

**HOW TAX COMPLEXITY HINDERS SMALL BUSI-
NESS: THE IMPACT ON JOB CREATION AND
ECONOMIC GROWTH**

HEARING

BEFORE THE

**COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES**

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HOW TAX COMPLEXITY HINDERS SMALL BUSINESS: THE IMPACT ON JOB CREATION AND ECONOMIC GROWTH

WEDNESDAY, APRIL 13, 2011

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

The Committee met, pursuant to call, at 1:00 p.m., in room 2360, Rayburn House Office Building. Hon. Sam Graves (chairman of the Committee) presiding.

Present: Representatives Graves, West, Walsh, Barletta, Velázquez, Schrader, Altmire, Clarke, Chu, Cicilline, and Keating.

Chairman GRAVES. Good afternoon. I call the hearing to order. I want to thank our witnesses all for being here today. I know some of you have come a long way and we appreciate it very much.

The U.S. economy appears to be strengthening and the labor market appears to be improving slowly. But energy prices are volatile and months of rising food, clothing, and fuel has also caused wholesale prices to rise. Small businesses continue to be affected by the uncertainty of more mandates, higher taxes, and additional regulations. It is difficult for our nation's job creators to do what we are expecting them to do and that is create jobs and spur investment. Against this backdrop and during the week prior to tax day, we meet to examine the federal tax code complexity and its impact on small businesses.

In our 2010 Report to Congress, the National Taxpayer Advocate, who is with us today, identified tax complexity as the top problem facing taxpayers. She also reported that U.S. taxpayers and businesses spend about 6.1 billion hours per year to comply with filing requirements. The tax code continues to expand—it is now 3.8 million words and there have been over 4,428 changes to it in the past 10 years, an average of more than 1 per day.

It is no secret that tax complexity has a disproportionate impact on small firms. The Small Business Administration's Office of Advocacy reported that small firms spend more per employee than large businesses to comply with the tax paperwork, recordkeeping, and reporting requirements. Surveys by the National Federation of Independent Business consistently rank federal taxes as one of the top five issues of concern to entrepreneurs. At a time when every added expense can mean the difference between a small entity's success or failure, clearly tax simplification is needed.

I am encouraged by Chairman Ryan's budget proposal, which recommends lowering the top individual and corporate tax rates.

According to the NFIB, nearly 75 percent of small firms are organized as pass-through entities such as sole proprietorships, partnerships, or LLCs where business income is passed through and taxed at the individual rate. In other words, most small businesses file their taxes on an individual return. Consideration of corporate tax reform without also considering individual rates would leave many small business owners out of the debate.

Again, I want to thank all of our witnesses for being here today and I will now turn to Ranking Member Velázquez for her opening statement.

Ms. VELÁZQUEZ. Good afternoon, everyone.

With tax day fast approaching, filing taxes is on the minds of many Americans, particularly small business owners. This Committee is well aware of the challenges created by the Internal Revenue Code. Over the past decade, businesses have repeatedly expressed to Committee members that tax complexity has become a major obstacle to job creation. While this issue has been recognized for some time, the problem seems to be getting worse, not better. As the Chairman stated, there has been approximately 4,428 changes to the tax code, an average of 1 per day. These changes compound an already burdensome tax system creating confusion and higher compliance costs. In fact, individuals and businesses spend about 6.1 billion hours per year complying with the filing requirements.

These burdens can hurt small businesses as they seek to compete both domestically and abroad. Small firms now spend up to 67 percent more on tax compliance than their corporate competitors. And on the global front, the U.S. ranks an embarrassing 65th worldwide for time spent complying with business tax filings.

This hearing will hopefully offer insight, not only on the problem but also on potential solutions. After all, as we look at policies to promote growth, tax reform should be a top priority. A fairer and simpler tax code can encourage entrepreneurship, promote investment, and lead to job creation. One thing is clear as we talk about reform. The needs of small businesses must come first. We cannot move forward without their input, and we must fully recognize the impact of how any changes will affect them. At a time when the economy is starting to exhibit sustained job creation, small firms cannot have new obstacles to expansion.

Fundamental tax reform obviously poses its own challenges. Back in 2005, this Committee heard testimony from the Tax Reform panel appointed by President Bush, but his recommendation, its recommendations went nowhere. The latest 2010 Deficit Commission similarly recommended a major overhaul to the tax code but the report did not gather enough support to force a vote in Congress.

Today's hearing will hopefully start the process of crafting solutions to our overly complex tax code. It is clear that small businesses and our economy can come out winners if reform is done right. Small businesses are the drivers of the nation's economy and we cannot afford to put the cost of collecting taxes on them. Entrepreneurs do not want preferential treatment; they just want equal treatment.

I look forward to today's testimony and I thank the witnesses for their participation. With that I yield back.

Chairman GRAVES. If the other Committee members have statements for the record I would appreciate you submitting those.

I would also like to take a real quick opportunity to explain the timing lights. Each of you has five minutes, and please try to stay within the five minutes. The light will be green and then it will turn yellow when we have one minute left and red when the time is up.

STATEMENTS OF THE HONORABLE NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE; STEVEN J. STROBEL, BLUESTAR ENERGY SOLUTIONS ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION; ROBERT KULP, KULP'S OF STRATFORD ON BEHALF OF THE NATIONAL ROOFING CONTRACTORS OF AMERICA; MONTY W. WALKER, WALKER BUSINESS ADVISORY SERVICES

Chairman GRAVES. I will now introduce our first witness, Nina Olson. She is the National Taxpayer Advocate, an appointment she has had since 2001. She leads the Internal Revenue Service's Taxpayer Advocate Service. The office is dedicated to assisting taxpayers with their IRS problems. And again, thank you for coming.

STATEMENT OF NINA E. OLSON

Ms. OLSON. Thank you, Mr. Chairman, Ranking Member Velázquez, and distinguished members of the Committee. Thank you for inviting me to testify today about the impact of tax complexity on small businesses.

My office estimates that small businesses alone spend at least 2.5 billion hours each year complying with income tax filing requirements. This is not a trifling matter because small businesses are the creators of most new jobs and the employers of about half the private sector workforce. To state the obvious, the more time and resources a small business spends on tax compliance, the less time it has to grow and hire employees.

In my 2010 Annual Report to Congress, I identified the need for Tax Reform as the number one most serious problem facing taxpayers and the IRS. The tax code is filled with special breaks helping taxpayers who can afford tax advice and discriminating against those who cannot. This complexity confuses taxpayers and creates a sense of distance between taxpayers and the government, which undermines taxpayer morale and leads to lower levels of voluntary compliance. The complexity of the tax code is also burdensome for the IRS, making it more difficult for the agency to meet taxpayer needs and probably resulting in more audit and enforcement actions than a simpler code would require.

My report advocates for comprehensive tax reform, which I believe is ultimately a necessity. But there are smaller steps we can take right now to ease the compliance burden of small businesses. I will briefly highlight several tax requirements that impose unnecessary compliance burdens on small business and require simplification or at the very least, more guidance.

First, the home office business deduction is unnecessarily complex and requires time-consuming recordkeeping by many small

businesses. We recommend the creation of an optional standard home office business deduction.

Second, the S corporation election process is confusing and causes many taxpayers to make inadvertent errors. As a result, some businesses inadvertently become classified as C corporations and their shareholders cannot deduct operating losses on their individual tax returns.

To address these problems, we recommend simplifying the election process to allow small business corporations to make an S election by checking a box on a timely filed Form 1120S.

Third, business owners need greater flexibility under the Trust Fund Recovery Penalty, which can apply against a person responsible for filing or paying over a business's employment taxes. Currently, the strict application of the penalty's willfulness component requires the responsible person to use all available funds to pay the delinquent tax and prohibits the use of any funds to pay operating expenses of the business even to keep the business going. We recommend the IRS not assess this penalty where there was an intervening bad act such as embezzlement and the taxpayer makes payment arrangements and remains current with payment and filing obligations.

Fourth, the IRS has long acknowledged that taxpayer service and enforcement both play important roles in maximizing tax compliance, but the IRS's compliance initiatives these days are rooted exclusively or primarily in enforcement measures. Particularly when it comes to small business taxpayers, I believe outreach initiatives that educate taxpayers about the bewildering array of income and employment tax requirements they face are critical. Several years ago the IRS conducted an extensive series of surveys and research studies to better understand the service needs and preferences of individual taxpayers. We have recommended the IRS replicate this process to better understand the service needs and preferences of small business taxpayers as well.

Finally, I want to close with a word about IRS collection policies and procedures. The IRS does not do enough to work proactively with small business taxpayers that have emerging collection problems, particularly those who fall behind on their employment tax obligations. The IRS should provide early assistance, including calling the taxpayer and discussing and utilizing flexible collection tools, such as installment agreements, partial payment installment agreements, and offers in compromise. Further, the IRS should develop a better understanding of the reasons for noncompliance among small business taxpayers so it can apply appropriate collection techniques. Toward that goal, it should develop a definition of economic hardship for small businesses that balance tax collection and promotion of a level playing field on the one hand with the government's and taxpayers' interest in helping small businesses remain viable and contributing to the country's economic growth on the other.

I appreciate your interest in these issues and would be happy to respond to collections—questions. Thank you. Collections, too. [Laughter.]

Chairman GRAVES. Thank you, Ms. Olson.

Our next witness, and I will be introducing on behalf of Mr. Walsh, but our next witness is Steven Strobel, the executive vice president and chief financial officer for BlueStar Energy Services, which is a retail energy supplier in Chicago, Illinois. He is testifying on behalf of the National Small Business Association. Mr. Strobel, we appreciate you being here. Thanks for coming.

STATEMENT OF STEVEN J. STROBEL

Mr. STROBEL. Thank you, Chairman Graves, Ranking Member Velázquez, Committee members. Thanks for the opportunity to testify today.

Although NSBA's members operate a wide variety of businesses, they all consistently rank reducing the tax burden among their top issues Congress and the administration needs to address. While the actual out-of-pocket cost is a huge issue, the sheer complexity of the tax code has been an ever-increasing administrative burden on America's small businesses, which unlike big corporations do not have large staffs of accountants, benefit coordinators, attorneys, personnel administrators, et cetera, at their disposal to deal with the regulatory and paperwork demands of the federal government.

According to NSBA's 2011 Small Business Taxation Survey, 87 percent of small business owners hire outside help to handle their tax reporting and filing requirements. The complexity of the current tax system forces small businesses to spend valuable time and financial resources on tax compliance instead of using these resources to do what they do best—grow the business and hire people. When asked in the NSBA Taxation Survey how much time and money per year is spent just on the administration of taxes, 50 percent of small businesses said they spend more than \$5,000, and more than a third spend more than 80 hours on tax filing preparation. At BlueStar, we spend about \$25,000 annually on our tax preparation.

As Congress and the administration grapple with a downturned economy, banking failures, and skyrocketing deficit, it is natural to look for ways to offset spending and raise revenues. However, it would be unwise for Congress to do so on the backs of small business owners, the very entrepreneurs who create jobs. To grow their businesses and hire new employees, small business owners need dependable and sufficient access to capital and public policies that boost investment and encourage entrepreneurship.

Reducing the U.S. deficit has a real benefit to small business growth in the U.S. and is something America's small business owners feel should be a national priority. Federal spending in 2010 amounted to approximately 24 percent of GDP, a level not seen since World War II, and in part due to an economic downturn. Even with an economic recovery and the ensuing increase in tax revenues and decrease in spending, without major changes federal spending will continue to outpace revenues. If we continue to run high deficits, increase interest, and constrict credit, it will negatively impact small businesses' ability to garner financing, and 80 percent of small businesses use credit.

Congress and the administration over the coming years must address the nation's budget deficit and the associated long-term debt. In addition to reducing the size and pay of the government work-

force and overall entitlement spending, one way to do that is to implement real tax reform. Tax reform is one of the NSBA's top 10 priorities. Based on a 2011 NSBA Taxation Survey, small businesses express support for tax reform that simplifies the tax code, broadens the base, lowers all individual and corporate tax rates, and makes the corporate tax code more competitive for U.S. businesses.

The current tax code is comprised of more than 10,000 pages of laws and regulations that, in their complexity and propensity for frequent change, serve as a disadvantage to small businesses. NSBA's members believe it is imperative that the U.S. move toward a simpler, fairer tax system that is designed to tax only once, is stable and predictable, is visible to the taxpayer, is simple in its administration and compliance, and is comprehensible using commonly understood finance and accounting concepts. And finally, is fair in its treatment to all citizens. These reforms can spur economic growth.

Another factor to consider is the international competitiveness of U.S. firms. Congress and the administration must ensure that our tax code does not impede our international competitiveness of U.S. companies, nor disincentivize domestic investment. One way to accomplish this is by enacting the fair tax.

In the 112th Congress, legislation has been introduced into the House and Senate, the Fair Tax Act of 2011, which the NSBA proudly supports. But whether it is the fair tax or any of the other tax reform recommendations that are currently on the table, any reform must be built around internationally competitive tax rules that result in a simpler, more efficient and less costly tax system that provides powerful incentives for businesses to invest and produce in the U.S. The economics of small businesses in all sectors would be strengthened by their ability to save and invest in this country and thus hire additional workers.

The NSBA believes efforts to reduce the regulatory and administrative burdens on small businesses must focus on overall simplification, eliminating inequities within the tax code, and enhancing taxpayer education and outreach. A simpler tax code that is more easily understood by taxpayers would have many benefits, not the least of which would be reduced cost of compliance and reduced unintentional errors. Accurate tax reporting and compliance is extremely important to small businesses but vague rules and poorly defined regulation understandably result in mistakes.

The more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations, and with the complexity facing many taxpayers, NSBA believes that development and implementation of initiatives to improve IRS guidance and assistance is important.

In conclusion, the NSBA is confident that fiscally responsible policies and entrepreneurially supportive tax simplification will lead to the long-term prosperity of the U.S. economy. It is critical that lawmakers avoid any move that would stymie the moderate economic growth we are starting to see in the U.S. economy and the growth in our small business community.

Thank you.

Chairman GRAVES. Thank you, Mr. Strobel.

Ms. Velázquez.

Ms. VELÁZQUEZ. It is my pleasure to introduce Mr. Robert Kulp. He is the founder of Kulp's of Stratford, Wisconsin. His firm is a roofing and insulation company that has been in business since 1985 and employs over 40 people. Mr. Kulp is testifying on behalf of the National Roofing Contractors of America with over 4,000 members worldwide. Welcome.

STATEMENT OF ROBERT KULP

Mr. KULP. Thank you. Chairman Graves, Ranking Member Velázquez, and members of the Committee, thank you for the opportunity to testify today.

I am Bob Kulp, co-owner of Kulp's of Stratford. We are a small roofing and insulation company doing residential and commercial roofing. We have also moved into installing and building integrated solar photovoltaic roofing. We employ between 30 and 50 people and we do about \$6 million in annual volume.

I am testifying today on behalf of the National Roofing Contractors Association, and I serve as a director, as well as chairman of the Government Relations Committee. Established in 1886, the NRCA is one of the nation's oldest trade associations and a voice of professional roofing contractors worldwide.

As the national unemployment situation continues to slowly improve, unemployment in the construction industry remains at an alarming 20 percent. Clearly, it is time to take steps to improve this situation. Reducing complexity in the tax code is a good place to start. NRCA urges Congress to take immediate action to simplify taxes in order to help spur job growth within the construction industry.

First, Congress should facilitate the creation of an estimated 40,000 jobs by reforming tax depreciation for commercial roofs. Depreciation reform would also enhance the energy efficiency of our nation's commercial buildings and simplify taxes for many small businesses. Depreciation reform is necessary because between 1981 and 1993, the depreciation schedule for commercial roofs was increased from 15 to 39 years. However, the current 39 year depreciation schedule is not a realistic measure of how long commercial roofs last, which is about 17 years. The large disparity between that 39-year depreciation schedule and the 17-year average lifespan of a commercial roof is an incentive for building owners to delay the replacement of failing roofs. This slows economic activity in our industry because many building owners choose to just do piecemeal repairs rather than replacing a failing roof in its entirety.

Several bills have been introduced in recent years to rectify this situation by reducing the depreciation schedule to a more realistic 20 years. This would facilitate the creation of an estimated 40,000 jobs in the roofing industry and add one billion dollars to the taxable annual revenue to the economy. Depreciation reform also would provide savings to small businesses of all types by simplifying their taxes and lowering energy costs. NRCA welcomes the opportunity to work with members of the Committee on legislation to create jobs by simplifying taxes through depreciation reform.

