Schwab office is, you walk in there, fill out a form, give them a check, and you have a plan.

The key for retirement planning for most small business owners is that they do it. Pick something and do it. So I do agree that the more plans you have, 20 different IRAs, it is cumbersome, it is complicated, lots of options. But, in this case, part of what the plan should be is to just make sure you do something. Pick it and then do it every year.

Because we can talk about the Social Security system, we can talk about whether it is going to be available for us or even for our kids, and that is very scary. But, regardless of what happens, what is funded, what is unfunded, if we can encourage people to put money aside for their own future, that is exactly what we should do. So the SEP plans, the IRA plans for the smallest businesses I think are outstanding.

I think when you get to bigger businesses with lots of employees and you have pension calculations and guaranteed funded amounts and unfunded amounts and possibilities of losing your qualified status, those things become very complicated. I think it is fortunate that the more complicated the plans are, typically the companies are bigger, and those are the ones who do have the accounting departments and the resources that perhaps maybe that cost is allocated appropriately.

But what I would hate to see happen is take away some of those options like the SEP plans that are available to the micro business owners, because that is the way they are investing in their own retirement today, And I like that part.

Mrs. KIRKPATRICK. In the interest of not consuming too much time, let me go to my other question. Thank you, Mr. Chairman.

And, Mr. Blackledge, I will ask you this. There is a requirement that the small business show that it is a going concern, and I am concerned about that right now with our economy. And I just would like your thoughts about should we address that as well.

Mr. BLACKLEDGE. You are talking about the hobby business rules?

Mrs. KIRKPATRICK. Yes.

Mr. BLACKLEDGE. I think that is an ongoing issue, one that IRS has tried over the years to try and define. But, unfortunately, it is a very complex area for adjudicating whether or not it truly is a small business effort or not. And it is more complicated now because the economy has made many businesses that might have been successful, might have been generating revenue over the short period of time required for the analysis but, unfortunately, because of the economy, they are simply not able to.

I think that is something that can be handled. I think the IRS is moving—in fact, I have seen some things in the IRS publications that they are trying to take a little more understanding look at that. And I suspect you will see they will be pushing that issue less this year internally because they understand the nature of the economy.

I want to raise one other point in terms of your first question. That, too, a lot of the complexity comes from the fact that we are connecting together things that people do as individuals. In this case, you are talking retirement plans, but the same analogy applies to health care. Those are things that really impact an individual. And the kind of business they work for shouldn't necessarily determine what options an individual has to have a retirement plan or to have tax-subsidized medical care; and for passthrough entities, which most small businesses are, that greatly complicates the tax structure. And it also forces on us a lot of decisions we don't want to make about what kind of retirement plan to offer our people or what kind of health care plan.

And because small businesses are inherently small and we have very few people to spread the administrative cost over, there also is a very high administration cost which makes us uncompetitive with the large businesses. So as much as possible, simplification could be disconnecting those things from the business and applying things such as health care deductibility and retirement plans at the individual level where they really belong.

Mrs. KIRKPATRICK. Thank you.

My last question is for Ms. Chin. Thank you.

Do you see incentives for savings in the current Tax Code for businesses? And let me explain this to you. We were an S Corporation, and I am a big saver. But every year the accountant would say, you need to zero out your balance. So we would start the first of the year with nothing in the bank, and that was really difficult. And I just wondered if you have had that same experience, if you think we should put incentives for savings into the Tax Code.

Ms. CHIN RYAN. Well, actually, Oregon is trying to do that right now at the State legislation, to deduct I think $1 or $2 from the employees. Right now, it is focused on employees for paid family leave, because, right now, it is unpaid. I don't know if it is going to pass or not. There are numerous issues.

Personally, I have had years where I have lost it because it was a decision whether to lay off an employee or keep them. And that really is the decision, whether you make a profit or not for me.

With my responsibility, I decided to keep them and have a loss. So you carry the losses over. And the years that I do have a profit, I have gladly paid. Because there are many years I don't pay the taxes because I carry over the losses.

So as far as the savings, I don't really—it is just business fluctuates. I don't really remember coming across that. This year, I will show a profit, and I will pay taxes.

But I do want to address very quickly the 401(k). I instituted a 401(k) in the first few years of my businesses, because I wanted to also put the maximum deductions. The rules have changed, where officers can only put 2 percent more than with the formula. I would like that to go back the way it was, because that really hindered my ability to actually put what I can in retirement. Because, as was mentioned before, small business owners, we invest back into the business. And that is what I have done. And so comparable to actually some of my employee, I have less in my 401(k).

It also is a very enticing employment benefit, especially in my industry which is high salaries and very excellent benefits, that I do have a match. And most financial planners say number one for retirement is 401(k) with employer matching. So I do offer all of that. I do entice my employees. I do try and have an employee-based type of company.

So it is one thing if you were to look at it as to, if possible, take out the limitations for officers. Because I would actually be pretty good off now for almost 20 years if I didn't have that limitation.

Mrs. KIRKPATRICK. Thank you.

Mr. Chairman, may I have the prerogative to go over my time?

Chairman SCHRADER. You are already over your time. A short statement might be acceptable.

Mrs. KIRKPATRICK. I just saw the other members shaking their heads about the incentives for savings; and I don't know, Mr. Blackledge, if you want—

Chairman SCHRADER. Very quick comment.

Mr. BLACKLEDGE. We also zero out our Triple A account every year. And I would agree that the nature of the IRS view of small businesses, particularly S Corporations, is that they should not be saving a lot. And I think some provisions in the Code to allow small businesses to accumulate more capital so they didn't have to constantly be borrowing from banks would certainly be beneficial. But it is a complex issue.

Mrs. KIRKPATRICK. Thank you, panel. Thank you, Chairman. Thank you very much.

Chairman SCHRADER. The Chair now recognizes the distinguished gentleman from Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

You know, the title of our discussion today is How the Complexity of the Tax Code Hinders Small Businesses. I would like to ask Mr. Hall, do you have any statistics on how many small businesses are deterred from even getting started as a result of the Tax Code or as a result of the complexity of trying to get started with all the different rules and regulations and besides taxes that—do you have any idea of that?

Mr. HALL. I, unfortunately, don't have any statistics on things that haven't happened, but that is very scary to me.

And back to my comment in Boston with that seminar, those 16 people who started small businesses, my concern is that there are lots of people out there who may also have been laid off or changed positions and may have an idea for a consulting service or a small business, even a manufacturing idea, something that they may have in another economic setting, may have chose to do that because the economy is down now, availability for credit is down now.

Maybe some of those things are not happening more today—this is strange—but they are not happening more today than they have never not happened before, and that is very concerning. Because, again, I think the ranking member had talked about 70 percent of all jobs come from small business; and every piece of discouragement to starting that small business is another discouragement for a new job. So although I don't have statistics on that, I would be afraid to know what that statistic is.

Mr. LUETKEMEYER. A lot of people think being the owner of your business is a really great thing. And it is. Whenever you start looking at all the problems that are associated with being a business owner, especially a small business owner, having to deal with the tax situation, getting an accountant, working with the insurance side of it, the financial side of it—then you have to deal with the employee side of it and the egos and the mismatch of all of the stuff. And then you wind up with trying to either produce or sell a product to the public on the whims of the public.

I mean, people think it is really neat to be a small business person. Just sit in their shoes for a little while, and I am sure all of you can empathize with that. As a small business owner myself, it is quite a chore.

But I was just curious if you had some statistics on how big a barrier the Tax Code actually was to people actually getting into this.

Along that line, then, I guess—at least my next question, what would be an alternative to the Code we have right now? We realize it is cumbersome, and I appreciate the efforts of the chairman. I simply support his efforts in trying to simplify it and having this hearing. Are there other things that we can do? Are there other types of taxation that we can go to?

I know a couple of you alluded to in your testimony—if each one of you would take just a couple of quick seconds to—and I will start with Mr. Stathis on the end.

Mr. STATHIS. They run the gamut. You have heard VAT tax, similar to what they use in Europe. You have heard of a flat tax.

Mr. LUETKEMEYER. Do you have a preference? I am under the clock here. So I apologize for jumping in.

Mr. STATHIS. A preference? I think that one of the other gentleman alluded to what the upheaval would to be the economy and the way it is right now that if you tried to make a massive change to, say, a flat tax, it could cause I think more damage than it did good. I think that is where we are right now. What we need to do is simplify what we have and maintain the structure, the simple structure but just simplify it.

Mr. LUETKEMEYER. Great.

Mr. Hall.

Mr. HALL. I think the same thing. I think not only would it not be practical, but it probably couldn't pass. I think simplification like the home office standard deduction. Back in the day, there was no standard deduction in lieu of itemized deductions. That is a nice roadmap for other potential standardized deductions.

There could be standard deductions for appreciation. There could be easier deductions for retirement plans that we have talked about. Moving some of those deductions to the entity level, like Mr. Blackledge mentioned on the self-employed health insurance deduction.

I think the Code itself accomplishes so many different things, not just revenue but social issues as well. I think just simplifying the issues now to make it easier to comply with is the path to go.

Mr. BLACKLEDGE. I would concur, obviously. Other tax systems have advantages. They have been beneficial to other countries. But the cost of transition could be horrendous.

Our tax system of many of the decisions that have been made in this country over the last 50 to 100 years have been based on this Tax Code; and if we changed it, just as when we changed the passive activity rules on business investments back when we had the savings and loan crisis, there could be some unintended consequences. But I think you can simplify the existing Code. Congress has made it complex.

One of the things overall that I think would help, in addition to the specifics of simplifying, would be to have a better process for Congress to vet potential changes in the Tax Code. The problem is that this Code has been built by individual Congress people and their staffs; and, in many cases, they are not well connected. We do not have common definitions. They have not been vetted either

with any kind of cooperative body or particularly with the IRS that is going to have to administer them. Often, the IRS ends up—and I have served on the IRS Advisory Council for a number of years, and often the IRS is thrown a tax law that they really don't know how to administer. And that has added to that complexity.

Mr. LUETKEMEYER. This is a follow-up that you piqued my interest in, and I will let Ms. Chin Ryan here in a second. But it would be neat if we would have a time frame within which you could plan for your future with your accountant to say this tax is only going to go into force 2, 5, 10 years from now so that, all of a sudden, we in Congress decide tomorrow we are going to change the Tax Code and your whole future plans are screwed up because of what we did. I think something like that.

Mr. BLACKLEDGE. If you do make a change, it is absolutely imperative that it somehow be transitioned in over a period of a number of years, which, unfortunately, will, of course, add to the complexity for that transition period.

Mr. LUETKEMEYER. Ms. Chin.

Ms. CHIN RYAN. In my written testimony, the examples I gave, I gave a solution. For example, the definition of accounting method, cash versus accrual, a solution could be if a business is 5 million or less, anyone can use the cash basis regardless of the type of entity. That would help reduce it.