Second, the NRCA calls for the immediate repeal of the 3 percent withholding on government contracts. Repeal of this law, which adds a new layer of complexity to a contractor's tax filing, is vital to job creation and economic growth in our industry. If the withholding law is not repealed, many roofing contractors will face serious repercussions. Cash flow and operating capital disruptions will be a tremendous burden particularly for small businesses. The bookkeeping systems of many small businesses simply are not set up to account for those large amounts that are withheld from invoices and withholding will complicate tax filings. Additionally, many roofing contractors will be simply forced to stop bidding government contracts in order to avoid those costly tax complexities. NRCA strongly urges Congress to quickly repeal this law that further complicates tax filings due to the 2012 implementation date that is fast approaching.

Third, NRCA supports legislation to reduce tax complexity by reforming how construction contractors can utilize the completed contract method of accounting. Under current law, contractors cannot use the completed contract method if the annual average gross receipts exceed \$10 million, a threshold that has not been adjusted for inflation since 1986. Contractors who cannot utilize a completed contract method must use a percentage of completion accounting method, which often does not accurately reflect results due to the required use of cost estimates. This is a major paperwork burden for many small and midsize contractors because of the need to estimate the percentage of a completed project and then retroactively amend those filings in subsequent years based on the actual numbers. This is another example of the complexity in the tax code that is an impediment to business growth and job creation, and increasingly more time and resources must be devoted to tax compliance rather than more productive forms of economic activity.

To conclude, NRCA urges Congress to address the alarming 20 percent unemployment rate in the construction industry by reducing tax complexity for contractors in our industry. Thank you for your consideration of the NRCA's views and the opportunity to testify today.

Chairman GRAVES. Our next witness is Monty Walker. Mr. Walker is a principal of Walker Business Advisory Services in Wichita Falls, Texas. He advises start-ups and established small firms on business transactions and tax matters. Mr. Walker, I appreciate you coming.

STATEMENT OF MONTY W. WALKER

Mr. WALKER. Chairman Graves, Ranking Member Velázquez, and members of the Committee, thank you for the opportunity to appear before you today.

My name is Monty Walker. I am a certified public accountant. I have a national advisory practice with a practice focus in the support of entrepreneurs, primarily in the area of business ownership transition planning and related support services.

Small businesses face many obstacles. Buying or starting a small business is often one of the most significant financial events ever experienced by an entrepreneur. Entrepreneurs approach the process of owning a small business with a hope and desire of creating

something better for their future while often exposing themselves to a large investment and debt. For many entrepreneurs, their small business is the center of their family's financial infrastructure providing the majority, if not all, of their family's current and future income.

Because of the importance small business plays in the life of a small business owner, the division between the small business and the small business owner often becomes blurred because every business decision has a direct and often significant impact on the small business owner and the small business owner's family. Additionally, almost every decision made by a small business owner has some form of tax implication.

Small business owners often start their business on a passion-based foundation doing something they enjoy, only to quickly learn that running a small business has many complex and confusing compliance requirements. Mail received from the various regulatory bodies becomes overwhelming. Unfortunately, many small business owners get out of compliance simply due to a failure to interpret correspondence being received from the IRS. This is especially true for small business owners who cannot afford the services of a tax professional.

For most small business owners, understanding the tax compliance requirements is beyond their reach. The complexity of the tax system is as perplexing as a foreign language. Due to limited discretionary cash flow, many small business owners do not have the ability to retain the services of a tax professional on an ongoing basis. As a result, many small businesses are attempting to maintain a substantial amount of required compliance through the efforts of untrained and unknowledgeable tax advisors, these advisors being themselves.

A lack of funds for ongoing professional assistance and a misinterpretation of the regulations often lead to failed compliance. The ever growing tax code, along with the temporary provisions and interpretations, make it increasingly difficult for small business owners to do any substantial long-term planning. This leads to small business owners being placed in the position to make decisions in a vacuum due to the unknown results which may occur. Since the tax system directly impacts so many decisions, small business owners will stand by on making business developments and new hire decisions when they have a lack of confidence in what will occur due to the unknowns in the tax system. This in part has added to and is currently adding to the soft business expansion and a lack of new hiring which is desperately needed as a part of the United States' economic recovery.

Small business ownership is wrought with risk and burdens. The burdens of owning a small business expand exponentially when the confusion and complexity of the tax system is introduced to the small business ownership equation. Maintaining compliance with the various governmental regulatory bodies is extremely time consuming and this is especially true for tax compliance. Additionally, maintaining tax compliance comes at a cost. The cost to properly maintain regulatory compliance is really the small business owner's opportunity cost associated with expending the same resources on business operations and business development. These resources

include both money and time. Between the money spent on tax professionals and time focused on maintaining compliance as opposed to spending the same time running the business, a small business owner's opportunity cost can be quite significant. Small business owners compliance time plus their compliance fees equals a small business owner's total opportunity cost.

In preparation for this hearing, I polled 20 small business owners with businesses ranging in revenue from 1 million to 5 million to determine their level of business opportunity cost. I learned that the average amount of time and fees expended by these business owners to maintain their tax compliance is time of 104 to 156 hours per year and professional fees ranging from \$5,000 to \$15,000 per year. When considering penalties and interest associated with the failure to maintain compliance, business opportunity costs can grow extremely large.

Understanding that this business opportunity cost exists is of utmost importance because the business opportunity cost correlates with the lost resources that could have been used for business development which in turn leads to the creation of new jobs. Thank you.

Chairman GRAVES. Thank you very much, Mr. Walker.

We will now move into questions. Ms. Olson, I have to say that it is refreshing to hear you talk about your position and the Office of Advocacy and that you are advocating for taxpayers. Do they listen to you?

Ms. OLSON. I think that the IRS understands the complexity that taxpayers need to live with. They are doing some research now but they are not doing the kind of comprehensive research on taxpayer needs and preferences for small business taxpayers that I need to see.

On the collection area, I think that they really feel the need to collect, collect, collect. They make very few phone calls out to taxpayers outbound to find out what is really going on in their situations. They often use levies as the calling card and get the call back in from the taxpayer saying what are you doing? I cannot make payroll. And there is generally a lack of sympathy in the employment tax area, which is why we are focusing so much on that area.

One thing we learned was that for an account to get assigned to someone, an employment tax account get assigned to someone to actually make a face-to-face call with a taxpayer, there is usually two years of arrearages. And as I think the representative down there, Mr. Walker would say, the sooner you can get to the taxpayer when the dollars are low, you have a greater chance of solving the problem and keeping them in compliance in the future and keeping the business going. But when it gets so large, like two years' worth of employment taxes, that is the kiss of death for a business.

Chairman GRAVES. My next question is—and I will start with Mr. Walker. And you can answer it from, obviously from your client's point of view; and Mr. Strobel, from your association's point of view; your members, Mr. Kulp. I do not know if it will pertain to you and I would like to hear Ms. Olson at the end. The administration is proposing higher taxes for pass-through small businesses that file their income taxes on an individual tax return—higher

taxes for couples with incomes over \$250,000 and individuals over \$200,000. Can you tell me how that would affect your clients that fall into that area?

Mr. WALKER. The area of practice I am in really shows the misnomer in this concept of excess of 250. Small business owners spend years developing a business, and many times they are developing it so that they can have it for retirement. They, on paper, are worth a lot of money but they may not make a lot during the time. So they are below 250 possibly while they are operating, then all of a sudden the economic event occurs and they may sell that business for a million dollars, which is designed to be their retirement. All of a sudden, now under the excess of 250, that is a wealthy individual. So it has a significant adverse impact on their willingness to even sell and they hold out. But it will be an adverse impact, especially on their ability to have retirement funds. It goes well beyond just normal operating taxes. This is a life event that can be adversely impacted by decision to increase above the 250.

Chairman GRAVES. Mr. Kulp, does it pertain to you?

Mr. KULP. I would agree with what he said but, no, it does not really directly.

Chairman GRAVES. Mr. Strobel.

Mr. STROBEL. I would talk about it in the context of BlueStar. We are a sub S corporation so all of our income goes straight through to our two owners. And so any increase in tax would be a direct impact on the resources available in our company to invest, do marketing, understand other investments that we could make to actually grow the company. So it would be a diminution in the resources available to grow the company.

Chairman GRAVES. Ms. Olson.

Ms. OLSON. Well, I get to pass on commenting about rates because that is really the, you know, the jurisdiction of the Office of Tax Policy in Treasury. But I would say, you know, our recommendation has been that you really simplify, you know, reduce the complexity of the code, really think long and hard about what is running through the code. And if you do that, you would have a broader base and be able to reduce rates for everyone involved. And that is sort of our position. We did it in 1986. I do not see why we cannot do it again.

Chairman GRAVES. Mr. Kulp, you mentioned already some things, some specifics on simplification, which I appreciated, 3 percent withholding and some other stuff. Just out of curiosity, Mr. Strobel or Mr. Walker, do you have any specifics? You mentioned a few, too, Mr. Walker, but other specific things when it comes to complexity? Are you talking total overhaul? You know, changing, you know, it is obviously very complicated now but any other ideas and thoughts? You know, coupled onto what Mr. Kulp said, too, about depreciation?

Mr. KULP. Depreciation is a significant problem. It is very complex. People do not know whether they should take a period expense or expense something immediately. So it is far beyond depreciation. If somebody is going to repair a vehicle, is that a depreciable event or is that a period expense? They spend—you can spend hours just trying to determine how that applies. So that is a great example. Capitalization versus expensing. The issues that

are a problem, especially when it comes to this depreciation matter, currently it does not matter if a business has been think long and hard about what is running through the code. And if you do that, you would have a broader base and be able to reduce rates for everyone involved. And that is sort of our position. We did it in 1986. I do not see why we cannot do it again.

Chairman GRAVES. Mr. Kulp, you mentioned already some specifics on simplification, which I appreciated, 3 percent withholding and some other stuff. Just out of curiosity, Mr. Strobel or Mr. Walker, do you have any specifics? You mentioned a few, too, Mr. Walker, but other specifics when it comes to complexity? Are you talking about total overhaul? You know, the code is obviously very complicated now, but any other ideas and thoughts? You know, coupled onto what Mr. Kulp said, too, about depreciation?

Mr. STROBEL. Depreciation is a significant problem. It is very complex. People do not know whether they should take a period expense or expense something immediately. So it is far beyond depreciation. If somebody is going to repair a vehicle, is that a depreciable event or is that a period expense? They spend—you can spend hours just trying to determine how that applies. So that is a great example. Capitalization versus expensing. The issues that are a problem, especially when it comes to this depreciation matter, currently it does not matter if a business has been in existence for 50 years. You can recapture all this depreciation and it can all of a sudden create ordinary income passing out of a S corporation when they sell those assets. That makes very little sense to me why that would happen. So complexity added with something like that is significant.

Mr. WALKER. I will ask the NSBA to follow up after the hearing with their specific recommendations.

Chairman GRAVES. Please do.

Ms. Velázquez.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman.

Ms. Olson, there seems to be broad consensus that we should eliminate a number of deductions and credits and use those revenues to lower tax rates. However, when the recent deficit commission outlined a tax plan to accomplish this, it was blocked from being brought or considered in the House.

So my question to you is how can comprehensive reform move forward if bipartisan recommendations like this never receive a vote?

Ms. OLSON. Well, I am not going to comment on the procedures of the House or the Senate. I am wiser than doing that. But I will respond by saying we have believed for a long time that there needs to be a dialogue and leadership, both in the House and in the administration, and also from the taxpayers themselves, that there has to be tax reform. And to up a plan, such as the Bipartisan Commission or the 2005 Presidential Commission, all are a good start. There are lots of good ideas out there. And what we need is the political will to be willing to work through those ideas. And whether it is just slugging it out in the Ways and Means Committee and the Senate Finance Committee, and with the White House, we absolutely need this to go forward.

Ms. VELÁZQUEZ. Thank you.

Mr. Walker, we would like to hear specific areas that we could simplify the tax code so that we could help small businesses do what they do best. So firms, based on your own experience, firms generally fund their business operation by taking on debt or through equity financing. Both have advantages and disadvantages, but it is clear that the tax code favors debt financing since interest is deductible.

So can you talk to us, when you advise firms, do you advise—and they finance their business—do you believe that we should address how the tax code treats debt versus equity financing as one area that maybe this Committee should be looking into?

Mr. WALKER. If anything has changed in the area of debt so that a small business is incapable of deducting the interest expense, that would be an adverse blow. Small business owners do not have the benefit of getting equity players. I think we could all walk outside and say that we do not see a long line of people wanting to take risk in small business investment. That is why entrepreneurs become entrepreneurs. They risk their own investment in themselves. So anything to change the debt structure that would eliminate or lower the interest—the ability to take an interest deduction is an adverse. It should only be looked to enhance some benefit that they could get.

Ms. VELÁZQUEZ. Mr. Kulp, you spoke about the depreciation schedule that is set at 39 years. If we look at our economy, one area where still it is very fragile is the housing construction area.

Mr. KULP. Sure.

Ms. VELÁZQUEZ. And so you said that the depreciation schedule for commercial roofs will have a positive impact. How is that the case that it will benefit other small businesses?

Mr. KULP. Great question. The NRCA did an extensive study a number of years ago that actually said that it would spur economic growth to the point where there would be 40,000 new jobs added to the roofing industry alone. And when you look at that along with, you know, that much more money flowing into the economy, one of my issues is static scoring versus dynamic scoring on the CBO. And I know I am not going to change that but it seems to me that if you look at how it plays out, enhancing owners' ability to move with roofing will definitely spur jobs and reduce the unemployment rate.

Ms. VELÁZQUEZ. Thank you. Mr. Strobel, the Fair Tax Plan will impose a national sales tax and eliminate the income tax, as well as all current deductions and credits, yet this will mean that carrying tax incentives for renewable energy and energy efficient products will no longer exist. As someone in the energy industry, do you believe that these industries can remain viable without such policies?

Mr. STROBEL. I think they can. Just to be clear, as an executive with BlueStar I am not advocating the fair tax that is an advocate position of the National Small Business Association. I think there is a place for some incentives. We see that with a lot of energy efficiency customers that there is an opportunity for them to take advantage of incentives. But there are real economic gains in our energy efficiency businesses where we go in and do a lighting retrofit, for instance, in a facility. Part of it is the incentives that are avail-

able but more importantly, it is the economic benefits of actually using less energy. So in the grand scheme of things I think there are some incentives and some rationale to the incentives but we find that many of our customers are more driven by the overall economics whether or not there are incentives.

Ms. VELÁZQUEZ. Thank you, Mr. Chair.

Chairman GRAVES. Mr. West.

Mr. WEST. Thank you, Mr. Chairman and Ranking Member.

We sat here and the question to the panel, we have all agreed that the tax code as it stands now is pretty complex, onerous, and I guess there are many with a loophole in there. So my question would be there are two reform perspectives out there: one is a flat tax and one is a fair tax. I would like to get your assessments on how those two reform systems, would it benefit or hinder the small businesses? And then maybe your estimation on what would be good rates for those respective systems. So flat tax, fair tax.

Ms. OLSON. Well, my office has written this past year or a year ago about a value-added tax and the administrative challenges for the Internal Revenue Service doing something like a sales tax that would be proposed in the fair tax. And we have concluded that it is doable. You would have to deal with the states, many of whom have their own and there are a lot of transition issues. Most of the countries around the world do not just have a sales tax alone because it would have to be so high. They have some kind of low level income tax and then a sales tax as well. So I think it is doable. It is just whether people will step up to that.

I would note one thing. What some commentators have said is the sales tax sort of disappears how much tax you are really paying depending on how it is reported on your receipt. In some countries around the world you never see it broken out. It is in the broken price that shows up on your receipt at the end and you have to think do you really want that disappeared or do you want people conscious of what they are paying.

Mr. STROBEL. Congressman, I would say I do not know if there is—it is a binary choice. There is probably going to be a mixture of some sort of rate reduction, hopefully, and I think that is the key as far as we are concerned. I think the lower the taxes, the better for the business. The more investment we can make in the business the faster we can grow and the more people we can hire. So I think the notion of reduced tax rate, which implies a reduced level of government expenditure, I think is the key to the long-term prosperity of our economy.