The different categories of income, a solution would be to eliminate the passive income and go back to earning other income. The same with Social Security is to—based—

Mr. LUETKEMEYER. So you prefer to keep the present system and simplify it with changes and improve it?

Ms. CHIN RYAN. As a business owner, you have long-term and short-term goals; and I think to completely rehaul the Tax Code is going to take a long time. But in the short term there could be a possible solution as we are parallel doing the long-term fix.

Mr. LUETKEMEYER. I appreciate it.

Thank you, Mr. Chairman.

Chairman SCHRADER. Thank you very much.

Let us go to the gentlelady from Illinois, Congressman Halvorson.

Mrs. HALVORSON. Thank you, Mr. Chairman; and thank you, panel, for being here. This is very informative.

I grew up with a self-employed father, and my husband and I are—we are owners of two small businesses ourselves. And I get quite angry at my husband when he doesn't save receipts, and we are constantly scrambling at the last minute, and I try to keep everything in a shoe box, and it doesn't always work. So I know how all of this happens at the last minute. You are trying to keep people like you in business.

In fact, I tell everybody, become a CPA, because there is always going to be work for you. Not that we want to take business away, but in the economy the way it is, we are trying to simplify things. So some of the things you can do yourself.

With talking about the itemization and keeping such records, whether it is about cell phones or all the different receipts you have to keep, what would you suggest or if you could elaborate? We may have touched on it a little bit, but how would you suggest we

do things differently with regards to keeping receipts or how to report things to make it easier on the business owner because of all the hours and hours we have to keep all the records straight? I don't know if anyone wants to specifically elaborate on that.

Mr. HALL. Again, I think the prototype is there. I think there are standard amounts that the IRS uses for a lot of things. There are standard deductions. We hope there is a standard home office deduction this term. There are per diem rates for travel. There is per diem rates for meals. It costs you a different amount to eat lunch in New York than it does in Sheboygan. So the per diem rate in Sheboygan is lower than the per diem rate in New York.

So I think there are lots of opportunities, again based on the math, scoring methods to determine how much a cell phone should cost in a certain area, allocate what your expected business percentage is. I think a standard amount for a lot of deductions, it could be an option for simplification, and all of those things would alleviate recordkeeping.

Mr. BLACKLEDGE. I think you just have to look at what the true impacts are on the Tax Code. In the Tax Code, you never collect every last dollar; and sometimes the complexity adds far more impact than the amount of revenue that is generated from it. On cell phones and computers, for example, there really is no marginal cost to the personal use of those cell phones. Plans now are unlimited. Cost of cell phones is inexpensive.

The Code just needs to be updated and put thresholds that are reasonably high on all of those items. And if someone is buying a $50,000 computer, perhaps you would require them to keep records of it. But certainly not with the kinds of computers and the kinds of equipment used by most small businesses. So setting lots of safe harbor thresholds below which you simply don't need to keep records would be a good approach.

Mrs. HALVORSON. The only other thing I want to touch on, I heard many times someone bringing up the difference between an employee and an independent contractor. When I was a State legislator, I had a bill that made it specific what an independent contractor was versus an employee; and we brought along a lot of businesses kicking and screaming. They were very angry with me.

But, in the end, I think people found out that I did not try to change anything. I did not try to make someone who was an independent contractor into an employee. And so it has really worked out. We have got step by step. And if there is anything I can do to help, maybe that is something we need to look at. It is written into the Illinois Tax Code, and it is really specifically stated what—if you follow these steps, you are automatically an independent contractor. It didn't hurt anybody. It specifically told you who was who.

Mr. BLACKLEDGE. I have worked with IRS and Treasury on that for probably 10 years, and I think the IRS is doing a good job now with their on-line determinator. Some of that could be further clarified, but it is always going to be an issue that is complicated. But I think the Congress and the IRS have done a good job of trying to clean up that issue.

Mrs. HALVORSON. Thank you all again for being here.

I yield back.

Chairman SCHRADER. Thank you.

Well, let us go to the Congressman from Colorado, Mr. Coffman.

Mr. COFFMAN. Thank you, Mr. Chairman.

One of the issues I think that is of concern to everybody is that of health care. We have had the health care savings account, which to me seems somewhat complicated for a small business to maneuver, but maybe it is not. And I wonder if you all can respond to that, how difficult it is to navigate or how simple it is to navigate for a small business.

Mr. BLACKLEDGE. I have looked into HSAs now for the last four or five renewals of my insurance, and the problem is not so much the complication, although there clearly is some complexity. It is that a lot of the insurance companies are simply not offering combinations of high-deductible insurance policies that, when combined with the cost of an HSA, assuming the business was to subsidize the HSA, saying that they really come out to be that much more inexpensive.

So I think that was a short-term step to try to make health insurance more affordable for small businesses, but a lot more needs to be done to really bring down the cost of health insurance overall. And HSAs I think are not proving to be the salvation that many people hoped they would be.

Mr. HALL. I think I agree that HSA, the big limitation—I think the processing, the administrative part works pretty well with having a credit card, a debit card. The process itself is relatively simple. It is the limited plans. You have to have a specific type of a health plan in order to take advantage of an HSA. Whether that plan works for your family or not then becomes the issue, and it becomes difficult.

That is why I like so much what H.R. 1470 does, which basically moves the self-employed health insurance deduction from page 1 of the 1040 over to the Schedule C. Most businesses pay for health insurance for their employees and get a full deduction for that, for Federal income taxes and FICA and Medicare and Social Security, everything. It is deductible for everything. But since that deduction is on Page 1 of the 1040, the small business owner does not get an SE tax deduction for it, which, basically, pure and simple means it is a 15.3 percent increase in health costs for the sole proprietor. And that is just not fair.

So, regardless of what type of plan, there is no limit. You don't have to have a high-deductible plan. Just moving that deduction, passing H.R. 1470, moving that to Schedule C is an immediate 15 percent reduction in health care costs for as many as 23 million small business owners out there.

Mr. STATHIS. I have seen similar results in my practice. We have HSAs, and our employees have been happy with it, and we have seen some real savings from it. And the administration of it is not very onerous. I have also seen smaller businesses that have put it in where they have not received as much benefit.

So I am kind of torn between—I think there is a size limit there, where a little bit larger businesses may be seeing some benefit than the smaller ones are. And that all gets down to cost. I don't think it is an administration thing. It is more about are you saving

money on the plan overall as compared to offering a traditional insurance plan.

Mr. COFFMAN. If you were going to offer—if the Congress were to offer a tax deduction for the sole proprietor, for the individuals purchasing health insurance to take the pressure off of the small business owner and to cover more people, what do you think that should look like? Should it be 100 percent? Should it be 35 percent? What would you—25 percent?

Mr. STATHIS. Are you looking at that time where he is only covering himself and not his employees?

Mr. COFFMAN. Correct.

Mr. STATHIS. If you are going to do that, it is not going to be on a level playing field with what other businesses have, because they are providing all of their employees health insurance benefits; and I think that probably the more correct answer would be to provide them incentive to cover their employees. Because uncovered employee health costs is rampant in this country. I deal with a lot of physicians, and they are frustrated in that, basically, they end up giving free medical care to a lot of people. And they look at that as their burden on society, but they do that.

Mr. COFFMAN. We are talking really about the independent contractor that doesn't have employees. The person that is out there or an individual that for some reason doesn't have COBRA and they are in between jobs, what would you offer them? It is getting a little beyond our discussion here.

Mr. STATHIS. If you are an independent contractor that has one employee, then you should be able to have the same full deduction that someone has that runs a multi-person company.

Mr. COFFMAN. Okay.

Mr. BLACKLEDGE. I think the real issue, too, is that health care is a tax expenditure; and every taxpayer, whether they work for a large business or a small business or no business at all, pays that cost of the tax expenditure. And I think every individual at the individual level should have the right to deduct a certain amount, with limitations, of health care insurance. There is no reason why a large corporation should be able to get a tax advantage and the small business or an individual should not.

Mr. COFFMAN. Okay. Mr. Chairman, I yield back the balance of my time.

Chairman SCHRADER. Well, thank you very much. It is very timely. We have been called for votes. So I appreciate the panel very, very much. A lively discussion. A lot of interest by members, and I appreciate the thoroughness of your responses.

I will ask unanimous consent that the members have 5 days to submit statements and supporting materials for the record. Without objection, so ordered.

This hearing is now adjourned. Thank you all very, very much.

[Whereupon, at 11:27 a.m., the Subcommittee was adjourned.]

KURT SCHRADER, OREGON
CHAIRMAN

VERN BUCHANAN, FLORIDA
RANKING MINORITY MEMBER

Congress of the United States
U.S. House of Representatives
Committee on Small Business
Subcommittee on Finance and Tax
2361 Rayburn House Office Building
Washington, DC 20515-6315

STATEMENT
of the
Honorable Kurt Schrader, Chair
Subcommittee on Finance and Tax of the
House Committee on Small Business
Hearing on "How the Complexity of the Tax Code Hinders Small Businesses"
Thursday, May 7, 2009

Talk to any entrepreneur and they will tell you the same thing--whether it's good times or bad, the tax code has become a true obstacle for small business. In an effort to untangle its complexity, the Obama Administration recently launched a bi-partisan reform panel. That group will work to overhaul the tax code, and ensure it meets current economic demands. For entrepreneurs, this reform will be critical. In its current, ever-expanding state, the tax code's maze of write-offs and regulations is restricting small business growth.

Whether we are talking about dollars spent or time lost, tax complexity is an enormous drain on small firms. This should come as no surprise. With 3.7 million words and over 70,000 pages, the tax code is a nightmare to navigate. It is also expensive to comply with.

In an average year, individuals and companies spend close to $265 billion doing their taxes. And small businesses pay the lion's share of that sum. In fact, entrepreneurs spend an estimated $1,304 per employee, roughly twice the amount that big companies pay.

In today's hearing, we are going to examine those costs, and look for ways in which the tax code can be simplified for small businesses.

When it comes to compliance, mounting expenses are compounded by an element of uncertainty. Many small firms struggle to determine what they owe, and what they can write off. With the tax code changing at a rate of roughly one alteration a day, it's no wonder entrepreneurs find it hard to follow.

In the face of daily tinkering, undefined deadlines and expiring provisions, small firms struggle to calculate long-term budgets. Given this uncertainty, it can be next to impossible to plan for the future. That confusion translates into postponed investments

and, without a doubt, fewer new hires. At a time when we are counting on startups to jumpstart our economy, we cannot afford that kind of setback.

Tax regulations shouldn't be such a stumbling block. For many entrepreneurs, they have the potential to encourage growth. In fact, small firms often make decisions based on the promise of write offs alone. For that reason, we need to be sure entrepreneurs are aware of every incentive available to them. Just as importantly, they should know how to take advantage of those provisions. A good example of this is the home office deduction.