Mr. KULP. As a small business owner I would say that anything that takes away the complexity and gives a long-term view is a good thing. It is so difficult with the complexity that we have now, you do not know really until the end of the year what we owe in taxes. I am an LLC. Money all flows through to me. I claim it on my personal income. The NRCA I do not know has taken a stance on this per se and I am here testifying on their behalf, but as a small business owner myself I would see that as an excellent alternative to a tax code that is miles thick.

Mr. WALKER. I concur with Ms. Olson. I do not see how we can level off with one sales tax and I am also concerned that eliminating all tax levels and going to a single sales tax demotivates

capital improvement. You have got to provide some incentive for people to invest. And so this is a tough situation but I know we can minimize the impact to small businesses by lowering the complexity of the code, just removing it completely, and going to some single layer tax, that could be very tough.

Ms. OLSON. If I might add, I think some advocates of a sales tax, forget how complex the state sales tax are with all of their exemptions and what constitutes a service versus a product and things like that. So you might find that you just have added a new volume of the International Revenue Code when you, you know, enact a sales tax. So it can be complex.

Mr. WEST. And a follow-up question for Mr. Kulp and Mr. Strobel then. What type of incentives do you think could be provided as far as our tax code to, you know, help you to grow your businesses?

Mr. KULP. That is a good question.

Mr. WEST. Well, I try to think of good questions.

Mr. KULP. Well, and that is a stalling tactic. Good question.

Mr. STROBEL. At least for our business, clearly in the energy efficiency business I think there is some room for promoting more energy efficiency, more rationale allocation of resources, at least in the energy industry. And so I think there is room for that in our industry. There is no doubt about it.

Mr. KULP. And probably more on a global level, I guess, from my own, the way I think is I do not like when the government chooses winners and losers so I have a hard time in articulating that well. But the NRCA staff I am sure would be delighted to work with you on that.

Mr. WEST. Thank you very much. And I yield back, Mr. Chairman.

Chairman GRAVES. Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

Briefly, to Mr. Walker and Ms. Olson. Last Congress passed a small business health care tax deduction and we all do these wonderful things trying to help small business. But my question to you two is have you gotten any calls on that and how easy is that actually?

Ms. OLSON. Well, it is a very complex deduction and my office has been working very hard to actually develop a calculator that we can roll out on, you know, we are going to test it internally with some fact patterns and then try to get it ready to roll out so that people can calculate how many full-time equivalents they have and how they meet that because it is a very complex provision. And if we do not do that, we will probably have a lot of inadvertent non-compliance. And more importantly, people not benefitting themselves, you know, achieving, receiving the benefits of a provision.

Mr. SCHRADER. They will not take advantage.

Ms. OLSON. They will not take it. Mr. Walker, do you concur?

Mr. WALKER. I concur. I am glad Ms. Olson mentioned the calculator. In all of the calls that I have received on this I have been saying I hope somebody comes out with something to calculate this. So that is the answer we are all looking for.

Mr. SCHRADER. All right. Very good. Very good.

Pretty much everyone here has testified about the complexity of the tax code and there is a proposal out there. The only one I know

of has gotten great bipartisan support on a national level and that was put forward by the Fiscal Commission. It does not get much simpler than eliminating every single tax expenditure and lowering all the rates to a mythological figure that no one in America could ever believe possible again of 814 and I think it is, what 25 percent or something like that? And corporate tax rate drops down to where we are almost competitive with the rest of the world. If you talk about the global competitiveness piece, to me, and of course you could add back targeted things to encourage investment at certain points in time when this Congress or the next Congress feel it is warranted or to take, you know, some disadvantaged populations.

To me, I think if we had the political courage to do anything that is simple that even I could understand in my veterinary practice, it would be to do that type of proposal. Could you comment on whether or not you are for that proposal and what you think your members might be interested in?

Mr. WALKER. I believe moving down to a simpler tax structure will work. I will go back to a prior comment. When we removed all the barriers and create simplification, there still has to be something there to incentivize. And so what will occur inevitably is it will create—we will go down to a simple process and it will begin to re-expand itself with complexity because we have to provide incentives to invest. So I think that would happen.

Chairman GRAVES. Mr. Kulp.

Mr. KULP. The overall tax code is not a part of this thing but back to the 3 percent withholding for government contracts. To me that is something that is so easy to eliminate and it just does not make sense. I know it is one small step but, again, that is, I guess, the only input I have on that.

Chairman GRAVES. Mr. Strobel.

Mr. STROBEL. There is a lot of attractiveness in the simplicity of what you have just described. I like that a lot. I think that as far as targeted incentives for investment, I think the fact that companies would have more capital available to let them figure out what they would invest in.

Chairman GRAVES. Good point.

Mr. STROBEL. I mentioned before, we talked a little bit about potential targeted investment in energy efficiency. I think that has a larger policy aspect to it, an energy self-sufficiency, energy independence, element to it that is attractive to us as a company and to me personally.

Chairman GRAVES. Ms. Olson.

Ms. OLSON. I think that, you know, we have recommended that we start with zero-based budgeting, that you just eliminate everything and then go piece by piece and say does this need to come in through the code? And that goes to the compelling public policy. Is there a public policy reason for putting something in the code? And then you ask what would it do to taxpayers who are the target of this public policy? Will they be able to comply with it? What will it do to the IRS? Will they torment taxpayers? Will the IRS not be able to administer it?

If I could talk for a minute about the withholding requirement, one thing that we have recommended instead of the 3 percent is

to require federal contractors, you know, the federal agency that is contracting, to get a response from the IRS whether that contractor is in compliance with their federal tax obligations before the contract is awarded? And in that way you are doing it in a proactive way as part of a qualification process, a procurement process, rather than doing withholding. And you get to the same results. You are only giving contracts to contractors who are compliant with their federal taxes.

Mr. SCHRADER. I think that is a good idea but simplicity is the key. I mean, the reason why we have all these gyrations with 3 percent is the government is trying to make money off of us at the bottom line and you pick winners and losers to your gentleman's comments and I think the beauty of what is being proposed by the Fiscal Commission allows us to do targeted or specific periods of time that I think Congress should review. And when that has outlived its usefulness and we moved to something else. It is energy maybe right right now. Maybe it is something else later on. I think I have a lot of confidence, believe it or not, in this Congress and in the Congress that is coming down the line but we have got to get small business some relief right now.

Thank you. And I yield back.

Mr. BARLETTA. Thank you, Mr. Chairman.

My wife and I, we are small business owners and we were a subchapter S corporation so I understand how raising taxes on businesses and people earning over \$250,000 will affect—have a direct effect on small business. Since I am here, I am a freshman, you know, all we have talked about was jobs and how we create jobs. And there is not a better committee than this Committee right here. When we talk about putting Americans back to work, seven out of ten jobs created are created by small business. So I understated how regulation and uncertainty affects small business.

My question is to Mr. Walker. Can you please provide more details about the impact of Congress constantly reauthorizing expiring provisions of the tax code on your small business?

Mr. WALKER. It was evident in this last session when it was unknown whether the current regulations were going to be extended. Many small business owners sat on the sideline and many budding entrepreneurs sat on the sideline simply waiting to see what was going to happen. We saw a downturn in any movements, pretty much any movements of businesses transitioning ownership, new ones coming in. So when the regulations are constantly changing, long-term planning becomes essentially impossible and a small business owner, if they cannot get their hands around it, they will sit idle. And it happens. So it is a negative to the economy when that goes on.

Mr. BARLETTA. So you would agree that, you know, passing a tax code for one year, two years, an extension of one or two years is not really doing anything to remove the uncertainty that small businesses are looking for to be able to invest and create jobs. And I am going to follow that up with the environment that we have created here in Washington with the overregulation and the uncertainty and government-run health care. All the obstacles that small businesses look at. Do you believe that we are stopping the entre-

preneurial spirit of American right now by our own doing here in Washington?

Mr. WALKER. I know for a fact that buying—not allowing extensions or regulations to be for periods of 8 years and 10 years. By not having that it does not motivate people to be willing to expose themselves to the kinds of debt and the risks it takes to really spur small business. I know that for a fact. So yes, doing these one- or two-year things are good for short-term savings tax deductions but they do not serve long-term planning needs.

Mr. BARLETTA. Thank you. I yield back, Mr. Chairman.

Chairman GRAVES. Ms. Chu.

Ms. CHU. Thank you, Mr. Chair.

I would like to ask a question about the issue of classifying an employee as an employee or as an independent contractor. The IRS has a 20-factor test to determine classification and it's confusing and unclear from what I read from the testimony that you have submitted. And there are small businesses that fear the penalties that will ensue if a worker is misclassified. In addition, of course, workers can be cheated if they are misclassified because they do not receive benefits and could lose the protection of employment and labor laws. So it is to the benefit of everybody to be accurately classified as either an independent contractor or an employee. I know Mr. Walker and Ms. Olson, you both addressed this?

Mr. Walker, what would we have to do to simplify the classifications so that both workers and employers could benefit?

Mr. WALKER. It would be a very definitive break to say the least. An employee falls into a particular category or a contractor falls into a particular category. Unfortunately, that is not the case right now. You simply have to make a decision based on what you think is applicable to that person. At present, if somebody is going to step up and be a contractor, if they were providing services to three or four other people doing similar type work, you can get comfortable with their contractor. But if they are only working for that one entrepreneur, then they may be an employee.

Now, unfortunately, that puts the onus on the employer, the entrepreneur, to have to figure out what is going on in that person's life. And that is difficult. So there needs to be some very definite definitions put in place as to what is an employee versus a contractor.

Ms. CHU. Do you have any suggestions?

Mr. WALKER. The type of work that they will be rendering. I think they have done a great job right now in saying does this person provide their own equipment? Are they controlled by the entrepreneur? That is a good way of doing it. But when you come in and look at the type of services that are being delivered, that is one way of breaking it down. It could be broken down into an industry. Make it very clear that the contractor, if they are going to place it with a contractor, has to submit something to the employer giving information about their background. Right now that is not required and it is simply a service agent uncovering something they find was not compliant and the entrepreneur is in trouble. So there has to be a bridge between the people who are being hired and the entrepreneur.

But the code does need to come up somehow. The only thing that is there is the 20-point test and it is just designed to say is there much control. That is the only thing that is in the code right now, how much control is there? That needs to be somehow expanded.

Ms. CHU. Ms. Olson.

Ms. OLSON. We have had lots of discussions with the business and small business community and their concerns are where we are with the status quo, that the IRS is not allowed to issue guidance other than what we have got out there. It is that they do not trust the IRS and what kind of guidance it is going to issue. So what we have proposed to break the logjam is that the IRS be instructed to engage with the business community and talk through just the very issues that Mr. Walker is raising, come up with some proposed guidance to submit to the tax writing committees, and that would form a basis. And then Congress could react to that if they felt that the IRS had not listened sufficiently to small business, et cetera.

I think that, you know, where we are is that there does need to be change for all the reasons that you have mentioned. And I will say once we come up with the clear sense of where we want to go with this, I had visited the United Kingdom and they actually have on their website a question and answer process for the employer to go through and answer these questions and it will get an answer back. If they do not—if you are an employer or, you know, you have independent contractors, if you do not like the answer it is not binding you of appeal rights. But if you like the answer, then unless you have misrepresented, you can rely on that as a safe harbor. And I think that is what businesses need. You know, a safe harbor. They need certainty. They need to know one way or another so they can proceed and plan.

Ms. CHU. Thank you. And could you also just say a few words about the business tax forms? You recommended two changes to business tax forms to improve reporting and tax compliance, just simply adding a line to Schedule C and adding check boxes to business tax returns. Could you elaborate on this?

Ms. OLSON. Well, actually, the IRS is actually going forward with this. One thing we had suggested was just that businesses be required to break out, you know, here are our receipts from 1099s that have been reported to the IRS. And here are our receipts other than what is being reported. And good accounting systems you just back out what your 1099s are. And we thought that would help drive some people who are in the cash economy to sort of report a little bit more.

And then the other question was a lot of people do not know that they have to do this information reporting so we really wanted to jog people's memories and say, you know, if you are a small business person and you have paid people over \$600 for services provided in the course of business, you know, have you filed your 1099s? And both of those are little behavioral reminders but would generate some additional income.

As a former preparer, I have seen what my taxpayers have done, my clients did, you know. They would add up their 1099s and then they would add a couple thousand dollars and say that is the addi-

tional amount we made. But maybe they add up and say more than a couple thousand dollars if that question were there.

Ms. CHU. And this is being implemented?

Ms. OLSON. The IRS is implementing a version of this now.

Ms. CHU. Thank you. I yield back.

Chairman GRAVES. Mr. Walsh.

Mr. WALSH. Thank you, Mr. Chairman, and thank you to each and every witness for coming in today, especially you, Mr. Strobel, from close to home in Chicago. Thank you.

Let me throw maybe a couple softballs your way. Expensing. Right now you have got to calculate depreciation and deduct that from your taxes. Would it be a heck of a lot easier if you could just write off the full cost of expenses in the first year? What would that do? What would that do, good or bad?

Mr. STROBEL. Well, from a tax perspective you would be better. I mean, there would be less tax to pay, more money available for investment.

Mr. WALSH. And what would that lead to? Less tax to pay would lead to what?

Mr. STROBEL. More money to invest in the business. More money to grow the business. More money to market. More money to understand our customers. It should lead to growth. It should lead to us be more competitive, help us be more differentiated and be more profitable. But also be able to employ more people. We need people to grow the business.

Mr. WALSH. Mr. Kulp.

Mr. KULP. I would agree with that. If the Section 179 I think it is called. I am not an accountant myself but my accountant tells me this, it is obviously put there for a reason by Congress because it does exactly what you are thinking it should do. It simply makes sense to be able to expense as much as possible. It makes you invest in the business, hire people, and buy goods and services that you otherwise would not.

Mr. WALSH. Mr. Walker.

Mr. WALKER. I concur. If you are able to write off 100 percent of your equipment costs, you lower income, lower tax, increase discretionary income. That is what allows somebody to actually make an investment and bring in people. I know on one occasion that I can think of right off the top of my head, a new business owner was coming in, had plans to hire five people, had to cut that down to three because they could not deduct a number of the items that they had projected they could once their accountant told them what they were actually going to be able to take as a deduction. A lot of it was equipment investment. So I know that that happens.

Mr. WALSH. Ms. Olson, would that be a good thing?

Ms. OLSON. Well, I think you would also have to address the issue of recapture that Mr. Walker spoke about because in our office that is where we see problems for taxpayers. It is a gotcha. You know, they do not know it exists and then suddenly they have disposed of an asset that they depreciated fully under 179 and then the liability is all back to them. So you have to deal with that.

Mr. WALSH. You know, thankfully, it looks like Congress is repealing the 1099 that was part of the health care legislation from last year. 1099s, though, are still an issue, even prior to this edi-

tion with the health care legislation. You still have to fill out 1099s and I am guessing that costs money and that is still a headache. Any sense as currently constituted they are an undue burden? Mr. Strobel? Mr. Kulp?

Mr. STROBEL. I guess I would say: Is it an undue burden? Filling out 1099s for us is not an undue burden.

Mr. WALSH. Mr. Kulp.

Mr. KULP. For us I guess we have gotten used to it to the point where, you know, it is like a frog thrown into the frying pan. You do not really know. But I believe the repeal of the 1099 within the health care provision is absolutely necessary because that would just proliferate them and make it very, very onerous and complex.

Mr. WALSH. Mr. Walker.

Mr. WALKER. The 1099 reporting as it currently is without the additional, it needs to be there. And I happen to come across many people who believe that if they have been paid less than \$600, they are not even supposed to pay income tax on that. So they even misunderstand the regs. But without having a 1099 reporting, absolutely income tax collections would go down. People would find ways to hide that money because they would believe nobody knows they made it. So it is necessary with our current structure.

Mr. WALSH. Ms. Olson, quick question. Is the IRS planning at all on implementing any sort of substantive e-filing system for business taxes?

Ms. OLSON. You know, I have not seen those plans and we have advocated for that for years. Even they used to have a system just for employment tax where you could use your telephone and they eliminated that. We did a study last year that said you need to reinstitute that. That is the only free electronic method for employment, you know, businesses to file.

Mr. WALSH. Why do not you think there has been movement on that?