Fifty-two percent of entrepreneurs operate out of their homes, and yet only a handful claim the deduction. To address this disconnect, Representative John McHugh and I introduced the Home Office Deduction Simplification Act. That bill should go a long way to streamline the compliance process for Entrepreneurs.

Whether it's creating a standard home office deduction or just generally modifying the tax code, there *are* ways to ease the small business burden. Of course, everyone has an opinion on how to make this happen-- from economists to policymakers. Today, we are going to hear from the people directly affected--entrepreneurs themselves.

I am pleased our small business representatives could join us, and look forward to hearing their insight on the issue. While we can't promise major tax reform in the *immediate* future, we *can* start building the foundation for change. At the very least, we can look for ways to blunt the burden in the short term, and set the stage for growth down the road.

Opening Statement for Hearing on
How the Complexity of the Tax Code Hinders Small Businesses
Vern Buchanan
Ranking Member
Subcommittee on Finance and Tax
Committee on Small Business
United States House of Representatives
Washington, DC
May 7, 2009

I want to thank Chairman Schrader for calling this important hearing on simplifying the tax code for America's small businesses. I would also like to extend my thanks to our witnesses who have taken time out of their schedules to provide this subcommittee with testimony today.

The present day tax code runs over 67,000 pages long. **67,000 pages.**

The Internal Revenue Service estimates it takes over 37 hours to complete the 1040 short form, the most basic income tax return we have.

So it should come as no surprise that a recent survey conducted by the Tax Foundation revealed that four in every five adults think the tax code is too complex, while 85% say that the system needs to be completely overhauled.

Small businesses are our most prolific job creators, creating 70% of new jobs nationwide. But small businesses have taken the brunt of the current economic downturn. We in Congress should be doing everything in our power to make it easier for small firms to start and grow their companies. It concerns me that the Administration has proposed several changes in tax policy that will have a negative impact on small businesses. Instead of raising taxes, we should be encouraging an environment that generates jobs and investment.

While Fortune 100 businesses hire armies of lawyers and accountants to find loopholes, exemptions, and deductions in the tax code's fine print, small business owners are forced to dig deep into their own pockets for help in simply trying to comply with the law.

I look forward to hearing the testimony before us today, and I yield back.

OSBRL Oregon Small Business For Responsible Leadership

May 4, 2009

The Honorable Kurt Schrader, Chair
U.S. House of Representatives Committee on Small Business
Subcommittee on Finance and Tax
2361 Rayburn House Office Building
Washington, DC 20515-6315

RE: *Tax Simplification and Small Business*

Dear Chair Schrader and Members of the Committee:

This testimony is submitted on behalf of the Oregon Small Business for Responsible Leadership (OSBRL). The OSBRL is a nonpartisan advocacy organization committed to the creation, promotion and preservation of small business that is beneficial to Oregon communities. We are an all-volunteer organization consisting of owners of small business in a broad variety of arenas, including attorneys, business consultants, CPAs, health professionals, IT professionals as well as industrial and manufacturing small businesses. Our organization actively participates in legislative advocacy with a strong voice for small businesses. We provide meaningful input to legislators in our Capitol in Salem, Oregon, on legislation to be introduced or pending before the Oregon Legislature. Our input is frequently requested by the Oregon policy makers, economic development think-tanks and environmental innovation organizations.

Over fifty percent of the Oregon Economy is represented by small business, while small business employers account for approximately 90% of all Oregon employers.

Main Issues

We will address three main areas that affect small business owners. They are the complexity of the tax code, the true cost of Social Security, and AMT.

Tax Code Complexity

OSBRL thinks one of the major tax issue facing small businesses is the tax code. There are various business entities. There are too many exemptions in each of the business entities. The time spent on keeping records to make sure they are in compliance with the law is extremely time consuming for small businesses and takes away from the day-to-day operations.

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The tax code is written by Congress, the regulations are written by IRS, and tax court cases/memorandum interprets the law. This has contributed to the complexity. In addition, the IRS generated revenue procedures, revenue rulings, circulars and on and on. Originally, some forms were only two (2) to three (3) pages (e.g. Forms 990 and 5500). Now, they are nine (9) to eleven (11) pages plus additional schedules. Originally the tax rates were high and the code was simpler. The government needs money to operate. When the tax rates were lowered, then the amount of money the government got was less. In order to increase tax revenues, the government through IRS, Congress put in rules to limit the deductions, thereby increasing taxable income and tax revenues and adding to complexity.

As a result, the past three (3) to four (4) decades, the complexity of the code and rules have been compounded. We have two examples.

Example #1 – Definition of Accounting Method

There are different rules and codes for different types of businesses, large or small companies. The current provisions for small companies are still complex. As an example, cash versus accrual basis. The cash basis is very simple. Accrual requires more accounting knowledge which small business may not have. IRS code says that if a business has gross revenue of $10 million or less, then they can elect the cash basis of accounting. But if the business is a C-Corp, the limit drops to $5 million. But if a partnership with a C-Corp partner, then it also drops to $5 million. But if manufacturing and only for certain types of items, the threshold drops to $1 million. There is a three step process to resolve this issue. The first step is to eliminate the code that does not apply. The second step is to check the business code and determine if it does fall in the $10 million or $1 million bracket? The third step is to determine if they use the correct business code in the return.

A solution could be if a business is $5 million or less, anyone can use the cash basis regardless of the type of entity.

Example #2: Different Categories of Income

Before all income was equal – all in the same group and taxed at the same rate. Then Congress created two types of income: earned income and other income. Earned income was taxed at 50% and other income was taxed at 70%. In 1986, a new tax code reduced the highest tax bracket to 28%. They paid for this by significantly reducing the itemized deductions for medical expenses and the deduction for interest and the deduction for IRA if the taxpayer is covered by a pension plan. IRS tried to limit the ability to deduct losses from tax shelters by creating another category called passive income and to ensure the passive income did not offset any other income they created another category of income which is portfolio income. Now there are three incomes: earned, passive, and portfolio. As a result, numerous definitions were created to define these types of income.

As an example, a business owner has to spend five hundred (500) hours of his/her time in order for it to be an active participation producing earned income. If it is active, losses can offset other earned income. If passive, it can't offset other income. If a business owner spent more than five

hundred (500) hours, it is deemed active and less than five hundred (500) hours, it is deemed passive. However, if this business has only one owner and the owner is the only one involved with the business or there are no other individual (an individual is a person as opposed to a business entity) that has spent one hundred (100) or less hours in this business, then this business is considered active. The activity level of the business owner determines if it is passive or earned. The reason for this level of complexity, the passive losses can only be used to offset passive income. They cannot be used to offset earned income or portfolio income which consists of interest and dividends. And these are not the total list of rules. It goes on and on and on.

A solution could be to eliminate the passive income and go back to earned and other income.

True Cost of Social Security

The true cost of Social Security (SS) also adds to the complexity. Currently, sole proprietorships automatically have to pay fifteen percent (15%) of income up to $100,000 into SS and Medicare before any itemized deductions, and then pay tax on that income again at the regular tax rates.

As an example, a sole proprietor earned $100, 000, then pays $15,300 into SS and pays approximately $10,000 to $15,000 into the federal income tax. A combined tax is approximately $25,000 to $30,000. If born into the right family and have $100,000 of dividends with no itemized deductions, the maximum tax paid is $15,000. In the past, only people who paid into SS were going to received SS benefits. This is why only people with earned income pay SS tax. Now the government has taken surplus SS payment and used it for general funs expenditures. This is the same as if an employer took money from his employee pension fund and used it to pay expenses of the corporation. If Congress were held to the same level of accountability for SS as employers as held for their employee pension plan Congress would certainly have legal problems.

Why does this affect small business? Fifteen and a third percent (15.3%) is a significant percentage to operating capital. The income is taxed again and this takes away from the small business owner the ability to plan for retirement.

A solution could be to pay SS tax on all income (no cap) regardless of source and thereby reducing the tax rate to a more manageable level. In order to replenish the SS system for surpluses spent for general fund activities, Congress could consider surtax on the adjusted gross income from all sources including dividends, interest, rental income, etc. The tax rate could be just one (1) or two (2) percentage and reduce SS tax rate to eight (8) or ten (10) percent depending upon the needs.

People should receive SS benefits in relation to their lifetime contributions. An example, people who have received government pensions and did not pay into SS and then enters the workforce and pays into SS for ten (10) years, should not receive the same benefits as someone who has paid into SS for forty (40) years. It should be based upon the life time contributions not just based upon the top ten (10) quarters. CCR NEED TO CHECK.

Alternative Minimum Tax (AMT)

Alternative Minimum Tax (AMT) adds another level o complexity. AMT was originally established to insure that wealthy individuals paid enough taxes. However, it has not been indexed to inflation. Many individuals fall into AMT. This is due to the adjustments for taxes, excess medical deductions and miscellaneous itemized deductions which include a deduction for un-reimbursed business expenses. For example if a sales man is paid as a sole proprietor and receives $150,000 but has $50,000 of un-reimbursed expenses, he will have taxable income of $100,000. However, if he is paid as an employee and receives $150,000 with un-reimbursed business expenses, he will still have taxable income of $100,000. However, he will lose much of the benefit of un-reimbursed because he will be subject to AMT because he must add back the $50,000 of un-reimbursed business expenses back to income for AMT purposes.

Conclusion

This testimony was not intended to be a "how much we know about the tax code" but to identify the complexity and frustration for small business owners. It has become apparent to us that most businesses, large and small, recognize their civic responsibility and are willing to pay their fair share for their business footprint. I would like to underscore the word "fair", as a fair tax code assures participation rather than encourages searching for intricate ways to pay as little as the law allows.

Please contact me if you have any questions or need additional information,. We look forward to working with you and your committee.

Yours respectfully,

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Testimony

Statement of Eric R. Blackledge

On

Tax simplification for Small Businesses

Before the

U.S. House of Representatives Small Business Committee
Subcommittee on Finance and Tax

May 7, 2009

Introduction

Chairman Schrader and Ranking Member Buchanan, thank you for the opportunity to talk with you today about simplifying the tax code and reducing the administrative burden for small business taxpayers. My name is Eric Blackledge and I am President of Blackledge Furniture in Corvallis Oregon. I have a long history of involvement in small business tax issues including serving as the Region 10 Tax Issues Advisory Chair to the SBA Office of Advocacy, and as chair of the US Chamber of Commerce Small Business Council Tax Policy Sub-council. I also am active in many other small business organizations and state and federal level tax policy advisory groups. In addition, I have had an opportunity to see the taxation system from the IRS perspective, as a member of both the IRS Advisory Council and the IRS Electronic Tax Administration Advisory Council.

The Internal Revenue Code has grown from simple beginnings to over 1,395,000 words, to which the Internal Revenue Service has added over another 8,000,000 words of interpretive regulations and instructions, and the courts have added even further pages of decisions. There are now over 650 IRS forms and schedules, with over 16,000 lines, 160 worksheets and 340 publications. Even IRS staff who are hired and trained to provide taxpayer assistance give incorrect tax information a fourth of the time based on GAO evaluations. There has been much discussion in recent years about the "Tax Gap" resulting from inaccurate filing. While some of this gap probably results from intentional under reporting, much of it also results from unintentional filing errors caused by complexity.

Although there have been suggestions to" simplify" the tax system by completely changing our tax structure to a consumption tax, a value added tax, or a "flat" income based tax, the potential economic impacts of transitions make such a major systemic change unlikely in the near future.

I will therefore limit my comments to eight key principles for good tax legislation that could make the current tax system simpler and easier for small businesses, and all taxpayers, to comply with. I will also suggest priorities for legislation that implements these principles. The details for each proposal are included in my written testimony. Many of these proposals have been supported by Committee members in the past, and I hope you will continue to support their passage in this Congress.

Principle 1. Remove outdated and un-necessary record keeping burdens that don't significantly impact tax revenue.

A top priority is removal of the outdated "Listed Property" record keeping requirements and deduction limitations on business cellular phones and computers. The Tax Reform Act of 1986 enacted code section 280F to

differentiate "listed property" from other depreciable business property. Listed property included cellular telephones and any computer, video or photo camera, or peripheral equipment not used in a "regular business establishment". At that time these technologies were expensive and any personal use might have significant non-deductable value, justifying a requirement for taxpayers to keep use logs.

Now, cell phones are a basic tool for all business and professional people, and most everyone else, because of far lower initial and monthly operating costs. Anyone can now get a good cell phone at no cost with a two year contract. Most plans also include free calling to selected numbers, or on all calls made during evening and weekend hours, making the marginal cost of personal use of a business cell phone essentially zero. If there is no additional cost for minor personal use, businesses should not be burdened with keeping detailed use logs to deduct an otherwise legitimate business expense.

The tax code also makes any computers not used in a business office, or in a qualified home office, listed property, requiring documentation under IRC 280F (d) (4) (c) (3) of the specific amount of business and personal use. Since 1986, the cost of computers has significantly decreased, and the ability and need for business people to use laptops and PDA computers outside of a regular office has greatly increased. As with cell phones, if there is a legitimate business need for the computer or PDA, there is little or no additional marginal cost for any personal use of the same equipment, since most hardware is replaced long before the end of its potential usable life.

Most government employees have office computers, laptops, PDAs, or cell phones, provided at taxpayer expense, which many of them also use for personal emails, personal conversations and other nongovernmental activities. Taxpayers should also no longer be burdened with outdated and impractical record keeping requirements and deduction limitations for basic business tools. Revenue scoring costs for these changes should not be high because JCT takes noncompliance into account and most business people probably already ignore these requirements because they no longer seem reasonable.

Cell phones, PDAs, computer equipment under $2500 in value, and similar equipment whether used in a regular office, a home office, or on the road, should be removed from listed property requirements, and any taxpayer who can show substantial (75% or greater) business use, should be allowed to deduct all monthly service charges and depreciate, or expense under IRC Section 179, the equipment costs, without detailed usage logs. Any extra cost recreational software or accessory equipment that is not required for business use should of course continue to be non-deductable.

Principle 2. Periodically update all dollar limitations and rate break points in the tax code by an appropriate and standard inflation factor.

This could be done with a one time adjustment for inflation that has occurred since each provision's adoption or last change, and the addition of a standard inflation adjustment provision for all dollar limits in the code that do not have a greater specific adjustment. This would preempt the many separate and different inflation adjustments in various areas of the code by defining a standard basis for measuring general monetary inflation, and requiring that whenever it has increased more than 15% or 20% since the last adjustment the IRS would calculate and issue by regulation new limitation amounts and rate breakpoints to apply to the following tax year. This would prevent inflation from changing the original intent of Congress on limits that have not received regular adjustments.

A good example of a provision needing modernization is the outdated $25 business gift limitation. In 1962, Congress passed Public Law 87-834, which limited the deductibility of a business gift to $25 to prevent the deduction of "excessive" gifts. This amount has never been adjusted for inflation. After 44 years of inflation, that $25 gift would now cost $172. The $25 limit applies to either a gift to a single person or an indirect gift received by a group such as a business customer. Thank you gifts to customers are an important sales generating tool for small businesses. There should not be unlimited gifting, but the $25 amount needs to be increased. Even a "thank you" plant delivered to a business would cost about $100.

The deductible business gift limit should be updated to at least $100, or the current equivalent value that $25 represented when the original law was passed, and this amount should be adjusted for inflation.

Another priority would be modernizing the outdated and poorly written limitation on "luxury" automobiles. The tax code defines passenger automobiles as 5-year property under ADS standards for cost recovery. However, in 1984 Congress limited the ability to expense or depreciate what they thought were "luxury" automobiles used for business by enacting Section 280F(a)(1). These limits have only increased by about 19.5% since 1987 under an outdated and very restrictive calculation formula, even with general inflation of 89% in that time. The current limits on depreciation or Sec. 179 expensing for automobiles purchased in 2009 are $2,960 the first year plus possible bonus depreciation, $4,800 the 2nd year, $2,850 the 3rd year, and $1,775 for each succeeding year." This is actually a decline from 2007 and 2008. That means that during the "normal" 5-year recovery period, a business could actually only fully recover the cost of a $14,160 vehicle. Even after 10 years, at 100% business use, a business could only recover the cost of a $23,035 car. With average use of only 15,000 miles a year, a business car would have 150,000 miles of use at the end of a 10-year recovery period, and many business users exceed that yearly mileage use. To consider an automobile costing

less than $15,000 a "luxury car" is simply unrealistic. The National Automobile Dealers Association indicates that the average new vehicle selling price in 2006 was $28,450. The only vehicles that still sell below this depreciation limitation are small compact cars such as the Hyundai Accent. None of these vehicles is designed to transport five adults, or is suitable for many valid business uses such as transporting samples. Most of these cheaper cars are also imported, which has helped contribute to the decline of American auto manufactures. The depreciation limitations also force businesses to keep older, more polluting, and less fuel-efficient vehicles in use.

The Joint Tax Committee staff indicates that the inadequate adjustment for inflation resulted from an unrealistic indexing formula in the original law that was based on a standard "basic" 1984 car, which does not include all of the expensive safety, pollution control, and fuel economy equipment that is now required on most cars.

The American automobile industry is in an economic crisis, and one or more of the remaining manufacturers may soon fail, with significant economy wide job and benefit losses. The tax code should encourage regular replacement of business vehicles, not unreasonably discourage them. If Ford, Chrysler, and GM fail, economists predict a loss of 3 million jobs and $60 Billion in annual tax revenue. Removing this antiquated provision will stimulate business purchases of new vehicles, and help rebuild auto sales.

The automobile depreciation limits should be adjusted to allow a person who needs to use an automobile for business to fully recover the cost of a vehicle with a cost basis of at least $25,000 during the standard 5-year recovery period, at 100% business use, and that amount should then be adjusted for average vehicle inflation.

Principle 3. As much as possible, take tax considerations out of the business issues involved in choosing a business entity by applying the same rules, and offering comparable tax advantages, to all forms of business organization.

A top priority is the equal and simple deductibility of group health insurance, for all small businesses. Although prior Congressional action partly corrected this inequity, 21 million self employed individuals are still required to treat their health insurance premiums expense as a non business expense that is included in the individual's income which is subject to the 15.3% self employment tax. This is not the case with other employees of corporations and governments. This inequity has always been an emotional disincentive for small business owners to provide group health insurance for their other employees. As more states or the Federal government adopt universal health insurance requirements, the impact of this

inequity will continued to grow, unless corrected. The National Taxpayer Advocate has recommended correction of this inequity in her Reports to Congress.

Congress should finally fully equalize the deductibility of a reasonable level of group health insurance at the entity level for all forms of businesses by repealing IRC section 162(l) (4). If there is concern about small businesses not providing coverage for similar non-owner employees, provisions could be added that deductable coverage be the same as for other employees of the same job class. An even better step for businesses would be for Congress to allow the deduction of a reasonable level of health insurance by individuals, so businesses could just provide monetary compensation, so employees could choose their own health plans and providers.

Another priority would be removing the inequitable limitations on all small businesses, other than "C" corporations, that would like to offer a "cafeteria" benefit option program to their employees.

Small businesses compete for workers with large businesses and the public sector. These employers can provide more employee benefit options to potential employees than most small businesses. Because of differing family situations, differences in the benefits available through other family members, or just because of different personal preferences, potential employees often want different employment benefits than other workers. Small business usually cannot afford the expense or administrative cost to provide a wide selection of benefits to all employees, particularly when they may not be important to many of their workers. The logical solution is to offer employees a given dollar cost benefit amount, but allow the employee to select the benefits they need.

Large employers have this option in the form of tax free "Cafeteria Plans", but the current restrictions on offering Cafeteria Plans makes them unusable for most small businesses because business owners could not be part of the plan. Current law specifically prevents sole proprietors, partners, sub chapter S corporation shareholders, and members of an LLC from participating in a cafeteria benefit plan even if they receive only the same level of benefit as other employees. These illogical limitations restrict the ability of small businesses to compete for workers, and prevent them from offering employees a very logical form of employment benefit.

Congress should enact legislation allowing "simple" cafeteria benefit plans that could be offered by all types of small business entities, for both non-owner and part owner employees, at a reasonable administrative cost and with adequate provisions to prevent misuse.

A third priority would be correcting the inequitable impact of Alternative Minimum Taxes on "pass through" entities such as S corporations, partnerships and Schedule C or F filers.

Small businesses are unfairly impacted by the Personal Alternative Minimum Tax because most small businesses and farms report their income and deductions, and pay taxes on their business income, in addition to their personal salaries and other income, on their personal 1040 tax return. This combined reporting of both personal and business income pushes a large percentage of small business people above the exemption limit and makes them calculate and pay the Personal AMT which applies at much lower income levels than the Corporate AMT. The Corporate AMT only applies if the 3 year average business gross income exceeds $7,500,000. Small businesses are also unfairly impacted because they are unable to actually deduct the large amounts of state income tax paid on their business income because of the low personal AMT exemption limit. Some state income tax rates exceed 10%. What remains of the business income, after paying taxes, must often be re-invested in the business, and is a key factor in a business' ability to survive and grow.

Taxpayer Advocate Olson, starting in her 2001 Report to Congress, has repeatedly indicated that if the individual AMT is not eliminated, Congress should "Eliminate personal exemptions, the standard deduction, deductable state and local taxes, and miscellaneous itemized deductions, as adjustment items for Individual Alternative Minimum Tax purposes." She has also advocated that the AMT be permanently indexed for inflation.