Ms. OLSON. I think it is a combination of both the concern on the part of the software developers, that the IRS is intruding on their environment, as well as it is not going to be a capital investment on the part of the IRS. You will need to fund the IRS to be able to do that.

I just, I feel it really is a necessity. We have an obligation to do that, particularly for small businesses.

Mr. WALSH. Thank you, all. Thank you, Mr. Chairman. I yield back.

Chairman GRAVES. Mr. Altmire.

Mr. ALTMIRE. Thank you, Mr. Chairman.

Mr. Walker, I want to follow up on the 1099 question. If the President signs as expected the repeal that the Congress sent him for the health care \$600 1099s, what would the law then revert to? What is the threshold for filling out 1099 forms?

Mr. WALKER. Six hundred dollars. It is right now \$600 and greater. Now, there are different levels of 1099s but we are talking about just a general miscellaneous 1099 is a \$600 amount. And that is an appropriate amount. That should not go away.

Mr. ALTMIRE. Above that.

Mr. WALKER. Anything at that or above.

Mr. ALTMIRE. Thank you. Mr. Strobel, regarding the fair tax, I am glad you are here because I wanted to catch you with some questions on this or have a conversation. Is it your understanding under the Fair Tax proposal, what happens to the FICA tax, the Medicare and Social Security?

Mr. STROBEL. We are going to have to follow up with you and the National Small Business Association. We will follow up on that question. All right?

Mr. ALTMIRE. Okay. My concern on that would be what happens to the way we fund Social Security and Medicare under that. Where did that number come from, the 23 percent with regard to the fair tax proposal? It is budget neutral according to the proponents of the Fair Tax? Who is the determinant of that? Who scores it?

Mr. STROBEL. The NSBA will follow up with you on that.

Mr. ALTMIRE. Okay. What about the percentage—do you generally know as a small business what is the percentage of small businesses that comply with sales tax currently?

Mr. STROBEL. I do not know. That is another—we can follow up with you.

Mr. ALTMIRE. That would be a concern that I believe the number assumes 100 percent compliance and under current law there is certainly nothing close to 100 percent compliance on the sales tax. So if you could have somebody from the association follow up with us.

Mr. STROBEL. Yes, we will.

Mr. ALTMIRE. Ms. Olson, the IRS Commissioner recently stated that he would like to overhaul the tax, as you know, administration process by focusing on third party reporting, and namely he wants to move to a system where the IRS would already have third party information when taxpayers file their returns. And as we were discussing, the 1099 reporting is an example of third party reporting. Do you believe that there is a way to implement such a program without creating the same sort of situation that we had with the 1099 regulations under the health care bill?

Ms. OLSON. Well, first, a couple of years ago we recommended that Congress force the IRS to look at the issue of getting income data in real-time during the filing season so taxpayers could download it into their software programs or the IRS could make it available to taxpayers in another way. So I welcomed, you know, the Commissioner's, you know, remarks in that regard.

I am concerned with the recent love of 1099 reporting. As much as I recognize and am an advocate for appropriate 1099 reporting because it does change taxpayer behavior. Once they know that we know the information, 96 percent of the time they report it on their returns. But there is a point of diminishing returns where the IRS gets so much information or the burden is being imposed on taxpayers who do not normally keep track of that information that you just create a real headache, which is what we saw with the expansion of information reporting.

So I think as we go out with information reporting we really have to think about that point of diminishing returns. I do not think the IRS should ask for information that it cannot do anything about or that the information itself is not really going to give

us a clear picture of what is going on with taxpayers. Having said that, you know, we can tell the taxpayer a lot. We can tell them what their wages are. We can tell them what their interest is. We can now tell them what their capital gains or losses are because we have basis reporting. And all of those are really beneficial things for the taxpayers and will minimize errors.

Mr. ALTMIRE. Great. Thank you. Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Owens.

Mr. OWENS. Thank you, Mr. Chairman.

Mr. Walker, there is some information that we have gotten that says there is about \$160 billion a year that is spent in tax compliance work. Now, if we simplified the code, would we not put folks like you out of business in large numbers?

Mr. WALKER. It very well could be. Because I am here advocating that I will probably get some phone calls.

Mr. OWENS. From your colleagues I suspect.

Mr. WALKER. From my colleagues. It will not eliminate the profession; it will just change the dynamic of the services delivered.

Mr. OWENS. But certainly it will shrink it if we see a decrease in those kinds of dollars diverted, right?

Mr. WALKER. It would need to. Right.

Mr. OWENS. I just always am curious about the unintended consequences of what we do here.

I want to raise one other question. We talked a little bit about the 179 deduction and there was some discussion about recapture issues, but there is also another issue that creates tax consequences and that is not matching up the amortization of the debt used to acquire the piece of capital equipment and the loss of the deduction because you have taken it in one year. Does that create any issues and do you see any way around that issue that we could implement?

Mr. WALKER. Is that for me?

Mr. OWENS. For you, yes.

Mr. WALKER. So your question is to the deduction on the 179 that is compared to the actual cash outlay that has occurred?

Mr. OWENS. Correct. Well, not cash—if you do a cash outlay I agree it is not an issue.

Mr. WALKER. Okay.

Mr. OWENS. Because then it is a wash. But if you finance, which most small businesses do, capital acquisitions, then you are in a situation where unless you can repeat the process every year you are in a position where you are creating a tax where there is no income.

Mr. WALKER. You have got a deduction where there is no income?

Mr. OWENS. Right.

Mr. WALKER. Well, the deduction then can be moved. So once you have taken the deduction, the deduction goes up to zeroing out your income and then it flows over into the next year. So the carry forward could allow that to happen. I do not see a problem with people getting a full deduction. The problem I have is limiting the benefit that they can get from that deduction. Under current 179 regulations, if somebody owns five different S corporations and they all take advantage of the deduction, you will—that deduction

goes to the individual tax return. And if the same person owns all businesses that person can only have one 179 deduction. So right now that is 500,000. But if you had 5 businesses maxing that out, there is 2.5 million. That business owner could lose \$2 million worth of deductions the way the code is written right now. So allowing the deductions is not the problem; it is making sure that you can benefit from that and moving it forward if you lose the ability to take a deduction in the year that you have actually done the 179 election.

Mr. OWENS. And we have also had a lot of conversation today about the issue of tax expenditures and whether or not we should eliminate all of those or whether, as you are suggesting, we should be doing targeting or targeted either tax deductions or tax credits. Does not that put Congress in the position of selecting winners?

Mr. WALKER. I do not know if it puts them in the position of selecting winners because it would apply across the spectrum of all the business owners. It is a targeting effect. Even if we simplify, just completely simplify, we will still have some targeting that will need to be done within the system over time. So it is the people who can take advantage of it and all these small business owners and the things at least we have talked about today, it applies to all of them. So it is not going to be one particular person or one particular sector.

Mr. OWENS. But it will be a particular—potentially a particular industry. Like, if you created an R&D credit for solar energy you would be solely focused on that particular industry.

Mr. WALKER. That would be accurate. But a 179 issue—

Mr. OWENS. Oh, I am sorry. I may have confused you because I was not just talking about 179. I was talking about the panoply of various credits we have in the tax code now.

Mr. WALKER. Right.

Mr. OWENS. If we eliminated all of those, and then you are suggesting we build them back up over time, you would be selecting winners to some degree, like we have now.

Mr. WALKER. Like we have now. Correct.

Mr. OWENS. Mr. Chairman, I yield back. Thank you.

Chairman GRAVES. Ms. Clarke.

Ms. CLARKE. Thank you very much, Mr. Chairman, Chairman Graves, and Ranking Member Velázquez. And I want to thank the panel for testifying before us today.

I would first like to just say that over the course of this Congress much has been said about our nation's deficit as it should be. I agree that we must aggressively tackle the debt. Unfortunately, I do not believe that we have been having an honest conversation with the American people about why we are in this deficit and how we can get out of it.

Again, while I agree that we must address our deficit, it must be done responsibly. However, I disagree with the constant refrain of the majority that says that we do not have a revenue problem and I think that is at the heart of what small business is trying to address here today is the complexity of our tax system. The refrain is that we have a spending problem. The fact of the matter is that we have both.

And at the beginning of the last decade we were operating with budget surpluses. Now we are operating at staggering deficits. And while we have two undeclared wars and an economic downturn have played a considerable role in increasing our debt, it is crystal clear that we began our sprint down this road due to what I believe were irresponsible tax cuts for those who could have most afforded them and robbing the Treasury of that much-needed revenue.

The majority is now using this lack of revenue as a justification to cut programs for the most vulnerable Americans. And many of my colleagues on the other side have sort of echoed Mr. Strobel's testimony lamenting the 35 percent corporate tax rate as the world's most expensive and it limits our global competitiveness, yet on March 24th of this year The New York Times published a story on how General Electric, one of our nation's largest corporations paid absolutely 0 in taxes after posting 14.2 billion in profits, 5.1 billion which was made right here in the United States of America.

So while I agree that we need to work hard to limit the burdens on our small businesses, and I agree in principle with President Obama about the need to reform the tax code, it seems to me that through our panel's testimony the goal here is to apply a tax code to our extraordinarily complex global economy that reflects little to no nuance or complexity. The attainment of the American dream is what makes our country and its civil society one of the greatest in the world. Our nation offers an opportunity for financial success and prosperity that cannot be found anywhere else on the planet. However, unfortunately, due to a number of factors, the attainment of the American dream has become elusive, so much so that many people, many small entrepreneurs are finding it hard to gain footing, access to capital, access to lending.

So my question to the panel is what do you believe is the responsibility of those who have been successful to this country that has made their success possible? It is for the entire panel.

Ms. OLSON. I do not know how to answer that question other than to say that every person and entity owes an obligation to the United States to pay their fair share of taxes under our laws. And if our laws are structured in a way so that as Congress has enacted them so that those with the assets and the ability to retain advisors who can find ways to structure their affairs so they pay less tax than the person or the entity that cannot afford that, then we have a tax system that is out of whack. And our testimony has been—my testimony has been, and my writing have been to that point. I think that it is not possible to get pure simplicity in a code. We are human beings, and as you say, we live in a very complex world. But we can do a much better job than the environment that we have today.

Ms. CLARKE. What I find ironic is that we do not hear anyone speak out when, for instance, GE pays no taxes. I have not heard from all of the business councils, all of the small business councils. And it would seem to me that if we are talking about fair tax and fair share, that it should go both ways.

And so I just wanted to put that on the table, Mr. Chairman, because I think we need to look at what is happening in its entirety. And I yield back.

Chairman GRAVES. Any more questions? Well, I want to say, as this Committee continues to focus on job creation we certainly appreciate hearing from all of you on the complexity that small businesses deal with when it comes to following the tax code and the problems that creates when it comes to job creation.

I wanted to let everybody know following today's hearing we are going to be sending a letter to the chairman and ranking member of the House Ways and Means Committee to share with them what we heard today. We want to make sure that small business's voice is being heard loud and clear when they are dealing with fundamental tax reform.

So with that I would ask unanimous consent that members have five legislative days to submit their statements and supporting materials for the record. And again, I appreciate all of you coming out today and sharing with us your thoughts and ideas and concerns. The hearing is adjourned.

[Whereupon, at 2:20 p.m., the hearing was adjourned.]

WRITTEN STATEMENT OF

NINA E. OLSON
NATIONAL TAXPAYER ADVOCATE

HEARING ON

HOW TAX COMPLEXITY HINDERS SMALL BUSINESSES:
THE IMPACT ON JOB CREATION AND ECONOMIC GROWTH

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

APRIL 13, 2011

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Chairman Graves, Ranking Member Velazquez, and distinguished Members of the Committee:

Thank you for inviting me to testify today on how the burden of tax complexity prevents small businesses from growing, hiring more workers, and investing back into their business and our economy. I would like to begin by saying bluntly that, in my view, the current state of the tax code is a mess. Since the last major reform 25 years ago, the code has become an ever-expanding patchwork of discrete provisions, often with little logical connection, and has become unreasonably difficult for taxpayers to understand. In the National Taxpayer Advocate's 2010 Annual Report to Congress, I identified the complexity of the tax code and the confusion and distrust it engenders as the number one most serious problem facing taxpayers – and the IRS. I titled that section of the report "The Time for Tax Reform Is Now," because while there has been a lot of talk about tax reform in recent years, experience has shown that it will require a sustained, bipartisan effort – with the support of an engaged public – to make tax reform a reality.

This complexity has a direct impact on small business viability and job growth. The more time and resources a small business spends on tax compliance, the less time it will have to grow and hire employees. A 2008 study conducted by the University of Maryland and the Center for Economic Studies of the U.S. Census Bureau found that all net job growth essentially comes from business formation (*i.e.*, start-ups).¹ In addition, a report issued by the Small Business Administration Office of Advocacy states that small businesses are generally the creators of most new jobs as well as the employers of about half of the private-sector workforce. While small businesses are responsible for substantial job growth, they also experience greater losses when the economy is shedding jobs.² Considering that over half of new start-ups fail within four years,³ it is essential that the tax system does not present an unnecessary hurdle to the success of these already fragile operations. In addition, because a substantial portion of businesses are pass-through entities, a real reduction in complexity will not occur unless individual *and* corporate tax reform occurs at the same time.

In my testimony, I first discuss how the complexity of the tax code impacts taxpayers by (1) imposing undue compliance burdens on both taxpayers and the IRS, (2) creating unfair advantages for the more sophisticated taxpayers, and (3) encouraging inadvertent as well as intentional noncompliance. I also provide suggestions on how to

¹ John Haltiwanger, Ron Jarmin and Javier Miranda, *Business Formation and Dynamics by Business Age: Results from the New Business Dynamics Statistics*, Center for Economic Studies, U.S. Census Bureau 13 (May 2008).

² Office of Advocacy, Small Business Administration, *The Small Business Economy: A Report to the President 1-2* (2010).

³ Bureau of Labor Statistics, Monthly Labor Review, Vol. 128, No. 5, *Survival and Longevity in the Business Employment Dynamics Data*, 51 (May 2005).

strategically undertake a comprehensive structural tax reform initiative.⁴ After discussing the general principles for tax reform, I discuss several current tax provisions that are burdensome to small businesses and require simplification to promote growth in hiring and investment in the economy. Finally, I will discuss the collection issues specific to small business taxpayers.

Before I delve into these issues, I wish to make two points clear. First, my statutory mandate is to address tax administration issues – not tax policy issues. While the line that separates tax administration and tax policy is sometimes fuzzy, I will try to describe the burdens that tax complexity imposes, identify challenges to enacting tax reform, and suggest some ways to approach it. However, my office does not take a position on tax rates, revenue levels, or the specifics of which tax breaks should be retained and which should be eliminated. Second, my statutory mandate is to present an independent taxpayer perspective. Therefore, although I am an IRS employee, my comments do not necessarily reflect the position of the IRS or the Administration.⁵

I. Tax Reform Principles Generally

A. The Current Tax Code Imposes Significant Compliance Burdens on Businesses.

Consider the following:

- Unincorporated business taxpayers find return preparation so overwhelming that about 71 percent now pay preparers to do it for them.⁶
- According to a TAS analysis of IRS data, small business taxpayers spend about 2.5 billion hours a year complying with the income tax filing requirements of the Internal Revenue Code (IRC).⁷ This estimate does not include time spent on

⁴ For a more detailed discussion of tax reform applicable to both individual and business taxpayers, see Hearing on Tax Reform before the Committee on Ways and Means, U.S. House of Representatives (Jan. 20, 2011) (Written Statement of Nina E. Olson, National Taxpayer Advocate).

⁵ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

⁶ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008).

⁷ The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for calendar year 2010 by the average amount of time the IRS estimated it took to complete the form. To isolate small businesses, the forms include: Form 1040 Schedules C, C-EZ, E, and F (excluding Form 2160 and 2106-EZ); Forms 1065, 1065B, 1120S. This estimate does not include information returns and employment tax returns, because we were unable to accurately isolate the small business portion of the total burden associated with these returns. The burden associated with these returns is significant. For

employment tax and information returns, because accurate estimates could not be developed based on the information available. In total, TAS estimates that both businesses and individuals spend approximately 6.1 billion hours on tax compliance.⁸ That figure includes information returns, but does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.

- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the "tax industry" requires the equivalent of more than three million full-time workers.⁹
- A 2005 report by the Government Accountability Office (GAO) reviewed various studies attempting to quantify costs of tax compliance for businesses, and estimated that it costs businesses between \$40 billion and \$85 billion.¹⁰

B. The Tax Code Is Rife with Complexity and Special Tax Breaks, Helping Taxpayers Who Can Afford Expensive Tax Advice and Discriminating Against Those Who Cannot.

The tax code contains a multitude of tax breaks that benefit narrow groups of taxpayers or industries. These tax breaks are enacted to encourage certain types of behavior or provide benefits in certain circumstances, but the average small business taxpayer does not qualify for the benefits.¹¹

example, the estimated average taxpayer burden for businesses (filing Form 1065 or 1120S) for completing and filing Schedule K-1 are approximately 765 million hours. Report 44591, Copies of Returns Posted in 2010, Cycle 52 (Dec. 2010). While the IRS estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and, as noted in the text, it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation.

⁸ The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2008 by the average amount of time the IRS estimated it took to complete the form.

⁹ This calculation assumes each employee works 2,000 hours per year (*i.e.*, 50 weeks, with two weeks off for vacation, at 40 hours per week).

¹⁰ For an overview of previous studies by the IRS and several outside analysts trying to quantify compliance costs, see Government Accountability Office, GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System 13-14* (Aug. 2005). The estimates do not include the costs of collecting and remitting income and payroll taxes for employees.

¹¹ Examples of such tax benefits include the Electric Vehicle Qualified Plug-In Electric Drive Motor Vehicles Credit in IRC § 30D; The Film and Television Productions Deduction in IRC § 181; the Forestry Conservations Bonds Credit in IRC §§ 54A(d)(1)(A) & 54B; and the Railroad Track Maintenance Credit in IRC § 45G.

Beyond these narrow provisions, the tax code contains many general provisions that well-advised taxpayers may exploit. Indeed, many large accounting firms, law firms, and investment banking firms have regularly mined the code for ambiguities to develop tax-reduction "products" they can sell to paying clients. While taxpayers who can afford pricey legal advice are benefiting disproportionately from tax breaks, unsophisticated taxpayers sometimes fail to claim tax breaks because they do not know they exist. An example of this lack of awareness is illustrated in the HIRE Act provision, discussed below.

Overall, the complexity of the tax code leads to perverse results. Taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. Yet, at the same time, sophisticated taxpayers often find arcane provisions that enable them to reduce or eliminate their tax liabilities.

C. Complexity Obscures Understanding and Creates a Sense of Distance Between Taxpayers and the Government, Resulting in Lower Rates of Voluntary Tax Compliance.

IRS data show that when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. Workers who are classified as employees have little opportunity to underreport their earned income because it is subject to tax withholding. Employees thus report about 99 percent of their earned income. But among workers whose income is not subject to withholding, compliance rates plummet. IRS studies show that nonfarm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.¹²

Noncompliance cheats honest taxpayers, who must pay more to make up the difference. To me, this raises an important question: Why is it that few Americans would steal from a local charity, yet a high percentage of taxpayers who have a choice about paying taxes appear to have no compunctions about cheating their fellow citizens?

The Taxpayer Advocate Service has conducted research into the causes of noncompliance and plans to conduct additional studies. While we do not have definitive answers, we can suggest at least two hypotheses. First, no one wants to feel like a "tax chump" – paying more while suspecting that others are taking advantage of loopholes to pay less. Taxpayers who believe they are unfairly paying more than others inevitably will feel more justified in "fudging" to right the perceived wrong. Transparency is a critical feature of a successful tax system. It is essential if the system is to build taxpayer confidence and maintain high rates of compliance. Simplifying the code to make computations more transparent would go a long way toward reassuring taxpayers that the system is not rigged against them.

¹² See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts at <http://www.irs.gov/newsroom/article/0,,id=154486,00.html>).

Second, most people feel a sense of affinity and unity with local organizations, while in relative terms, they feel disconnected from the federal government. This may be because members of a community generally understand the services that local organizations provide and the benefits they personally derive, while many Americans do not understand how their tax dollars are spent or how they benefit. Or it may be because people know the leaders of local community groups personally, while the government seems faceless. Either way, I suspect that stealing from a local charity feels to many like stealing from family and friends, while cheating on one's taxes feels to some like a victimless offense.¹³

For these reasons, I think it is important to increase taxpayer awareness of the connection between taxes paid and benefits received. I have recommended that Congress direct the IRS to provide all taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent. This "taxpayer receipt" could be a more detailed version of the pie chart currently published by the IRS but would be provided directly to each taxpayer annually.¹⁴ I believe better public awareness of the connection between taxes and government spending may improve civic morale, increase tax compliance, and make more productive the national dialogue over looming fiscal policy choices as well.

D. The Dirty Little Secret: Tax Breaks Generally Benefit the Masses.

There is a widespread belief that the influence of "special interests" is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers, including several described above. But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from tax breaks that are technically called "tax expenditures." A tax expenditure is generally defined as any reduction in tax revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.¹⁵

In the following example, we present a tax computation that illustrates the role of tax expenditures with a small business owner. The scenario is fictitious, but it illustrates the extent to which various tax benefits may apply to a small business owner.

¹³ See generally National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 147-150 (Research Study: *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (discussing the effect of social norms on tax compliance).

¹⁴ See IRS Form 1040 Instructions (2009), at 100.

¹⁵ Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 § 3(3) (July 12, 1974). When Congress wishes to spend money, it may do so in either of two ways. It can make expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. For a detailed discussion of tax expenditures, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

Example: SMALL BUSINESS OWNER

Taxpayer B, as a sole proprietor, operates his own contracting business that grosses almost half a million dollars yearly, but after the costs of equipment and supplies yields income of \$200,000, out of which B pays \$25,000 in expenses such as wages, licenses, insurance, fees, and advertising. Late in 2010, B buys a new SUV of over 6,000 pounds that he drove solely for business that year. Under a provision for "bonus" depreciation, the full \$60,000 price is deductible. Because B's contracting business is considered a domestic production activity, he also can deduct about \$5,000 of "qualified production activities income." Through the business, B obtains health insurance for \$10,000 and puts away another \$10,000 for retirement (in a simplified employee pension plan known as a SEP). As a self-employed proprietor, B must pay about \$14,850 in self-employment (SE) tax, but half of this is deductible.

B's spouse earns \$25,000 as a kindergarten teacher, buying classroom supplies out of pocket, of which she can deduct \$250. The Bs pay \$10,000 in state, local, and property tax, \$10,000 in home mortgage interest, and \$5,000 in charitable contributions.

Although the Bs have income of \$200,000, the deduction of numerous tax expenditures brings them down into the 25-percent marginal bracket (and the Alternative Minimum Tax does not apply to this situation). For income tax purposes, after an \$800 Making Work Pay credit, B pays about \$10,300, or an effective tax rate of five percent of the \$200,000. In addition, B pays about \$14,850 of SE tax (the counterpart to certain payroll tax on employees).

Table 1. Tax Treatment

Category	Item	Amount (\$)	Net (\$)
Income	Business income after expenses	175,000	200,000
	Salary	25,000	
Deductions	Bonus depreciation	60,000	(124,950)
	Domestic production	5,000	
	Health insurance (SE)	10,000	
	Retirement (SEP)	10,000	
	½ SE tax (rounded)	7,400	
	Schoolteacher expenses	250	
	State, local, and property taxes	10,000	
	Mortgage interest	10,000	
	Charitable contributions	5,000	
	Exemptions	7,300	
Taxable income (25% marginal bracket)			75,050
Income tax	(rounded)		11,100
Credit	Making Work Pay		(800)
Net tax	(5% result)		10,300

This scenario illustrates that tax reform is not an easy issue. In theory, most of us agree that the tax code is too complex and that broadening the tax base by eliminating

existing tax breaks in exchange for lower rates would improve the system.¹⁶ In practice, the prospect of lower rates may seem speculative and distant, while the threatened loss of existing breaks raises immediate concerns.

Despite these concerns, I personally believe that fundamental tax reform is essential and urgent. More importantly, I believe that taxpayers will support tax reform by wide margins if they gain a better understanding of the trade-offs involved and are engaged in an informed dialogue. If tax reform is enacted on a revenue-neutral basis, the average taxpayer's bill will not go up, and taxpayers will be much happier to have a more transparent system. They will understand how much tax they are paying, they will understand how their tax is computed, and many will save time and money by no longer needing to pay a preparer to do the job for them.

Both to gauge and build public support, I encourage you to discuss with your constituents both the complexity of the existing tax code and the trade-offs between tax rates and tax breaks that reform will require. An uninformed taxpayer who hears he may lose a tax break will instinctively seek to retain it to prevent his tax bill from rising. An informed taxpayer who understands she will be losing a tax break, but probably will not pay more tax because rates will be substantially lowered, will have a very different reaction. The Tax Reform Act of 1986 was the last major revision of the tax code, and despite considerable initial concerns, taxpayers came around. On the final votes, the Act was supported by significant bipartisan majorities in the House and the Senate.¹⁷ I expect that a similar dynamic will play out again in the near future.

E. A Zero-Based Budgeting Approach Could Assist Congress in Deciding Which Tax Breaks and IRS-Administered Social and Economic Programs to Retain and Which to Eliminate.

My suggestion is to approach tax reform in a manner similar to zero-based budgeting. Under that approach, the starting point would be a tax code without any exclusions or reductions in income or tax. As discussions proceed, tax breaks and IRS-administered social and economic programs would be added only if lawmakers decide that, on balance, the public policy benefits of running the provision or program through the tax code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS. Factors to consider in this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is

¹⁶ The bipartisan fiscal commission appointed by the President recently made recommendations along these lines. See National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 15, 28-34 (Dec. 2010) at <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>

¹⁷ The vote to approve the conference report was 292-136 in the House and 74-23 in the Senate. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 4 (1987).

provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure for achieving that purpose.¹⁸

The immediate elimination of certain tax benefits could cause hardships for businesses where established pricing or conduct is based on those provisions. Thus, if Congress decides to eliminate tax incentives in situations like this, it should consider transitional relief.

In our 2010 Annual Report to Congress, I recommended adoption of a process to evaluate whether a tax expenditure presents an administrative challenge to the IRS or taxpayers and the extent to which it achieves its intended purpose.¹⁹ In addition, in our 2009 report I proposed an analytic framework for evaluating whether specific social and economic benefit programs – including benefits targeting businesses – should be run through the tax system.²⁰ If we apply this rigorous analytical framework to all proposed tax expenditures, we will adopt solely those provisions that fulfill a compelling public policy purpose, that the IRS can effectively administer without undue burden to taxpayers, and that are designed to capture information to evaluate whether the benefit achieves its intended public policy outcome.

F. The Odds of Achieving Tax Reform Are Higher if the Issue Is Addressed Separately from Decisions About Adjustments to Revenue Levels.

I am concerned that if comprehensive structural tax reform and revenue levels are considered together as part of a package, the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, my suggestion is that Congress consider addressing these issues separately. First, Congress could enact comprehensive structural tax reform on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust rates accordingly. Conversely, Congress can address these two items on parallel tracks and marry them up at the end.

II. Recommendations to Simplify Several Specific Provisions that Create Unnecessary Compliance Burdens for Small Business Taxpayers.

Even without fundamental tax reform, there is much we can do to ease the compliance burdens of small businesses. In the following discussion, I will point out several tax provisions that create unnecessary compliance burdens on small businesses and require simplification, or at the very least, more guidance.

¹⁸ See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

¹⁹ See *id.*

²⁰ National Taxpayer Advocate 2009 Annual Report to Congress, Vol. 2, at 75-104 (*Running Social Programs Through the Tax System*).

A. A Study Similar to the Taxpayer Assistance Blueprint (TAB) for Small Business and Self-Employed Taxpayers is Necessary to Understand the Particular Needs of this Taxpayer Population.

In its fiscal year 2006 appropriations report, Congress directed the IRS, the IRS Oversight Board, and the National Taxpayer Advocate to develop a five-year strategic plan for taxpayer service.²¹ In September 2005, the IRS formed the Taxpayer Assistance Blueprint (TAB) team, with employees from several IRS functions, including the Taxpayer Advocate Service (TAS), in response to this directive. In support of the TAB, the IRS, TAS, and the IRS Oversight Board conducted in-depth studies, including surveys, to enhance understanding of the needs and preferences of individual taxpayers. The TAB originated an approach to planning and structuring IRS research efforts on taxpayer service, forming a methodology for the IRS to follow to ensure a cohesive research structure that would complement and build on previous findings. Because of the TAB studies and additional research by TAS, the IRS now knows more than ever about individual taxpayer needs and preferences, including the willingness of individual taxpayers to try new methods of receiving IRS services.²²

I am, however, concerned that the focus of the TAB has remained on Wage & Investment (W&I) division taxpayers. In directing the creation of a five-year taxpayer service strategic plan, the House and Senate Appropriations Committees were focusing on taxpayer service issues generally. W&I deals with individual taxpayers who are not engaged in a trade or business, and it is of course important that they be served. But small business taxpayers who fall under the jurisdiction of the Small Business/Self-Employed (SB/SE) division and tax-exempt organizations that fall under the Tax Exempt/Governmental Entities (TE/GE) division also require service from the IRS. Because of the complexity of the laws, they may, in fact, need more service. The TAB should be expanded to cover the taxpayers those divisions serve. I have made this recommendation in prior reports to Congress²³ and continue to urge the IRS to expand the TAB to a broader range of taxpayers. Although both SB/SE and TE/GE have conducted some research into aspects of their taxpayer populations, neither operating division has undertaken the comprehensive and rigorous approach that distinguished the TAB. Absent that disciplined approach, neither unit will adequately understand or meet the service needs of its respective taxpayers.

The following two items illustrate the importance of creating a taxpayer blueprint for small businesses:

²¹ H. R. Conf. Rep. No. 109-307, at 209 (2005). See also S. Rep. No. 109-10, at 134 (2005).

²² See National Taxpayer Advocate 2006 Annual Report to Congress vol. 2, 1-15 (Research Study: Study of Taxpayer Needs, Preferences, and Willingness to Use IRS Services).

²³ See, e.g., National Taxpayer Advocate 2008 Annual Report to Congress 97, 105; IRS, Report to Congress Progress on the Implementation of The Taxpayer Assistance Blueprint April 2007 to February 2008, 46; and National Taxpayer Advocate 2007 Annual Report to Congress viii, 37-38, 209.

Truck Drivers: A Case Study in Making Decisions Without Understanding the Particular Needs of a Specialized Taxpayer Segment. In an effort to cut costs and based on a recommendation made by the IRS's Printing and Postage Budget Reduction (PPBR) Task Force, the IRS eliminated direct mailings of tax packages to individuals and small businesses for the 2010 tax year. The IRS communicated this decision by mailing postcards to impacted taxpayers. However, after the postcards were sent, the IRS decided to also cut the package for Form 2290, which includes the Heavy Highway Vehicle Use Tax Return filed by truck drivers. No postcards went to this specialized segment of small business taxpayers, truck drivers who may spend much of their time away on the road and arrive home to find they have no forms to file a return. I am concerned that the failure to communicate this change will lead many of these taxpayers into unintentional noncompliance. A TAB study would have been helpful to understand the needs of this specialized segment of small businesses.²⁴

Attempts to Cut Costs May be Futile Without Understanding Small Business Taxpayer Needs. In connection with the above-referenced PPBR decision to eliminate direct mailings of tax packages, a recent Treasury Inspector General for Tax Administration (TIGTA) report raised concerns about the IRS's tracking of its savings and the lack of documentation detailing how the IRS calculated or validated its savings estimates.²⁵ For example, over 11 million taxpayers received postcards explaining the direct mailing elimination. Yet through mid-March, order requests processed through the toll-free 1-800-TAX-FORM line experienced about a ten percent *increase* (over 266,000 orders) when it has previously experienced a six to eight percent *decrease* per year. When the IRS mails forms through this program, it costs significantly more resources to manually supply the forms rather than mail in bulk. Thus, the additional costs associated with the manual mailing could negate the estimated cost savings in the printing and postage budget. In addition, the cost estimates only considered printing and postage savings and failed to factor in the downstream consequences of noncompliance caused by the decision to stop direct mailings. Therefore, upon factoring in all the associated additional costs, the IRS may find it achieved no savings at all, while it significantly reduced taxpayer services. Such decisions would have been more well-informed if the IRS understood the needs of all of the affected taxpayer populations before implementation.²⁶

B. Complexity and Lack of Awareness of the HIRE Act Diminishes the Effect of Important Hiring Incentives.

The Hiring Incentives to Restore Employment (HIRE) Act was designed to create new jobs in the private sector by helping small businesses invest, expand, and hire more

²⁴ Information Provided from PPBR Implementation Team to TAS (March 30, 2011).