Proposals to eliminate the individual AMT and offset the revenue with an across the board "surtax" on individual incomes would still have an adverse discriminatory impact on small businesses, who report all their business income in addition to their personal income on their personal return. This approach also ignores the original, and reasonable, intent of the AMT not to be a general revenue source, but to target only those who take excessive or unfair advantage of the regular tax system.

Congress should provide better equality in the tax treatment of small business income with the far more generous "C" corporation AMT exemption on business income of $7,500,000. An additional "business income" exemption of up to $250,000, should be added to the personal AMT code for business income reported on a Schedule K1 or Schedules C or F for a business in which the taxpayer materially participates. Congress should also set a reasonable minimum gross taxable income threshold of perhaps $250,000 in Adjusted Gross Income for all taxpayers before the AMT calculation would even be required. The deduction for state and local taxes paid should also be permanently allowed in the personal AMT calculation.

These changes would remove the AMT burden for most taxpayers and provide some equitability with the C corporation AMT exemption, with a lower tax expenditure cost than full repeal, and also restore the original congressional intent of the AMT.

Principle 4. Do not create new tax expenditure benefits in the tax code, and then take them away from many taxpayers through complicated phase-outs, limitations, adjustments, recaptures, or a lack the of matching exemptions in the Alternative Minimum Tax provisions.

A prime example is the ineffectiveness of the Section 1202 and Section 1244 incentives for small business equity investment. Congress passed Section 1202 and Section 1244 of the tax code to encourage direct investment in small business startups. Most business startups are under capitalized and are financed largely with expensive short-term borrowing, which is a major reason for their high failure rate. These provisions were adopted because of the realization that new businesses need a stable base of equity capital to survive and grow. It is very difficult for new businesses to get equity capital because of the far higher risk and lack of market liquidity of small business stock compared to other investments.

Section 1202 provided an incentive of a partial exclusion on the capital gain from a sale of Qualified Small Business Stock held for more than 5 years. Congress recently raised the exclusion percentage on a temporary basis. However, the reduction in the capital gains tax rates on all investments combined with the failure of Congress to include the 1202 exemption in the AMT tax provisions has effectively eliminated much of the value of this incentive. Section 1244 also provides an incentive by allowing a greater offset of capital losses on small business investments against other income. Both of these provisions have been less effective than intended in promoting small business investment because they provide no up-front tax incentive for an investor who may have to hold the stock for a long period. In recognition of this, President Obama has proposed eliminating the capital gains tax up to $250,000 on start-ups and small businesses to encourage innovation and economic growth.

Congress should make permanent the current regular tax code exclusion on part of the gain on Section 1202 qualified small business stock and also exempt it in the AMT calculation. This could revitalize an important tool for small business financing, particularly if capital gains rates increase in the future. As an alternative, Congress should consider providing a 10% up-front tax credit for investment in Qualified Small Business Stock, which would help offset the much higher risk of loss. The credit could be recaptured at 20%

per year if the stock is sold within 5 years and would reduce the stock basis in the event of a gain.

Principle 5. Reduce long cost recovery periods, and complex record keeping for small business equipment purchases and facility improvements.

The Section 179 small business expensing provisions are a key factor in helping small businesses survive and grow by improving their ability to quickly, and simply, recover the costs of investments in new equipment. This promotes business productivity and provides a major stimulus to the general economy from increased purchasing capability, particularly with the limited credit available to small and new businesses. Without rapid cost recovery, many small businesses have inadequate capital to continue and grow. Timely cost recovery is particularly critical for start-up businesses that are often dependent on personal savings or high interest credit card financing. This has become even more critical because of the severe restrictions on bank credit availability due to the current economic crisis.

Bureau of Labor Statistics research has found that 44 % of all new businesses fail within their first two years, and 66% fail within 4 years. Tax regulations that unreasonably delay or prevent businesses from recovering their costs can be a major factor in that high failure rate.

Congress should make permanent the current $250,000 expensing limitation and $800,000 investment cap for Section 179 property, so small businesses can make equipment purchases when they need them.

There is also a need to change the definition of Section 179 property to reflect the changing needs of small business. In 1958, when this Section was first approved, the US economy was strongly manufacturing oriented and most small businesses needed to purchase production equipment. Over the last 50 years the US economy has become more service and innovation oriented and the capital expenditure needs of small businesses have changed.

To compete for customers and clients, businesses today need functional and attractive facilities in which to conduct business. Better facilities also help businesses attract and retain more highly skilled employees. New businesses often face significant costs in remodeling and preparing a business property for their use which must then be recovered over a long period. This can consume a large amount of the business' initial capital, and make it difficult for the business to survive and grow. Congress has partly recognized the changing capital investment needs of small business by including non-structural leasehold

improvements for some kinds of business real property in recent short-term stimulus measures. Prior to the 1986 tax act, tenant improvements to real property could be depreciated over the remaining lease period.

Congress should amend the definition of Section 179 property to include general non-structural remodeling improvements to business real property used for conducting business with customers or clients. This would include changes to interior and exterior surfaces, and items such as display windows, nonstructural partitions, and building fixtures. The current exclusion of heating and air conditioning equipment from Section 179 property should also be changed to encourage businesses to replace old equipment with new high energy efficiency units. For more expensive improvements, Congress should shorten the depreciation period for nonstructural real property improvements to 15 years on a straight-line basis. These changes would have significant short-term and long-term economic stimulus effects.

Principle 6. Provide alternative "simple" provisions in the tax code that provide equitable tax deduction benefits to small businesses without excessive administrative requirements and costs that often become a barrier to small business use of a tax benefit.

A high priority would be passage of a "simple" home office deduction alternative. Most small businesses are prevented from recovering the cost of a home office even if they meet the other qualifications because of the complexity of the current requirements to calculate proportionate expenses and depreciation for the designated office area.

New entrepreneurs who are unsure how long they will need a home office may be particularly concerned about the recapture of depreciation, or need for other adjustments, when they sell their home, whether they actually deducted the full potential depreciation or not. Most startup businesses that operate outside the home usually choose to rent business space and equipment rather than own it, partly to avoid all the tax complexities. New home based businesses are usually even smaller and less knowledgeable about the tax code.

IRS Tax Payer Advocate Nina Olson in her 2007 Report to Congress agreed, stating:

> "The tax laws regarding the home office deduction are considered by many to be too complex and the record keeping responsibilities associated with the deduction to be too time-consuming. It is questionable whether most taxpayers who are eligible to take the deduction actually do so." She recommends that; "Congress should amend IRC Sec 208A to create an optional standard home office deduction. The legislative provision would direct the Secretary of the Treasury to draft regulations which calculate the

deduction by multiplying an applicable standard rate, as determined and published by the Commissioner of the IRS on a periodic basis, by the applicable square footage of the portion of the dwelling unit described in IRC Sec. 280A(c)."

Currently, home-based businesses represent 52 percent of all American firms and generate 10 percent of the total country's GDP, or economic revenue. In the future, that percentage is likely to grow as new technologies and the Internet make new business models possible and increase the ability of people to work remotely, rather than commute. Because the Tax Code does not exclude income resulting from work done in home offices, it should also allow home office workers a reasonable ability to deduct the cost of space and equipment actually used to produce the income. Working from the home has become more attractive because of the increased costs of commuting, high commercial real estate and parking costs, and the desire of many workers to have more involvement with their children and families. Government should also have an interest in promoting working at home as a way to reduce the need for new highway construction, conserve energy, and reduce "green-house gas" emissions from unnecessary commutes to a distant business office.

Business owners and home based businesses should have a simple optional way to deduct a reasonable standardized amount for utilizing part of their home for business use, without the current calculation complexity. This amount could be based on the square footage of the office area used, with clear calculation guidelines, and an upper limit. The deduction amount should also be limited by the amount of income produced by the related business activity. This concept would be similar to the standard deduction options for business travel per diem or auto mileage, and would not involve depreciation calculations and later re-capture. Home office users could choose to continue to follow the current deductibility rules, or choose the more conservative, but simpler, standard deduction, which would include a reasonable cost allowance based on the space used for typical costs, including utility expense, real estate taxes, and maintenance costs.

Current home office deduction requirements also include outdated and unrealistic requirements for physical customer presence and exclusive use that also need to be changed to permit reasonable deductibility.

Internal Revenue Code Section 280A(c) (1) defines the deductibility requirements for a "qualified" home office. The Code currently permits a deduction for a home office in a taxpayer's residence only if it is -

"...exclusively used on a regular basis –

(A) as the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business",

or for certain specifically defined business storage or home care facility uses.

Many at-home workers are afraid to use the home office business deduction because of the fear of audits on vague issues and the extra record keeping and calculations that may be required. The existing requirements for qualified activity are also unrealistic and outdated by the realities of today's technologies, and current business practices, and should be modified.

The "exclusive" use requirement-

The Code requires any home office to be "exclusively used on a regular basis" as a place for business. IRS Publication 587 currently states, "You do not meet the requirements of the exclusive use test if you use the area in question both for business and personal purposes." This is actually a much higher standard than is applied to regular fully deductable business locations. A reality of today's business world, where employees carry cell phones and work at internet connected computers, is that most workers conduct some personal business and receive some personal calls or emails during the day at their place of business. The same is true in the public sector, where GAO investigations have even found IRS employees using their computers for personal email and activities in the IRS Building. It probably happens in most government offices. It is both unrealistic and unreasonable not to also allow some minor de minimis personal activity in an otherwise qualified home office area used 80% or more for business.

The "principal place of business" requirement-

As the first optional test, the Code allows a deduction for a home office which functions "as the principal place of business for any trade or business of the taxpayer". Previous IRS regulations stated "a home office in which a taxpayer engages in a business as a self-employed person would rarely qualify as the taxpayer's principal place of business if the taxpayer's primary source of income is wages for services performed in another business on an employer's premises." Yet, the code clearly allows for multiple businesses of a taxpayer. Many new home based businesses are started on a part-time basis, during evenings and weekends, while the entrepreneur still has the income cushion of a regular job. Regulations should clearly allow deduction of a home office used for new business activity; even if the taxpayer's primary income is from a different business.

The Code also states that "...the term 'principal place of business' includes a place of business which is used by the taxpayer for the administrative activities of any trade or business of the taxpayer if there is no other fixed location of such trade or

business where the taxpayer conducts substantial administrative activities of such trade or business." This allows outside sale representatives and others to deduct a home administrative office when they have no alternate office location.

Unfortunately, for many small businesses the inability "to conduct substantial administrative activities" at their regular place of business" is often the result of a lack of time, rather than a lack of space. In a small business, the owner or manager is often also the front line person who actively waits on customers and actively supervises employees during regular business hours. To deal with all the competitive and regulatory issues that most small businesses face, successful owners and managers often need to work on business issues in the evenings and on weekends, even after working a 50 to 80 hour week. Large businesses have specialized executive staffs to do planning, administrative and accounting functions and other support activities, but small businesses don't. Small business people can have a legitimate business need for a home office in which they can regularly work, even if it is not the principal place of business where they physically serve their customers. IRS Regulations should allow small businesses to deduct otherwise qualified home offices used for administrative work even when they have a primary place of business outside the home.

Interestingly, the code currently allows a clear deduction for home offices and other business uses in separate "free standing structures" on a residential property "...such as a studio, garage, or barn" without meeting the requirements of being the principal place of business or the requirement for meeting with clients. Why should some taxpayers who can afford a large house with a detached garage, or have a large enough lot where they can legally build a separate structure, be exempted from these home office use requirements when poorer taxpayers living in smaller houses can't use the same standards for deducting business use of part of an attached room?

Part owners of partnership, S corporation and LLC structured small businesses, are also specifically prohibited from deducting a home office, or renting part of their home to their corporation. However, many small businesses want the protection of an S corporation or LLC structure and may have no other place to operate their business other than their home. Owners or managers of small corporations or partnerships should not be denied the ability to recover the costs of a home office if they meet the other reasonable requirements for deductibility.

The "used by patients, clients, or customers" requirement-

The current IRS Publication 587 on "Business Use of Your Home" states that the taxpayer must "physically meet with patients, clients, or customers on your premises.", to qualify as a home office The actual IRC code only requires that it be "a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business." Today, many businesses deal with their customers electronically through websites, without any physical presence. Major and minor business transactions are now fully

completed, over the internet, or through emails, faxes or on the telephone. The old physical presence requirements are obsolete and block reasonable recovery of expenses for many small home based businesses.

Congress should modernize the definition of a qualified home office for entrepreneurs who have a need to use an area of their home on a regular basis for normal business activity. The "principle place of business" requirement should be modified in statute to allow a home office when it is needed to regularly perform work activities outside the principle business location. The exclusive use requirement should also be changed to allow occasional personal activity comparable to that which occurs in a regular business office, and legislation should clarify that use of the office for electronic business transactions has the same validity as use for physical business interaction.

Principle 7. Reduce the burden on taxpayers to create complex legal arrangements to preserve family businesses for their children, because of uncertain or excessive Estate Taxes.

The Estate Tax currently affects only those estates with an adjusted value over $3.5 million and collects only about $24 billion in revenue. Under existing law the estate tax will be fully eliminated for one year in 2010, but without the normal "step up" or re-valuation in basis to the value of the assets at the date of death. To avoid future complexity, is important to retain this traditional re-valuation in basis with each generational transfer because most individuals do not keep adequate records to determine the original cost of most personal assets. This makes it difficult to determine the basis and taxable gain when the receivers eventually sell the assets. Executors of estates can face penalties for not providing correct basis valuation information.

Unless new Congressional action is taken, the Estate Tax will then return in 2011 under old rules, with only a $1 million exemption and with a maximum tax rate up to 55%. After many years of hard work, and monetary inflation, many small businesses can have appraised valuations well over that exemption level, resulting in significant potential estate tax liability upon the death of the business owners. Because much of the "wealth" that is taxed by the Estate Tax is actually just the result of inflation in the dollar value of assets such as businesses and homes over the 20 years or more between generations, it is particularly important that Estate Tax exemptions also be adjusted regularly for inflation.

Before 2010, adopt the provision in the recent Budget Reconciliation for a permanent unified Gift and Estate Tax exclusion of $3.5 million per individual, with a maximum tax rate of 45%, in addition to maintaining the current Code provisions intended to help family farms and business survive generation transfers. The code should continue to provide a re-valuation of the basis of

inherited assets based on their value at the time of death and any unused part of a spouse's exemption should be transferable to a surviving spouse.

Principle 8. It is important to regularly evaluate the actual impacts of the tax system, and the financial and regulatory environment on the ability of small businesses to succeed and grow. The Congress and Administration should seek broad based input from small businesses about the problems they face, and the ideas they can develop for improving the small business economy, by authorizing a National Small Business Summit on economic recovery.

If we are going to rebuild a growing and sustainable economy, government needs to better understand and address the unique needs of the small business community, particularly in the area of taxation and regulation. According to the latest SBA research, over 99% of all US, businesses are small businesses and they provide over 50.4% of all private sector jobs. Small businesses created over 79% of the net new domestic jobs in 2005. Small Business is a major factor in the export of traded sector goods and services, which is vital to our economic future. Unlike many large businesses, most of these businesses are also American owned, and their jobs and profits stay in the US to grow our economy.

This year marks the beginning of a new Presidency, with many new leaders in the Administration, in federal agencies, and in the Congress. For these leaders to be effective in helping rebuild the small business economy, they need to better understand its needs. It has been over 14 years since the federal government last sought broad based and balanced input on the problems affecting the small businesses, through the 1995 White House Conference on Small Business.

That National Summit process provided lasting benefits to both the small business community and to the government. Small business representatives came from across the country to learn about the governmental process and communicate their problems, concerns, and ideas. The administration and Congress also benefited by obtaining a better understanding of the factors which impact small businesses and their ability to create jobs and economic growth. The representatives had an opportunity to discuss, with our leaders, creative and efficient solutions to national problems that affect small businesses. This dialogue significantly enhanced the Administration's "re-inventing government" process and they recommended regular periodic summits. Many of the 60 recommendations developed by the delegates in 1995 were later implemented by Congress or federal agencies with lasting economic benefits. Continuing activity by participants on some issue areas, such as tax policy, has also helped build cooperative partnerships with federal agencies to resolve long-term problems for small business.

Now, new and different problems threaten the survival and potential growth of the small business economy. With the devastating impact of this economic recession, it is imperative that Congress take action this year to initiate another National Small Business Summit to understand what will help rebuild the small business economy.

A new Summit format would involve Congress more heavily in the selection of both an organizing Commission and Conference delegates. Congressional leaders would receive special recognition and have an opportunity to participate in the Summit.

Delegates would be real small business people and include representatives of all states to reflect the country's geographic and social diversity. The delegates would be selected by Congressional and Presidential appointment and by application to the SBA Office of Advocacy. A Small Business Summit would provide Congress and the Administration with input on the broad concerns of small businesses rather than the positions of separate business and trade associations that focus mostly on their own, or their industry's, priorities. Actual small business owners will be able to communicate what is actually needed to help them grow their businesses and the economy.

The Summit should be efficiently organized by a conference contractor, with policy guidance from an appointed Commission and the SBA Chief Counsel for Advocacy. The contractor would solicit private sector sponsors for Conference events to minimize public cost and delegate registration fees.

The Summit would utilize cost efficient electronic information sharing and communication technologies, to develop and communicate issues. This would enable state delegations and issue groups to share information and ideas prior to the National Summit, and eliminate the need for expensive state and regional level meetings that were used in past summits. With this cost efficient format, the event sponsorships and delegate registration fees should fund all direct Summit costs other than SBA staff time and communication costs.

To start this Summit process, I ask that the House Small Business Committee add a provision to the SBA Re-Authorization bill matching the provision in the Senate version of the Reauthorization which authorizes a National Small Business Summit on Economic Recovery in 2010.

Thank you and I would be pleased to answer any questions.

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House Committee on Small Business Subcommittee on Finance and Tax
Hearing on
"How the Complexity of the Tax Code Hinders Small Businesses"

May 7, 2009

Chairman Schrader, Ranking Member Buchanan, and members of the subcommittee, I want to thank you for the opportunity to testify here today about the need to simply the tax code for small businesses.

I am a micro-business owner, a CPA who has assisted small businesses for over 25 years, and the National Tax Advisor for the National Association for the Self-Employed, an organization representing 250,000 micro-businesses all with ten employees or less. I can tell you that in each of these hats I wear, confusion and complexity surrounding the tax code is one of the primary concerns expressed by small business owners. During this testimony, I will discuss four areas where simplification of the tax code would greatly benefit micro-business owners by reducing their tax reporting burdens while also increasing tax compliance: 1) the Internal Revenue Service's adoption of more simplified, "plain English" forms and documentation; 2) the establishment of a standard home office deduction; 3) clarification of the definition of an independent contractor; and 4) allowing sole proprietors to deduct their health insurance premiums in the same manner as larger corporations.

The IRS is the federal agency that micro-businesses have the most contact with and of course, are most fearful of. It is also the most infamous for its excessive paperwork and unclear instructions and forms. Though, I will note that as a CPA I have been very pleased with the efforts made by the Internal Revenue Service over the past few years to become small business friendly. The IRS's enhanced outreach and educational efforts as well as their work in the Office of Burden Reduction to simplify and minimize paperwork have made positive strides. Its commitment to its website and the availability of information has been very good and certainly recognized by the NASE and many small business owners.

However, despite steps toward improvement, with over 1.4 million words, the tax code is so convoluted that it is extremely difficult for taxpayers, tax practitioners and the IRS to reliably and accurately comply with or enforce the breadth of tax regulations. The IRS currently estimates that a self-employed taxpayer, one filing Form 1040 with corresponding Schedule C, will have to spend on average over 56.9 hours in preparation and filing of his/her return at an average cost of $440 dollars. According to a 2006 Tax Foundation study, individuals, businesses and nonprofits spent an estimated 6 billion hours complying with the federal income tax code, with an estimated compliance cost of over $265.1 billion. Businesses bear the majority of tax compliance costs, totaling nearly $148 billion or 56 percent of total compliance costs.

The majority of NASE members are one to three person businesses with over half working from their home. This is a very unique segment of the business population, in which many do their taxes on their own with assistance from tax preparation software. Thus, the NASE wanted to find out what our micro-business members felt about the current tax code. In March of 2007 we conducted a survey to determine which factor of the federal tax code they found most burdensome. Overwhelmingly respondents indicated that it was the complexity of the tax code and tax forms. Additionally, these members indicated that the simplification of the tax code is what they would most like to improve about our current system.

Simplification of the tax code will not only ease the regulatory burden on small businesses, but will also improve compliance with IRS regulations. Despite the time and cost spent on compliance, according to IRS data from the National Research Program (NRP), the nation's tax gap, the difference between what taxpayers should pay and what they actually pay on a timely basis, is approximately $353 billion. The tax gap has three key components which include underreporting of income, underpayment of taxes and non-filing of returns. There have been numerous proposals by the Department of Treasury and in Congress regarding how to effectively increase compliance and minimize the tax gap. These proposals include imposing withholding on payments made to independent contractors, increasing withholdings on government contractor payments and increasing the reporting requirements on various financial transactions.