²⁵ TIGTA, Ref. No. 2011-40-025, *Publishing and Mail Costs Need to Be More Effectively Managed to Reduce Future Costs* (Feb. 28, 2011).

²⁶ Information Provided from PPBR Implementation Team to TAS (March 30, 2011).

workers.²⁷ Under the HIRE Act, a qualified employer is relieved from paying the employer's share (6.2 percent) of the Old-Age, Survivors and Disability Insurance Benefits tax (commonly referred to as Social Security) on all wages paid to formerly unemployed qualified employees from March 19, 2010, through December 31, 2010.²⁸ The employer may also receive a tax credit of up to \$1,000 for each new employee retained on the payroll for at least one year.²⁹

The complexity and general lack of awareness of the HIRE Act diminishes the impact of the tax incentives intended to encourage hiring. The enactment of the law was immediately eclipsed by interest in the enactment of the Patient Protection and Affordable Care Act.³⁰ Thus, many businesses were potentially unaware of the beneficial hiring incentives in the HIRE Act - especially those that only meet with their accountants at the end of the year.³¹

Even for businesses that were aware of the incentives, the poor timing and circumstances surrounding the enactment of this Act created a complex and confusing reporting situation. The relief from the employer's share of payroll taxes began on March 19, 2010, a Friday in the middle of a pay period, and less than two weeks from the end of a payroll tax quarter. Even though the relief from payroll matching was available for wages paid on a small portion of the *first* quarter of 2010 (between March 19 and March 31), businesses were directed to claim this credit during the *second* quarter payroll period and prepare their first quarter 2010 Form 941, *Employer's Quarterly Federal Tax Return*, as if the law had not taken effect.³² Only time will tell if this unusual quarterly reporting results in increased and possibly incorrect wage reporting discrepancy inquiries in 2011.

Further, the requirements of the statute create compliance and administrative burdens. Because the purpose of the credit is to increase the number of employees on-roll, a business cannot simply replace an employee and qualify for the credit. There are exceptions if an employee is replaced because he or she separated from employment

²⁷ Pub. L. No. 111-147, 124 Stat. 71 (March 18, 2010); see also <http://www.dcms.gov/topics/hiring-incentives-to-restore-employment-act.htm> (last viewed March 29, 2011).

²⁸ IRC § 3111(d).

²⁹ To encourage businesses to retain the new hires for at least 52 consecutive weeks, the HIRE Act provides a credit up to the lesser of \$1,000 or 6.2 percent of the first \$16,129.03 of wages paid to each retained worker. The credit will be claimed on the employer's 2011 income tax return (except a fiscal year taxpayer may be eligible to claim the credit on a 2010 tax return). There is no minimum weekly number of hours of work required to qualify for the credit. See Pub. L. No. 111-147, § 102, 124 Stat. 71, 75 (March 18, 2010).

³⁰ Pub. L. No. 111-148, 124 Stat. 119 (March 23, 2010).

³¹ See Russell Marketing Research, *Findings from Task 149: The Taxpayer Advocate Service Research Program with a Focus on the Detailed Study of the Underserved Segment – Phase II, Study #3, 8* (July 2002).

³² IRS, *FAQs About Claiming the Payroll Exemption*, available at <http://www.irs.gov/businesses/small/article/0,,id=220750,00.html> (last viewed April 8, 2011).

voluntarily or for cause. This provision creates a burden for small businesses to document something they did not do (replace an employee), and if questioned, prove a negative. For the IRS, this provision creates the burden of a nearly unenforceable statute.

The application of these provisions is further complicated by an unusual definition of "unemployed" and the requirement to have the formerly unemployed, once properly identified, complete an affidavit attesting to his or her jobless status. Under the Act, the definition of "unemployed" is not based on a worker seeking employment, but rather an individual not having worked for more than 40 hours during the 60-day period ending on the date the individual begins employment.³³ For example, a student who is neither working nor seeking employment during the school year, but is hired for the summer is considered unemployed for purposes of the HIRE Act and could qualify an employer for payroll tax relief. Reliance on a common understanding of the term "unemployed" could cause an employer to miss out on substantial tax relief – up to \$6,622 per employee.³⁴

C. The Creation of an Optional Standard Home Office Business Deduction Would Reduce Small Business Burden.

The tax laws regarding the home office deduction are considered by many to be too complex while the associated recordkeeping responsibilities are considered too time-consuming. Specifically, the complexity associated with the current requirements to calculate the portion of the home expenses attributable to the home office, and to calculate the depreciation for that area, may discourage eligible taxpayers from taking the deduction. In addition, the process of reporting the deduction differs based on the type of business conducted and whether the taxpayer is an employee or self-employed.³⁵

One way to encourage eligible taxpayers to take the deduction is to simplify the provision. Accordingly, in my 2007 Annual Report, I recommended that Congress amend IRC § 280A to create an optional standard home office deduction. The

³³ Pub. L. No. 111-147, § 101, 124 Stat. 71, 73 (March 18, 2010). The new, qualified employee must sign an affidavit stating "Under penalties of perjury, I certify I have not been employed for more than 40 hours in the 60-day period ending on _____, 2010 when I began my employment." To meet this requirement, the IRS created a new form, Form W-11, *Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit*, and added one more responsibility for small businesses already feeling "taxed" by too many requirements and forms.

³⁴ The maximum payroll tax that may be forgiven is \$6,622 per employee. This figure is calculated by multiplying the employer portion of social security taxes (6.2 percent) by the maximum taxable wages of \$106,800. There is no maximum dollar amount of relief per employer.

³⁵ For the reporting requirements associated with this deduction, see IRS Pub. 587, *Business Use of Your Home*. The home office business deduction is reported on several different schedules, depending on whether the taxpayer is an employee (Schedule A), a self-employed individual with nonfarm business income (Schedule C), or a self-employed individual with farm income (Schedule F). Employees who itemize deductions on Schedule A report the deduction on Line 21, "Unreimbursed employee expenses." The taxpayer must also attach Form 2106, *Employee Business Expenses*.

legislative provision would direct the Secretary to draft regulations that calculate the deduction by multiplying an applicable standard rate, as determined and published by the Commissioner on a periodic basis, by the applicable square footage of the portion of the dwelling unit described in IRC § 280A(c).³⁶ Finally, to decrease the taxpayer burden associated with reporting the deduction, Congress should encourage the IRS to simplify the reporting of the optional standard deduction on Schedule A, *Itemized Deductions*; Schedule C, *Profit or Loss From Business*; and Schedule F, *Profit or Loss From Farming*.

D. Simplification of the S Corp Election Process Would Alleviate Burden on Small Businesses.

Subchapter S corporations are the most common corporate entity in the tax system. In Fiscal Year (FY) 2009, 4.5 million S corporation returns were filed, accounting for about 64 percent of all corporate returns, with 45 percent of S corporation returns reporting gross receipts under \$100,000 and 63 percent reporting gross receipts under \$250,000.³⁷ S corporation status is highly desirable because in addition to traditional corporate attributes such as limited liability and transferable ownership, these corporations “pass-through” profits or losses to shareholders who report the income and receive the tax benefit of any losses on their individual returns.³⁸

Small business corporations may elect to be treated as flow-through entities by submitting Form 2553, *Election by a Small Business Corporation*, on or before the 15th day of the third month of the tax year,³⁹ while an S corporation tax return is not due until the 15th day of the third month after the end of the tax year.⁴⁰ Many taxpayers overlook this requirement, subjecting themselves to serious tax consequences that include taxation on the corporate level and the inability to deduct operating losses on shareholders' individual tax returns.

Businesses that wait until the tax return filing date to make this election are deemed to have made the election for the succeeding year, and must seek retroactive relief upon a showing of reasonable cause under one of four revenue procedures or through a private

³⁶ The standard rate must include a clearly identifiable depreciation component for taxpayers to be able to track depreciation. Upon the sale of a residence, taxpayers must recapture any allowed or allowable additional depreciation pursuant to IRC § 1250. For simplification, the depreciation component should be calculated based on the straight-line method of depreciation to render the recapture calculation unnecessary. Nonetheless, the taxpayer would still need to track depreciation, because upon the sale of the residence, the amount of the home sale exclusion in IRC § 121 must be reduced by any depreciation allowed or allowable after May 6, 1997.

³⁷ IRS, *Data Book 2009*, Table 2, 4; IRS, CDW, Business Returns Transaction File (Tax Year 2009).

³⁸ IRC § 1361(a)(1) defines an “S corporation” as “a small business corporation for which an election under §1362(a) is in effect for such year.”

³⁹ IRC § 1362(b)(1)(B); Treas. Reg. § 1.1362-6(a)(2).

⁴⁰ IRC §§ 6037 and 6072(b); Treas. Reg. § 1.6037-1(b); Instructions for Form 1120S, *U.S. Income Tax Return for an S Corporation*, at 3 (2009).

letter ruling (PLR) request.⁴¹ Challenges in the S election process for taxpayers include the complexity of relief procedures for a late S corporation election; the often prohibitive cost of retroactive relief via a PLR; the IRS's inability to verify the receipt and acceptance of S corporation returns and election applications; and the downstream burdens on shareholders of the conversion of S corporation returns to regular, taxable corporate returns. In processing years 2008 and 2009, 81,431 and 97,823 S corporation returns respectively could not be processed as filed because of missing or late elections, IRS errors in recognizing or processing a valid election, and an absence of effective relief procedures.⁴² These unprocessed returns accounted for nearly 17 and 24 percent of all new S corporation filings for those two years.⁴³

To alleviate the burden on small businesses, I recommend that Congress simplify the S corporation election process by amending IRC § 1362(b)(1) to allow a small business corporation to elect to be treated as an S corporation by checking a box on its timely filed (including extensions) Form 1120S, *U.S. Income Tax Return for an S Corporation*.⁴⁴ I also recommend that the IRS expedite the issuance of a consolidated revenue procedure for late election relief; immediately identify and correct accounts where tax was assessed without following deficiency procedures; expand outreach efforts to include a simple and complete guide to the late election relief process; develop an administrative appeal process for taxpayers whose elections are denied; and allow electronic filing of the S corporation election form.⁴⁵

⁴¹ IRC § 1362(b)(3) and (b)(5). See Rev. Proc. 2007-62, 2007-2 C.B. 786; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 97-48, 1997-2 C.B. 521. The IRS Office of Chief Counsel issued 226 PLRs for late S corporation elections under IRC § 1362 from FY 2007 to FY 2009, for which the IRS charged a user fee ranging from \$625 to \$14,000 per request. TIGTA, Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010). For current PLR procedures and user fees, see Rev. Proc. 2011-1, 2011 I.R.B. 1.

⁴² Business Master File (BMF) Extract from IRS Compliance Data Warehouse (CDW) for Processing Years 2007-2009 (June 2010). If there is no election on file, the return information cannot "post" to the IRS Master File, and the return becomes "unpostable."

⁴³ Prior IRS research reports revealed approximately 20 percent of these returns remain unpostable for multiple years. IRS, Small Business/Self-Employed Division (SB/SE) Research report, *Profile Taxpayers with Unpostable Initial 1120S Returns* (May 2007).

⁴⁴ See National Taxpayer Advocate 2010 Annual Report to Congress 410-411 (Legislative Recommendation: *Extend the Due Date for S Corporation Elections to Reduce the High Rate of Untimely Elections*). See also National Taxpayer Advocate 2004 Annual Report to Congress 390; National Taxpayer Advocate 2002 Annual Report to Congress 246.

⁴⁵ National Taxpayer Advocate 2010 Annual Report to Congress 278-90 (Most Serious Problem: *S Corporation Election Process Unduly Burdens Small Businesses*).

E. The Worker Classification Rules are Complex and Create Uncertainty.

Misclassification of workers can have serious consequences for the workers, the recipients of the services they provide, and tax administration in general. Whether a worker is classified as an employee or independent contractor affects the application of labor laws⁴⁶ as well as tax treatment for both the worker and the service recipient.⁴⁷ Unfortunately, the rules are complex and ambiguous, leading to intentional as well as inadvertent noncompliance in this area.

The following aspects of the classification rules lead to confusion and may even cause inadvertent misclassification of workers:

- Common Law Test Does Not Provide Clear Answers. The common law 20-factor test to determine proper classification is complex, subjective, and does not always produce clear answers. The potential for errors and abuse is high in those gray areas where not all factors yield the same result, particularly because there are no weighting rules.⁴⁸
- Section 530 Safe Harbor Rule Creates Confusion. The safe harbor rule of § 530 of the Revenue Act of 1978 adds confusion to an already complicated set of classification rules.⁴⁹ Apparently, § 530 was enacted "to alleviate what was perceived as overly zealous pursuit and assessment of taxes and penalties against employers who had, in good faith, misclassified their employees as independent contractors."⁵⁰ However, interpretation of the provision has become an additional source of disputes and confusion.⁵¹

⁴⁶ Such protections include the Fair Labor Standards Act, Family Medical Leave Act, Occupational Safety and Health Act, and the National Labor Relations Act. Misclassified workers may also lose access to employer-provided benefits such as health insurance coverage and pensions. See Government Accountability Office, GAO-07-859T, *Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification* (May 8, 2007); Subcomm. on Income Security and Family Support, Comm. on Ways and Means, Advisory ISFS-6 (May 1, 2007).

⁴⁷ For a detailed discussion of the tax treatment of both classifications, see Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

⁴⁸ In Revenue Ruling 87-41, 1987-1 C.B. 296, the IRS developed a list of 20 factors, based on cases and rulings decided over the years, to determine whether an employer-employee relationship exists.

⁴⁹ Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885-86 (Nov. 6, 1978) (codified as amended at 26 U.S.C. §§ 3401, 3101).

⁵⁰ *Boles Trucking, Inc. v. U.S.*, 77 F.3d 236, 239 (8th Cir. 1996) (citation omitted).

⁵¹ The confusion stems from the following: (1) location of the provision outside the Tax Code, (2) the reliance on facts and circumstances, (3) the provision only applies to service providers and not workers, and (4) the application of the provision to employment taxes, which is statutorily defined to include income tax withholding. Pub. L. No. 95-600, § 530(c)(1), 92 Stat. 2763, 2885-86 (Nov. 6, 1978). Further, judicial

- Consequences of Reclassification by IRS. Whether misclassification is inadvertent or deliberate, significant tax consequences result if the IRS subsequently reclassifies the worker after an audit. For example, the service recipient may be liable for employment taxes for a number of years,⁵² interest, penalties, and potential disqualification of employee benefit plans. The worker may have to pay self-employment taxes and lose the ability to take certain business-related deductions. In addition, if the worker is classified as an employee, he or she may be barred from claiming a refund of self-employment taxes because the statutory period for claiming a refund expired while the IRS was dealing with the employer's classification issue. Further, the worker has no right to petition the classification determination to the U.S. Tax Court under IRC § 7436.
- Lack of Published Guidance. Because the Revenue Act of 1978 prohibits Treasury and the IRS from publishing regulations and revenue rulings on worker classification for employment taxes, there is no current guidance. Given that general working conditions have changed significantly over the last three decades, such a prohibition is contrary to sound tax administration and likely increases the potential for both deliberate and inadvertent misclassification. Although the IRS has published training materials on this issue, they do not carry the force of law.⁵³ We also acknowledge that that private industry is rightfully concerned about any guidance issued by the government, especially if industry is not consulted beforehand.

In order to reduce the complexities and ambiguities associated with the worker classification rules, in the 2008 Annual Report to Congress I recommended the following:

1. Replace § 530 with a provision applicable to both employment and income taxes, and require the IRS to consult with the industry and report back to the tax-writing committees on the findings of such consultations, with the ultimate goal on the part of the Secretary to issue guidance based on such findings, including a specific industry focus,⁵⁴

decisions have made clear that there is no *de minimis* exception to the substantive consistency requirement of § 530. See *Institute for Resource Management, Inc. v. U.S.*, 90-2 U.S.T.C. ¶ 50,586 (Cl. Ct. 1990).

⁵² IRC § 3509.

⁵³ See, e.g., IRS Pub. 1779, *Independent Contractor or Employee*.