For small and micro-businesses, these proposals would only add to the tax compliance burden by creating a whole new set of perplexing and – for many – unmanageable and costly filing requirements. Efforts to address the tax gap and compliance must focus on overall simplification, eliminating issues of inequity within the tax code, and enhancing taxpayer education and outreach. The majority of small business taxpayers want to comply with existing tax laws, thus making tax regulations easier to understand is the most effective and equitable way to improve compliance and to reduce the tax gap.

In late March, the Administration announced the formation of a task force to propose ways to simplify the tax code, reduce evasion, close loopholes and reduce the tax gap. Led by former Federal Reserve Chairman Paul Volcker, the task force plans to provide its recommendations to President Obama by December 4, 2009. As Congress and the Administration review ways to reduce to the tax gap, we encourage lawmakers to focus on the great compliance benefits associated with tax simplification, rather than on proposals which increase the regulatory burdens placed on small businesses.

According to the General Accounting Office, a small business owner faces more than 200 IRS forms and schedules that could apply in a given year. Many of these forms are complicated to understand. The IRS Form 4562, which relates to Depreciation and Amortization, and its corresponding publications are a prime example of vague forms and publications that would benefit from simplification and plain language. A small business owner who purchases a $1,500 computer will have to read 16 pages of obscure instructions to fill out this two page form. Additionally, the IRS indicates that the estimated burden for taxpayers who file this form is approximately 47 hours. Let me reiterate: 47 hours to fill out a two page form.

Minimizing the complexity of the tax code and paperwork burden faced by small business is one solution that policymakers and taxpayers alike have endorsed. The first step in this effort to reduce confusion surrounding the tax code should be to ensure that all forms and publications are in clear, concise language that is easy to understand by all. The National Association for the Self-Employed strongly supports H.R. 946, the "Plain Language Act of 2009." Use of plain language will allow all citizens to more accurately understand and comply with their responsibilities while also fostering more accountability within the federal government. Most importantly, it will boost the bottom line for businesses and government alike. Plain language will require less time and money spent on education, preparation and compliance.

Micro-business owners do not have the luxury of an extensive accounting and human resources department which can focus their time on recordkeeping and complying with regulation. Typically, the business owner is responsible for every aspect of their business taking on the role of CEO, HR manager, accountant and even janitor. Every hour spent wrestling to understand complicated rules and regulations is less time spent managing and growing their business. Every dollar they spend on experts and professional assistance is less money they have to reinvest into their business.

The home office deduction is a prime example of a provision of the tax code that needs simplification. The forms and instructions are too complicated. The paperwork requires too much recordkeeping and takes too much time to complete. In addition, NASE members expressed a substantial fear that claiming the deduction will trigger an IRS audit. All of these obstacles cause many home-based business owners, who qualify, to avoid the deduction altogether.

The creation of a $1,500 standard home office deduction option as proposed in the "Home Office Deduction Simplification Act" (H.R. 1561) would address all of these barriers to utilizing the home office deduction. In fact, we found in a May 2008 online poll that over 60% of those home-based businesses who were not currently employing the home office deduction would do so if they were offered a standard deduction option.

Last year, the NASE nominated the home office deduction for the SBA Office of Advocacy's Regulatory Review and Reform (r3) initiative. As you may be aware, after review of over 80 nominated regulations the SBA Office of Advocacy selected the home office deduction as one of their Top 10 Rules for Review and Reform in 2008.

Micro-business owners face stringent and confusing requirements to qualify for the home office deduction. IRS publication 587, *Business Use of Your Home*, devotes five pages in an attempt to explain and clarify the key requirement for taking the deduction: exclusive and regular use of your home as your principal place of business. While the IRS does its best to make clear what they mean by exclusive and regular, many assumptions are left to the business owner. In addition, the overall qualifying provisions are very limited.

Once a small business owner qualifies for the deduction, he or she then faces the complexity of the IRS form. A self-employed business owner must differentiate between direct and indirect expenses and also between deductible mortgage interest and excess mortgage interest. Some of the expenses are deductible even if the business has a loss and some are not. Many small businesses who qualify for this important deduction do not take it because it is too onerous to fill out the form.

The lack of clarity present in the requirements to take the deduction and the preparation of the form enhances the concern of the self-employed owner that he or she may do something incorrectly. In a May 2008 survey conducted by the NASE, only 27% of members working from a home office took the home office deduction. The fear of being "red-flagged" by the IRS for review and/or audit was the top reason why qualifying business owners did not utilize the home office deduction.

A second area of the tax code that creates considerable confusion and is excessively burdensome for micro-businesses relates to the definitions of "employee" and "independent contractor." A majority of micro-businesses and the self-employed either utilize independent contractors or are themselves independent contractors. Confusion about who is an employee and who is an independent contractor has cost small businesses more than three-quarters of a billion dollars in IRS penalties and back-taxes during the past 10 years.

The issues plaguing worker classification stem from the fact that classification of an individual into an employee or an independent contractor is subjective under the tax code. The IRS has a complicated 20-point checklist the can be used as a guideline in determining whether or not an individual is an employee or an independent contractor. Yet, using this checklist does not guarantee that a person is correctly classified. Other IRS materials published to assist in classification are equally as convoluted. Micro-business owners and self-employed individuals have indicated that when utilizing the IRS's tax assistance help line on this issue, they have received different answers from different agents on this same issue. A large part of the problem is that there is no one, single, homogenous definition of the term "employee." Thus, there is no clear and concise manner for a self-employed individual or micro-business owner to easily determine when an individual should be classified as an independent contractor or an employee.

To further exacerbate matters, an IRS reclassification of worker status can occur two or three years after a tax return was filed. When forced to reclassify an independent contractor to an employee the business must pay the back payroll taxes the IRS says should have been paid in the prior years, as well as interest and penalties.

With more and more individuals conducting a business out of their home as "independent contractors" and the economic incentive to employers to use independent contractors rather than employees, the issue of worker reclassification continues to be a key area for the recovery of revenue by the IRS despite its recent efforts to become more small business friendly. Due to the regulations vagueness and complexity it is very easy for the IRS to arbitrarily reclassify workers and thus, require micro-business owners to pay enormous sums of back taxes and penalties, which ultimately force them to go out of business. Reclassification of 10 independent contractors to the classification of employee, with taxes, penalties and interest can net 100 times more revenue than auditing an individual. (Willingham & Coté, 2001)

The predicament lies in the need for us to protect both micro-businesses who make a good faith effort to classify workers and independent contractors who choose to have the independence and entrepreneurial freedom under that classification, while also protecting employees from potential abuse by employers.

The NASE supports legislation that would clarify worker classification by creating a general test and incorporation test. The general test requires that to be classified as an independent contractor, the business and/or contractor must demonstrate:

- Economic independence;
- Workplace independence; and
- A written contract between the independent contractor and the business (service recipient).

The incorporation test qualifies LLCs and corporations as independent contractors as long as there is:

- A written contract; and
- The contractors provide for their own benefits.

As long as businesses and independent contractors file Form 1099 each year, they qualify for protection by the safe harbor provisions found in section 530 of the 1978 Revenue Act if reclassified by the IRS.

Compliance will be improved because the written contract between the independent contractor and business will make clear their tax responsibilities, the new rules will not apply if the business does not comply with reporting requirements, and also Form 1099s will be issued to individuals who perform services. An independent contractor operating through his/her own corporation or limited-liability company must file all required income and employment tax returns in order to be protected.

The NASE is working to educate legislators on this issue in the 111th Congress and encourage legislation which would amend the tax code to simplify and clarify the definition of independent contractor.

The final issue I would like to discuss is one not only of tax simplification, but also one of tax fairness. Sole proprietors are not able to deduct the cost of their health insurance premiums for the purposes of self-employment tax. Self-employment tax is FICA tax for the self-employed. The self-employed pay FICA at a rate equivalent to employees and employers for a total of 15.3 percent. While 100 percent deductibility of health insurance premiums has been phased in, it does not solve this tax inequity. Sole proprietors are required to pay two types of taxes on their annual tax returns: income tax and self-employment tax. One hundred percent deductibility relates only to income tax and not self-employment tax.

Sole proprietors are the only business entity that does not receive a full deduction for health care costs. All other business entities receive a deduction for health insurance premiums as an ordinary and necessary business expense for all employees, including owners. Employees and the owner pay for their health insurance premiums pre-tax, and therefore they are not subject to FICA taxes. However, sole-proprietors (Schedule C filers) do not receive this "business deduction" for health insurance premiums. The premiums are not paid with pre-tax dollars and are exposed to self-employment tax. Accordingly, the sole proprietor pays this tax (15.3 percent on self-employment income up to $106,000) on his insurance premiums.

The most recent Kaiser Family Foundation study indicated that the self-employed pay on average $12,106 annually for family health coverage. Because they cannot deduct these

premiums as an ordinary business expense, they are required to pay $1,852.22 in additional taxes that no other business entity must pay. This is money that NASE members tell us they would use to reinvest into their business, or utilize to offset the rising premium costs they face each year so they may hold on to their coverage a little longer. In these difficult financial times, removing this inequity would be a significant economic stimulus for the self-employed.

The NASE has endorsed the "Tax Equity for our Nation's Self Employed Act of 2009," H.R. 1470. This legislation would correct this inequity in the tax code and also make it easier for micro-businesses to afford health insurance. We encourage Congress to pass this legislation.

Complex and inequitable tax regulations only make it more difficult for the self-employed community to comply with the tax code. This burden imposed on micro-business is disproportionate to that of larger businesses because smaller firms do not have accounting and legal departments at their disposal to decipher and comply with the maze of tax regulation. On behalf of the NASE's 250,000 micro-business owners, I encourage you to help streamline complicated tax forms and procedures, pass a standard home office deduction, clarify the definition of an independent contractor and allow sole proprietors to fully deduction their health insurance costs in the same manner as larger corporations.

Thank you very much for the opportunity to testify before the subcommittee today.

Written Testimony of

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Before

The U.S. House of Representatives

Committee on Small Business
Subcommittee on Finance and Tax

Hearing on

"How the Complexity of the Tax Code Hinders Small Businesses"

May 7, 2009
Washington, D.C.

Good Morning, Chairman Schrader, ranking member Buchanan and committee members. My name is Stam Stathis. I am a Partner in CPA Associates, P.L.C., a Florida licensed CPA firm located in Bradenton, Florida. It is my honor and pleasure to be testifying today as a CPA with over 28 years of experience and who has prepared hundreds of tax returns for Small Businesses and their owners.

Opening Remarks:

During the span of my career, I have gone from manually posted records to today's widespread computerized accounting systems. With the advent of the computer as a commonplace tool for business, one would think that the accuracy and ease of reporting financial information would be simplified. However, I have not found this to be the case. While it is true that the end product, a financial statement is easier to formulate. The accuracy of the information reported has suffered greatly. In my opinion, the root cause of this inaccuracy is in the lack of understanding of fundamental accounting principles.

While computers and the software that run them can organize information into a given reporting format, the information produced is only as accurate as the information entered - which is a reflection on the skill and knowledge of the person entering the information into the computer system. The same can be said for the Tax Code. That is the higher the knowledge and skill of the person preparing a tax return, the more accurate the result. Since the advent of computerized accounting systems, the Federal Government has increased the basic complexity of preparing an accurate tax return to a level that is beyond the skill of most, if not all taxpayers. We have a saying in my office that "ignorance is cheap".

With the added complexity of preparing an accurate tax return, many small business owners have either been forced to hire a competent professional to aid them in preparing their tax returns at considerable expense or to go it on their own and hope they do not prepare a return with too many inaccuracies. However, incorrect preparation of the tax return is not the only risk the small business owner faces. The Internal Revenue Code, as currently written, has very complex and in some cases arcane rules for the uninformed small business owner.

If there is one take away from my presentation, it is if you could sit in my seat and feel the anger and frustration of the small business owners in dealing with the Internal Revenue Code and its complexity - as I do in my every day practice. You would immediately be moved to simplify the Internal Revenue Code as it applies to the small business community.

Analysis:

Choice of Entity Complexities: A small businessperson's choice of entity: sole proprietorship, partnership, S-Corporation or C-Corporation can be a huge burden in regard to the complexity of the Tax Code with which he or she must comply. In particular, S-Corporations provide some level of liability protection for the small business owner, but are extremely complicated when it comes to such compliance issues as shareholder health insurance premiums, shareholder loans, inadvertent S-election termination, passive activity rules, reasonable compensation, S-Corporation built-in gains tax, proper fringe benefit treatment and depreciation methods.

One way to improve and simplify the selection of the choice of entity type is for Congress to allow partnerships and sole proprietorships to utilize the FICA and W-2 system of reporting. Currently, the IRS does not allow a partner in a partnership nor the individual owner of a sole proprietorship to be classified as an employee. This leads to under withholding and payment of taxes by the small business owner.

Capital Formation and Taxes: Many owners of small businesses fail to properly estimate their taxable income because they equate profit with cash in the bank. Small businesses are usually thinly capitalized. As such, all profits are put back into the business and are reflected on the owner's financial statements in their inventory or as a reduction in debt. Congress should endeavor to pass legislation that encourages the formation of capital by small business owners. The increase in small business capital will lead to a stronger business with the ability to survive the cyclical nature of business.

Shareholder Health Insurance Premiums: Current IRS regulations require that a 2% or greater shareholder include in their taxable wages on Form W-2 the amount paid on their behalf for health insurance. The deduction is then allowable on page 1 of Form 1040 as an adjustment to income. The difficulty lies in including such payments on a shareholder's W-2 because many small businesses use payroll companies that do not properly address the issue. Small business owners that do their own payroll are likely not to be knowledgeable of the intricacies of the IRS Regulations.

In years past, the self-employed health insurance deduction was limited to 40%, and then to 60% before progressing to the status of now being 100% deductible. Since the deduction is now 100% allowable, it is my opinion that the deduction revert back to the corporate level.

Similarly for sole proprietors that report on Schedule C, the deduction should be allowed as a business expense reportable on Schedule C rather than as an adjustment to income reportable on page 1 of the Form 1040. This would resolve the disparate treatment that a sole proprietor must intrinsically pay self-employment taxes on amounts paid for health insurance that employees (including S-Corporation shareholder employees) do not.

Shareholder Loans to an S-Corporation: The amount of losses an S-Corporation shareholder can take is limited to the adjusted basis of the shareholder's stock, plus any direct loans the shareholder makes to the corporation. Securing a loan for an S-Corporation invariably requires a shareholder guarantee. The guarantee of the loan from a lender to the S-Corporation is not sufficient (according to IRS rulings) for a shareholder to deduct losses against such business funds. However, in the case of an LLC/partnership a partner who guarantees the amount of the loan is allowed to fully deduct losses up to the extent that he or she has given a personal guarantee. Such inconsistent treatment should be addressed.

The imputed interest rules required in relation to shareholder loans to (or from) his or her corporation are particularly onerous. Such loans are subject to the imputed interest rules and require detailed attachments to tax returns that even highly trained professionals struggle to properly complete. The interaction of the imputed interest rules with passive activity limitations and self-charged interest regulations add to the confusion. More often than not, the end result of all the computations is an interest income recognition that washes with interest expense recognition. Simplification in this area would be a welcome relief.

Inadvertent S-Corporation Election Termination: Under IRC 385 and related case law, the IRS has the power to recharacterize corporate debt if it is actually disguised equity. Thus, if the corporation classifies a transfer of funds from a shareholder as a loan, the IRS may argue that the debt is actually equity. Accordingly, S-Corporation debt that resembles equity can be potentially troublesome because this might represent a second class of stock, which can conceivably terminate an S-election. Many times one owner of a business will have substantially more assets than another. A loan made by the more substantial shareholder has legitimate business reasons for being made. Congress should remove this obstacle for the small business owner.

Listed Property Record Keeping: The tax code has outdated rules for small electronic equipment. Since the implementation of the Tax Reform Act of 1986, businesses have been required to keep detailed use records for "listed properties" such as computers, cellular telephones, and similar equipment. When the Act was passed into law, these electronic items were not the commonplace items that they are today.

Since 1986, technological advances have changed the way personal computers, cellular telephones, and similar equipment is used in business. Today, these items are used in all types of businesses and are critical to small business success. The costs for these items have gone down substantially and in the case of cellular telephones, many providers offer unlimited airtime use for a fixed rate.

Today, it is overly burdensome for a small business owner to maintain detailed use records for personal computers, cellular telephones and similar items. The cost associated with the maintenance of these records is greater, in many cases, than the actual cost of the expenses being detailed. I would recommend that Congress remove the burden of maintaining detailed use records for computers, cellular telephones and similar items by reclassifying these items from listed property (under section 280f(d)(4)(v)) to that of business property.

Automobile Record Keeping: The tax code has onerous record keeping requirements for personal automobile use. Many small business owners must use their personal automobile for business purposes to reduce costs. In order to deduct the expenses related to this automobile use, the business owner must maintain detailed travel logs, detailing mileage, beginning point, ending point, business purpose of the trip and who they were going to see.

Using an example of a sales representative who travels to 10 appointments each day, 250 days of the year, this person would have to record 2,500 detailed entries to deduct the expenses associated with the business related travel. Also, any non-business related travel would have to be tracked as well. Unfortunately, many small business people are unable and/or unwilling to track their travel in such a detailed manner and rely on estimates. Under IRS examination, this method does not stand up, and the legitimate business expense is disallowed.

Congress should look at implementing alternatives to this onerous reporting standard. One method that might be considered for individuals with greater than 50% business use is keeping records for only personal use.

Meals and Entertainment Expenses: Record keeping for meals and entertainment expenses required by the tax code is burdensome. Not only does a small business owner need to keep and maintain detailed records of the expenditure, but also maintain various other required items of documentation as to the reason for the expenditures. For larger and more sophisticated business owners with accounting departments the records are much easier to maintain. That is, termination or nonpayment for noncompliance is a real threat. For the small business owner self-discipline is not a real threat.

Many small business owners do not understand the detail of the records they must keep and maintain as substantiation for the deduction.

Business Gifts vs. Promotion: The distinction between business gifts and advertising/promotion is difficult to understand. For the small business owner, personal relationships are some of the most valuable items they have. They often give "gifts" to their customers, both to express their gratitude and strengthen these relationships.
Per the tax code, business gifts of up to $25 per recipient are deductible. That is why many small business owners call their gifts "promotions" or "advertising". In their mind, if they give a client an item, with their name prominently engraved on it and it costs more than $25, it should be fully deductible. I would urge Congress to look at the dollar limitation on gifts as it relates to promotion.

Home Office Deduction: The tax code's rules for the "Home Office" deduction are very complex. The tax code allows a deduction for expenses related to the portion of a business owner's home that is dedicated to the business. However, to qualify for the home office deduction the business owner must be able to prove the following:

1. Exclusive use of the portion of the home for business use. The tax court has held that exclusive use during business hours is not enough to qualify, if the space is put to personal use occasionally after hours. In one case, business use was NOT exclusive where the space was used for one day each year for personal use.
2. Regular use of the portion of the home for business use.
3. And the home office must be one of the following:
    a. The business owner's principal place of business for any trade or business.
    b. The place where patients, clients, or customers regularly meet or deal with the business owner in the normal course of business.
    c. The place where the business owner conducts the administrative or management activities for the business, and no other fixed location of the business exists.

Once a portion of the business owner's home qualifies for the deduction, then the complex IRS form must be filled out. This form requires the small business owner to correctly categorize expenses as either direct (those expenses that are related to the business use, such as repairs to walls of the office) or indirect (those related to the entire home, such as electricity, insurance, etc.)

Many small business owners believe that claiming the home office deduction is an IRS audit "red flag." So, due to the complexity and perceived risk many small business owners, who could legitimately claim this expense, do not and miss the potential tax savings.

In order to recognize the way people work in society today, I would recommend that Congress look at relaxing the exclusive use portion of the test.

Fiscal Year Flexibility: The fiscal year and filing requirements imposed by the Tax Code are too limiting for fiscal year S-Corporations. Under the current tax laws, C-Corporations can adopt any fiscal year (regardless of business purpose) for reporting its income, expenses, etc. In contrast, an S-Corporation can only choose a calendar year, or a fiscal year as prescribed in Code Sec. 444 (September 30, October 31, or November 30), unless it can establish a business purpose for reporting on a fiscal year basis.

Congress should exempt small business S-Corporations from the provisions of Code Section 444. The ability to have a year-end other than a calendar would greatly benefit the Small Business owner and his ability to manage his business.

Fixed Asset Additions: Currently capitalizing fixed assets costs can be taken as a deduction under Section 179. Generally, a Section 179 deduction cannot cause a business loss. However, to the Small Business owner's way of thinking he has expended the funds to purchase the item regardless of the impact to his income. Congress should look at allowing the Small Business owner to deduct the cost of these assets irrespective of the creation of a net operating loss (NOL). The ability to carryback the NOL to prior more profitable years would allow the small business owner to see an immediate return on his investment

Retirement Plans: The implementation of retirement plans for small businesses can be one of the most costly employee benefit provided by an employer. I have seen many small employers drop retirement plans shortly after adoption do to the continued administrative, compliance and cost issues. Congress needs to establish retirement plans that provide adequate retirement benefits to small business owners without onerous reporting requirements and costs to maintain.

Conclusion:

I appreciate the opportunity to present my ideas for simplifying the Internal Revenue Code for Small Business owners and would be pleased to discuss or clarify my ideas with Members or staff of the House Committee on Small Business at any time.

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