⁵⁴ Our initial recommendation published in the 2008 Annual Report to Congress required the Secretary to issue guidance. However, based on our discussions with small business groups, we subsequently refined the recommendation to propose that Congress mandate the IRS to hold a series of consultations with the industry and report back to the tax writing committee on findings. See National Taxpayer Advocate 2008 Annual Report to Congress 375-390.

2. Direct the IRS to develop an electronic tool to determinate worker classifications that employers would be entitled to use and rely upon, absent misrepresentation;
3. Allow both employers and employees to request classification determinations and seek recourse in the Tax Court,⁵⁵ and
4. Direct the IRS to conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.

F. Protection from Third-Party Payer Failures is Necessary to Protect Small Businesses from Significant Harm.

Third-party payers provide valuable services to employers, especially small businesses, by helping them comply with federal, state, and local employment tax requirements.⁵⁶ A third-party payer is any person that provides the services of filing, reporting, withholding, and payment of employment taxes on behalf of the client taxpayers. In recent years, a number of these payers have gone out of business or embezzled their customers' funds.⁵⁷ When payers do not file the required employment tax returns or make the required deposits, employers remain liable for the underlying tax, interest, and penalties.⁵⁸ Usually, defunct third-party payers do not have sufficient assets to collect against upon default.

When third-party payers fail or commit fraud and abscond with their customers' funds, their clients face serious economic difficulties. Because the Code does not protect taxpayers from third-party payer failures, the IRS faces difficult decisions about how to handle these cases and often has no recourse other than to initiate collection of unpaid employment taxes from the employers and the business owners under IRC § 6672. As a result, small businesses may not only be forced to pay the amount twice – once to the payer that absconded with or dissipated the funds and a second time to the IRS – but

⁵⁵ IRC § 7436 allows an employer that has been audited regarding employment taxes to petition the United States Tax Court to litigate the issue of whether a worker is an independent contractor or employee, or whether the employer is entitled to relief from any misclassification under § 530 of the Revenue Act of 1978. The collection of any underpayment of employment taxes is barred while the action is pending. This provision does not authorize the employee to petition the Tax Court.

⁵⁶ See Table 1.22.1, *Third Party Arrangements*, National Taxpayer Advocate 2007 Annual Report to Congress 339.

⁵⁷ IRS, *Examples of Employment Tax Fraud Investigations - Fiscal Year 2011*, available at <http://www.irs.gov/compliance/enforcement/article/0,,id=228085,00.html> (last viewed April 8, 2011)

⁵⁸ See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act); IRC §§ 3301-3311 (Federal Unemployment Tax Act); IRC §§ 3401-3407 (collection of income at source on wages); IRC §§ 3501-3511 (general provisions related to employment taxes); IRC § 6011 (general requirement of return, statement, or list); IRC § 6051 (receipt for employees); and IRC § 6302(g) (deposits of Social Security taxes).

also may be liable for interest and penalties.⁵⁹ Some small businesses may not be able to recover from these setbacks and be forced to cease operations.

This issue demonstrates the vital need for taxpayer protection in the payroll service industry, particularly for small business taxpayers that hire smaller third-party payers. I recommend that Congress amend the Code to define a third-party payer; make a third-party payer jointly and severally liable for the amount of tax collected from client employers but not paid over to the Treasury, plus applicable interest and penalties; authorize the IRS to require payers to register with the IRS and be sufficiently bonded; include third-party payers within the definition of a "person" subject to the trust fund recovery penalty (TFRP); and clarify that the TFRP survives bankruptcy when the debtor is not an individual.⁶⁰

G. The Willfulness Component of the Trust Fund Recovery Penalty Statute Prevents Business Owners from Continuing Operation of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act.

IRC § 6672 provides for the assessment of a Trust Fund Recovery Penalty against any person who is responsible for withholding and paying over employment taxes and certain types of excise taxes, often referred to as the "trust fund" taxes, to the IRS and who willfully fails to do so.⁶¹ As a result of the courts' interpretation of the willfulness component of the statute, in situations where no changes in ownership occur, after finding out about an employment tax liability, the responsible person must use all available funds to pay the delinquency and cannot use any of the funds to pay operating expenses of the business, even to keep the business going.⁶² This outcome does not change even if the delinquency resulted from a third-party bad act, such as embezzlement by a trusted employee or third-party payer.⁶³ The statute does not contain a reasonable cause exception.

Courts and legal scholars have commented that the current judicial interpretation of willfulness is "harsh," "draconian," and "somewhat counterintuitive," and have advocated

⁵⁹ See, e.g., IRC §§ 6656(a) and 6672(a).

⁶⁰ See National Taxpayer Advocate 2007 Annual Report to Congress 538-544.

⁶¹ "Responsible person" is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, and pay over the withheld taxes. IRC §§ 6671(b) and 6672(a). See also *Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothlin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).

⁶² Willfulness exists if the responsible person obtains knowledge of a withholding tax delinquency and continues to permit payments to be made to other creditors. *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970); *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987); *Wright v. U.S.*, 809 F.2d 425 (7th Cir. 1987).

⁶³ *Anuforo v. Comm'r.*, 614 F.3d 799 (8th Cir. 2010); *McCloskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa 2009). See also National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; Legislative Recommendation: *Taxpayer Protection from Third Party Payer Failures*).

for change in the statute.⁶⁴ This interpretation appears to cause unjust results when a responsible person of a struggling business tries to resolve a past tax delinquency, which resulted from an intervening bad act, and agrees to repay the liability in installments instead of liquidating the business.⁶⁵ Because current judicial interpretation of the TFRP willfulness component effectively requires a business owner to stop operating a business and pay all available cash to the IRS, or to resign after obtaining knowledge about the liability, the government may be forced to make outlays in the form of unemployment benefits or food stamps to the laid-off employees. Thus, the strict application of the TFRP willfulness component can destroy the taxpayer's business, harm the taxpayer's and his employees' financial welfare, and reduce future federal revenue. In these circumstances, it is in the best interests of the government to encourage business owners to continue to operate and pay off the delinquencies in installments rather than liquidate the business and lay off employees.

I recommend that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful, if the delinquent business: (1) makes payment arrangements to satisfy the liability based upon the IRS's determination of minimal working capital needs of the business, and (2) remains current with payment and filing obligations.⁶⁶

III. Small Businesses Facing Compliance Issues Often Face Devastating Yet Avoidable Consequences.

The current policies and procedures of the IRS Collection operation provide inadequate attention and service to small business taxpayers with emerging collection problems, particularly those concerning employment tax obligations. The IRS needs to provide early assistance to these taxpayers and provide flexible collection tools. Moreover, the IRS must strive to understand the taxpayer's reason for noncompliance in order to apply the appropriate collection technique.

⁶⁴ *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997); *Phillips v. U.S.*, 73 F.3d 939, 943 (9th Cir. 1996). See also Corrie Lynn Lyle, *The Wrath of IRC § 6672: The Renewed Call for Change – Is Anyone Listening? If You Are a Corporate Official, You Had Better Be*, 74 S. Cal. L. Rev. 1133 (May 2001).

⁶⁵ See, *Baimbridge v. U.S.*, 335 F. Supp. 2d 1084 (S.D. Cal. 2004) (“[S]erious injustice may result from a penalty assessment being predicated on non-IRS payments which were contemplated by the installment agreement”).

⁶⁶ Similar to the IRC § 7122(d)(2) requirement for allowable living expenses (ALE) analysis, the IRS should base its determination of minimal working capital needs on a thorough analysis of all facts and circumstances of each taxpayer and ensure that its determination will not leave the taxpayer without adequate funds to meet its basic operating expenses, including current and future tax obligations. The ALE standards are only applicable to individuals. IRM 5.15.1.7 (Oct. 2, 2009).

A. By Differentiating the Types of Noncompliance, the IRS Would be Better Able to Apply Appropriate Treatments to Small Businesses.

To apply the correct treatment for noncompliance, it is essential that the IRS understand the business's needs, vulnerabilities, and reasons for noncompliance. IRS collection practices involving small businesses make little or no distinction between "start-up" businesses, those that have been chronically delinquent, and those that have longstanding histories of successful operation and tax compliance prior to their current delinquencies. Particularly in the latter category, IRS collection policies and procedures provide little direction or flexibility to recognize that the long-term survival of these businesses represents a "win-win" outcome for both the small businesses and the U.S. government: more revenue, more jobs, and more contributions to the nation's economy. Especially in light of the recent recession, the IRS needs to adjust its collection practices to provide a potentially viable small business with a fair opportunity to resolve an outstanding tax debt in a manner that allows the business to survive.

B. Early Intervention Is Key to Assisting Small Businesses Facing Compliance Issues.

A study conducted by the Bureau of Labor Statistics in 2005 concluded that approximately a third of newly-established small businesses fail within two years of start-up, and over half fail within four years.⁶⁷ Considering this high failure rate, tax debt problems involving small business taxpayers, e.g., late federal tax deposits, unfiled returns, or returns filed with balances due, are clear warning signs of high-risk collection cases. However, IRS collection practices routinely fail to recognize these "red flag" conditions, and consequently do not provide early intervention in small business tax cases at the point when IRS actions can best correct taxpayer behavior, as well as collect the delinquent revenue.

The FTD Alert is a collection tool that "alerts" the IRS to taxpayers that appear to be falling behind on their federal tax deposits (FTDs), but the IRS rarely uses this tool to proactively contact small business taxpayers before employment tax debts materialize. In fiscal year 2010, the IRS invested only 0.4 percent of the Collection resources devoted to the collection of delinquent accounts (Taxpayer Delinquent Accounts or TDAs) into the FTD Alert program.⁶⁸

The collection process does not provide adequate attention to business-related (BMF) tax debts until they "pyramid" into substantial amounts.⁶⁹ The majority of unresolved

⁶⁷ Bureau of Labor Statistics, Monthly Labor Review, Vol. 128, No. 5, *Survival and Longevity in the Business Employment Dynamics Data*, 51 (May 2005).

⁶⁸ IRS, Collection Activity Report, NO-5000-23, *Collection Workload Indicators* (Oct. 2010), TDA Cumulative Report No 5000-23 Mth 092010, page 0001.

⁶⁹ For example, in FY 2010, 24 percent of the BMF notices that the IRS considered "closed" were actually "deferred," a closing status indicating the dollar amounts of the delinquencies did not (yet) warrant the use

BMF notices that are selected for collection action as delinquent accounts are assigned initially to the Automated Collection System (ACS), which is not successful in resolving most business cases.⁷⁰ The time these cases spend in the ACS, and later the Queue, does not improve the collectability of these accounts, or allow the IRS to intervene when the taxpayer could most benefit from a contact.

At focus groups conducted at the 2009 IRS Nationwide Tax Forums, when tax practitioners were asked to identify actions the IRS could take to help small business taxpayers, one of the main strategies recommended was "the need for the IRS to react faster." Participants stated, "The main problem is that many taxpayers are buried too deep by the time the IRS gets involved."⁷¹ In FY 2010, the typical BMF case assignment for the Collection Field function involved 5.6 delinquent accounts per business taxpayer.⁷² It appears that the typical business case that the IRS believes warrants a field contact has already accumulated two years of employment tax delinquencies before a face-to-face contact is even attempted.⁷³ By this time, unfortunately, many of these small business taxpayers are "buried too deep" to effect a successful resolution of their tax debt.

At this stage, the IRS generally uses tax liens, levies, seizures, and the Trust Fund Recovery Penalty to collect as much of the delinquency as possible. In fact, between FY 2006 and 2010, the IRS's use of liens and levies and the assessment of TFRPs increased substantially.⁷⁴ While the TFRP can be useful in certain situations, the increased emphasis on routinely making trust fund penalty determinations early in the collection process does not appear to be an efficient treatment for employment tax deficiencies. From FY 2006 to 2010, the dollar value of new TFRP delinquent accounts

of additional Collection resources. IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

⁷⁰ For example, in FY 2010, while ACS collected \$557 million on business tax delinquencies, over \$23 billion was transferred to the Collection Queue, awaiting assignment to the Collection Field function (Cff) – approximately 42 times the amount collected! IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

⁷¹ IRS, SB/SE Research, *Your Clients and the Economy – How Can the IRS Help*, 4 (Jan. 2010).

⁷² IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

⁷³ Of the BMF Trust Fund notices that were not resolved in the notice stream during FY 2010, approximately 23 percent were "closed" as "deferred" accounts, *i.e.*, due to the relatively small dollar amounts of the delinquencies, the IRS systemically determined to not pursue them as TDAs. IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010).

⁷⁴ From FYs 2006 to 2010, the issuance of Notices of Federal Tax Lien (NFTLs) increased by 55 percent, while the levies issued rose 172 percent. IRS, Collection Activity Report NO-5000-23, *Collection Workload Indicators* (Oct. 2010). In fiscal year 2006, the IRS Cff issued 245,757 levies and 348,888 NFTLs. These numbers have increased each year through FY 2010, when 542,045 NFTLs were filed and 667,322 levies were issued by the Cff. Additionally, TFRP assessments issued as delinquent accounts increased by 52 percent during this five-year period. IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

has increased by 30 percent, but dollars collected (including refund offsets) on these accounts have *declined by 23 percent*.⁷⁵ In general, the IRS collects very few of the dollars it assesses through TFRPs.⁷⁶

C. The Use of Flexible Collection Tools Would Help Small Businesses to Come into Compliance.

On the other hand, more flexible collection tools, such as installment agreements (IAs) and offers in compromise (OICs) are infrequently used by the IRS to resolve business-related tax delinquencies. For example, in FY 2010, the IRS approved only about 95,000 installment agreements involving tax debts for business taxpayers, even though it issued approximately 5.4 million initial collection notices during the year, and approximately 2.5 million delinquent accounts were in open status at year-end.⁷⁷ In addition, the IRS accepted less than 14,000 offers in FY 2010.⁷⁸ The process the IRS uses to consider an OIC on business tax debts makes it exceptionally difficult for a small business taxpayer to qualify for an offer without liquidating the business.⁷⁹

D. Economic Hardship Safeguards that Currently Apply Only to Individuals Should Also Apply to Small Business Taxpayers.

Statutory and administrative provisions that safeguard against some IRS collection actions by taking the taxpayer's economic hardship into account do not apply to business taxpayers. For example:

- IRC § 6343 requires the IRS to release a levy that is causing an economic hardship due to the financial condition of the taxpayer;⁸⁰
- Pursuant to IRC § 7122, Treasury regulations permit the IRS to enter into an effective tax administration offer in compromise where the taxpayer's liability could be collected in full but collection would create an economic hardship,⁸¹ and

⁷⁵ IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010). Excluding refund offsets, dollars collected on TFRP TDAs have declined by 45 percent from FY 2006 to FY 2010.

⁷⁶ IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

⁷⁷ IRS, Collection Activity Report, NO-5000-242, *Taxpayer Delinquent Account Cumulative Report, Part 2 – Accounts Receivable Notices* (Oct. 2010); IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010); TDA Cumulative Report No 5000-6 FY 2010, page 1079 (The data cited herein relate to Business Master File Accounts).

⁷⁸ IRS, Collection Activity Report, NO-5000-108, *Offer in Compromise Activity Report* (Oct. 2010).

⁷⁹ See IRM 5.8.5, *Offer in Compromise, Financial Analysis* for more detail on this matter.

⁸⁰ IRC § 6343(a)(1)(D). Treas. Reg. § 301.6343-1(b)(4) provides that economic hardship is present "if satisfaction of the levy in whole or in part will cause an *individual* taxpayer to be unable to pay his or her reasonable basic living expenses." (Emphasis added.)

- The IRS may remove taxpayers' accounts from active inventory and report them as Currently Not Collectible (CNC) where collection of the liability would create a hardship for the taxpayers by leaving them unable to meet necessary living expenses.⁸²

Because all of these provisions define hardship with reference to a Treasury Regulation applicable only to *individual* taxpayers, none of them is available to business taxpayers.⁸³ Allowing the IRS to consider, when it commences collection activity against a small business, whether the *business* is in economic hardship would put small businesses on the same footing as individuals. We acknowledge that this is a delicate issue, but we believe, although difficult, it is possible to develop an approach that addresses these concerns fairly.

IV. Conclusion: Tax Reform Can and Should Reduce the Costs of Small Business Tax Compliance.

For all the reasons described above, I believe that fundamental tax reform must be made a priority. However, in order to be effective and far-reaching, such fundamental tax reform should include *both* corporate tax reform *and* individual tax reform. Focusing only on corporate tax reform would ignore the fact that a substantial number of businesses – both incorporated and unincorporated – are pass-through entities and therefore, a real reduction in complexity and taxpayer burden *will not occur* unless individual tax reform occurs at the same time as corporate tax reform.⁸⁴

A simpler, more transparent tax code will substantially reduce the costs of tax compliance for small businesses; increase the likelihood that taxpayers will claim all tax benefits to which they are entitled; reduce the likelihood that more sophisticated taxpayers can exploit arcane provisions to avoid paying their fair share of tax; improve

⁸¹ Treas. Reg. § 301.7122-1(b)(3), providing that economic hardship is defined by Treas. Reg. § 301.6343-1(b)(4); IRM 5.8.11.2.1 (Sept. 23, 2008). Treasury considered allowing businesses to enter into an offer in compromise based on effective tax administration and economic hardship, but ultimately concluded that it did not necessarily promote effective tax administration. T.D. 9007, 67 Fed. Reg. 48,025, 48,026 (July 23, 2002) (preamble).

⁸² IRM 5.16.1.1 (June 29, 2010). IRM 5.15.1 (Oct. 2, 2010) refers employees to Treas. Reg. § 301.6343-1(b)(4) in analyzing a taxpayer's financial condition.

⁸³ IRM 5.8.11.2.1(2) (Sept. 23, 2008) provides: "Note: Because economic hardship is defined as the inability to meet reasonable basic living expenses, it applies only to individuals (including sole proprietorship entities). Compromise on economic hardship grounds is not available to corporations, partnerships, or other non-individual entities." (Emphasis in original.) IRM 5.16.1.1 (June 29, 2010) provides: "**Reminder:** Hardship closing codes can **only** be used for individual or joint IMF assessments, sole proprietorships, general partnerships, and LLCs where an individual owner is identified as the liable taxpayer." (Emphasis in original).

⁸⁴ In calendar year 2010, 3.4 million Forms 1065 and 1065B were filed and 4.5 million Forms 1120S were filed. IRS Document 6149, 2010 Update: Calendar Year Return Projections by State CY 2010 -2017 (Nov. 2010).

taxpayer morale and tax compliance; and enable the IRS to administer the tax system more effectively and better meet small business taxpayers' needs.

Testimony of Steven J. Strobel

BlueStar Energy Solutions

**On Behalf of
The National Small Business Association**



House Committee on Small Business

Hearing:

**“How Tax Complexity Hinders Small Businesses: The Impact on Job
Creation and Economic Growth.”**

April 13, 2011

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Chairman Graves, Ranking Member Velazquez, and members of the committee, thank you for the opportunity to testify on ways tax complexity impacts job creation and economic growth by placing an unfair burden on America's small businesses. My name is Steven J. Strobel and I am Executive Vice President & Chief Financial Officer at BlueStar Energy Solutions, located in Chicago, Illinois. BlueStar is a retail energy supplier providing electricity and energy efficiency solutions to commercial, industrial and residential customers primarily in Illinois, Pennsylvania, Ohio, Maryland and DC. I am testifying today on behalf of the National Small Business Association (NSBA). Since 1937, NSBA has advocated on behalf of America's entrepreneurs. Reaching more than 150,000 small-business owners nationwide, NSBA serves as an umbrella group to myriad regional, state and local small-business associations and Chambers of Commerce and is proud to be the nation's first small-business advocacy organization.

Although NSBA's members operate a wide variety of businesses, they all consistently rank reducing the tax burden among their top issues for Congress and the administration to address. While the actual out-of-pocket cost is a huge issue, the sheer complexity of the tax code has been an ever-increasing thorn in the sides of America's small businesses. We tend to be an easy target since unlike big corporations—which have large staffs of accountants, benefits coordinators, attorneys, personnel administrators, etc. at their disposal—small businesses often are at a loss to keep up with, implement, afford, or even understand the overwhelming regulatory and paperwork demands of the federal government.

Approximately 37 percent of NSBA members have fewer than five employees—few, if any of whom is a tax specialist—leaving business owners with no other choice but to hire outside help to keep track of all their additional reporting and filing requirements. In fact, according to NSBA's 2011 Small Business Taxation Survey, only 13 percent of small-business owners handle their taxes internally—meaning 87 percent are forced to pay an external accountant—this data should send a strong message to the Internal Revenue Service (IRS) and Congress that the tax code is far too complex. BlueStar is a Sub S corporation and the two owners' tax returns are completed by outside accountants.

Not only is the burden a heavy one, but it is disproportional as well. According to U.S. Small Business Administration (SBA) Office of Advocacy research, the relative cost of tax compliance for small firms is 67 percent higher than for their larger competitors. For firms with less than twenty employees, the per-employee cost of complying with the tax code is \$1,304—and that doesn't include filing costs or actual taxes.

The current tax system is so complex and burdensome that small businesses are spending valuable time and financial resources on record-keeping and outside help to ensure compliance instead of using these resources to do what they do best: grow their business, create jobs, and stimulate the economy. When asked in the NSBA Taxation Survey, how much time and money per year is spent just on the administration of taxes, 50 percent of small businesses said they spend more than \$5,000 and more than a third (38 percent) spend more than 80 hours. BlueStar spends over \$25,000 annually on tax preparation.

As Congress and the administration grapples with a down-turned economy, banking failures and a skyrocketing deficit, it is only natural to look for ways to offset spending and raise revenues. However, it is inconceivable and unacceptable for Congress to do so on the backs of small-business owners—the very entrepreneurs whose job creation has led America out of every recession for thirty years or more. The U.S. economy and job growth are starting to show signs of improvement. However, most small-business owners are not yet in a position to start hiring new employees and they won't be until they have access to safe, dependable, and sufficient access to capital, and public policies that boost investment and encourage entrepreneurship.

Reducing the U.S. deficit has a real benefit to small-business growth in the U.S. and is something America's small-business owners feel should be a national priority. The U.S. has always been a leader in entrepreneurship, however if we do not address our record-high deficit, high debt levels, and our byzantine tax code, our global competitiveness will be stymied.

Congress and the administration over the coming years must address the nation's budget deficit and the associated long-term debt. In addition to reducing the size and pay of the government workforce and overall entitlement spending, one way to do that is to implement real tax reform: simplify the tax code, broaden the base, lower all individual and corporate tax rates, and make the corporate tax code more competitive for U.S. business. These reforms will create a surge in economic growth.

Based on the 2011 NSBA Taxation Survey, when it comes to tax policy, small businesses expressed support for deficit reduction policies that reign-in entitlement spending, and tax reform that reduces both corporate and individual tax rates coupled with a reduction in business and individual deductions.

Federal spending in 2010 amounted to approximately 24 percent of gross domestic product (GDP)—a level not seen since World War II—in part due to the economic downturn. Even with an economic recovery and the ensuing increase in tax revenues and decrease in spending on stimulative and safety net programs—without major changes—federal spending will continue to outpace revenues. If we continue to run high deficits, increased interest rates and constricted credit will negatively impact small businesses' ability to garner financing, the life-blood of every small firm.

According to a recent U.S. Small Business Administration Office of Advocacy study, 80 percent of small firms use credit. If long-term government deficits exacerbate the current credit crunch or adversely affect small firms' future ability to access credit, the effects on the small-business community—and their ability to create jobs and grow the U.S. economy—would be disastrous.

As voted on by NSBA's members at the biennial Small Business Congress, tax reform is one of NSBA's top ten priorities. The current tax code is comprised of more than 10,000 pages of laws and regulations that, in their complexity and propensity for frequent change, serve as a disadvantage to small businesses. NSBA's members believe it is

imperative that the U.S. moves toward a simpler, fairer tax system that is: designed to tax only once; stable and predictable; visible to the taxpayer; simple in its administration and compliance; comprehensible using commonly understood finance/accounting concepts; and fair in its treatment of all citizens.

At a time of record trade deficits and manufacturing job loss, U.S. companies are struggling to compete against foreign competitors. Congress and the administration must recognize that in order to rebuild our workforce and remain competitive, we must ensure that our tax code does not impede the international competitiveness of US companies nor dis-incentivize domestic investment. One option worth consideration is the Fair Tax. In the 112th Congress, legislation has been introduced in the House and Senate, the *Fair Tax Act of 2011* (H.R. 25/S. 13), which NSBA proudly supports.

The Fair Tax allows Americans to keep 100 percent of their paycheck, pension, and Social Security payments, thus enabling them to save more, invest in their businesses, and boost our economy through job creation and innovation. A national sales tax would achieve fairness by employing a single tax rate, close loopholes and deductions and cause the savings rate of Americans to substantially increase.

Most significantly though is the fact that a national sales tax is border adjustable and would place exporting by U.S. companies on a level playing field with our foreign competitors. U.S. exports—including those of small businesses—would benefit from the enactment of a national sales tax. Most of our trading partners have tax systems that are border adjustable. They are able to strip out their tax when exporting their goods. In comparison, our income tax is not border adjustable and therefore, American goods that are sent overseas are taxed twice—once by the income tax and once when they reach their destination. This puts U.S. companies at a competitive disadvantage with our foreign competitors, as well as hurts Americans' ability to save and invest domestically.

Whether it is the Fair Tax or any of the other tax reform recommendations currently on the table, any reform must be built around internationally-competitive tax rules that result in a simpler, more efficient and less costly tax system that provides powerful incentives for businesses to invest and produce in the U.S. The economics of small businesses in all sectors—manufacturers, service providers, farmers and ranchers—would be strengthened by their ability to save and invest in this country, and thus hire additional workers.

The NSBA believes efforts to reduce the regulatory and administrative burdens on small businesses must focus on overall simplification, eliminating inequities within the tax code, and enhancing taxpayer education and outreach. A simpler tax code that is more easily understood by taxpayers would have many benefits, not the least of which would be reduced cost of compliance and reduced unintentional errors. Accurate tax reporting and compliance is extremely important to small business but vague rules and poorly defined regulations understandably result in mistakes. Those who make a good faith effort, yet are inaccurately complying should be assisted through education and tax simplification efforts. Those willfully disregarding their tax liability should be held accountable. However, increased enforcement at the expense of taxpayer education will

not in the long term accomplish sustained, improved compliance. The more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. With the complexity facing many taxpayers, NSBA believes the development and implementation of initiatives to improve IRS guidance and assistance is important.

Although the next few years are likely to require continued economic stimulation—spending and tax cuts—which may deepen the deficit, NSBA is confident that fiscally responsible policies and entrepreneurially-supportive tax simplification will lead to the long-term prosperity of the U.S. economy. It is critical that lawmakers avoid any move which would stymie the moderate economic growth we're just now seeing in the U.S. economy and from the small-business community.



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Statement of Robert Kulp

On behalf of the

National Roofing Contractors Association

House Committee on Small Business

**“How Tax Complexity Hinders Small Businesses:
The Impact on Job Creation and Economic Growth”**

April 13, 2011

Chairman Graves, Ranking Member Velázquez, and distinguished members of the committee, thank you for the opportunity to testify today on behalf of the National Roofing Contractors Association (NRCA) to discuss how tax complexity hinders the ability of small businesses to create jobs. I am Bob Kulp, founder and co-owner of Kulp's Of Stratford LLC, a roofing contractor in Stratford, Wisconsin. I currently serve on the NRCA board of directors and as chairman of the association's government relations committee.

Established in 1886, NRCA is one of the nation's oldest trade associations and the voice of professional roofing contractors worldwide. It is an association of roofing, roof deck, and waterproofing contractors; industry-related associate members, including manufacturers, distributors, architects, consultants, engineers, government agencies and international members. NRCA has approximately 4,000 members from all 50 states and 54 countries. NRCA contractors typically are small businesses, with the average member employing 45 people in peak season and having sales of \$4.5 million per year.

Kulp's Of Stratford is involved in both commercial and residential roofing and insulation with an emphasis on metal and thermoplastic roofing systems and interior spray foam installations. We have a specialty metals division that includes fabrication and finishing of projects such as complete steeple structures as well as finials on steeples for churches. We also are now involved with installing Building Integrated Solar Photovoltaic roofing. Kulp's employs between 35-50 people depending on the season and we have about \$6 million in annual sales.

As the national unemployment situation continues to slowly improve, unemployment in the construction industry remains at an alarming 20.0 percent, according to the Bureau of Labor Statistics. There appears to be little relief in sight for our industry during these difficult economic times. Clearly, the time is right to take steps to improve this situation, and reducing complexity in the tax code is a good place to start.

Given the continued highly difficult economic conditions in the construction industry, NRCA urges Congress to take immediate action on tax policy measures that will remove impediments and spur job growth within our industry. NRCA strongly supports depreciation reform for commercial roofs, repeal of the three percent withholding tax on government contracts, and the reform of the completed contract method (CCM) of accounting. We believe enactment of these initiatives will reduce and simplify taxes, thus allowing entrepreneurs to create jobs in construction and other industries, particularly among small businesses.

Depreciation Reform

Small businesses within the roofing industry are uniquely positioned to play a critical role in creating jobs for American workers. Congress should facilitate the creation of an estimated 40,000 jobs annually within our industry by passing legislation to reduce the depreciation schedule for commercial roofs from 39 years to 20 years. In addition to creating 40,000 jobs among contractors and manufacturers, such legislation would also enhance the energy efficiency of our nation's commercial buildings and simplify taxes for small businesses in many industries.

Depreciation reform is necessary because between 1981 and 1993 the depreciation schedule for nonresidential property was increased from 15 years to 39 years. However, the current 39-year depreciation schedule is not a realistic measure of the average life span of a commercial roof. A study by Ducker Worldwide, a leading industrial research firm, determined the average life expectancy of a commercial roof to be 17 years.

The large disparity between the 39-year depreciation schedule and the average life span of a commercial roof is a major incentive for building owners to delay the replacement of failing roofs. This is slowing economic activity and the adoption of more advanced energy-efficient roofs, because an owner who replaces a roof before 39 years have elapsed must continue to depreciate that roof for tax purposes even though it no longer exists. A Treasury Department Report to Congress on Depreciation Recovery Periods and Methods confirmed this problem by finding "...a 'cascading' effect, where several roofs are being depreciated at the same time, even though only one is physically present." Given this situation, many building owners choose to do only piecemeal repairs, most often with older technology, rather than replace a failing roof in its entirety with new, more energy-efficient materials.

In the 111th Congress, several bills (H.R. 426 and H.R. 5396) were introduced with bipartisan support to rectify this situation. This legislation would reduce the depreciation schedule from 39 to 20 years for commercial roofs that meet a benchmark energy-efficiency standard. This would facilitate job creation in our industry by accelerating demand for commercial roofs by eliminating the disincentive in the tax code for building owners to delay replacement of failing roofs. Enactment of this legislation would also benefit small businesses of all types by

mitigating the “cascading effect” of having to depreciate more than one roof in instances where a roof must be replaced before the 39-year depreciation schedule has been completed.

According to the Ducker Worldwide study, depreciation reform would produce the following benefits by accelerating demand for commercial roofs:

- Create 40,000 new jobs within the roofing industry;
- Add \$1 billion of taxable annual revenue to the economy;
- Provide savings to small businesses of all types through a simpler and more equitable system of taxation and lower energy costs; and,
- Reduce U.S. energy consumption by 13.3 million kilowatt hours annually and cut carbon emissions by 20 million lbs. per year.

Depreciation reform for commercial roofs enjoys support of a diverse coalition of businesses, manufacturers, and labor groups. The bill would create jobs not through a special tax incentive, but by the removal of an obstacle in the tax code which restricts economic growth in the construction industry. Additionally, it would help improve property values, thus increasing resources for schools and local authorities.

NRCA is working with a wide array of members to explore opportunities for depreciation reform in the 112th Congress. We welcome the opportunity to work with members of the House Small Business Committee on this issue, which has great potential to create jobs among small businesses in the construction industry.

Three Percent Withholding Tax on Government Contracts

NRCA calls for the immediate repeal of the three percent withholding on government contracts mandated in Section 511 of the *Tax Increase Prevention and Reconciliation Act of 2005* (TIPRA) through the prompt passage of the Withholding Tax Relief Act of 2011 (H.R. 674). Repeal of the withholding law, which adds a new layer of complexity to a contractor’s tax filing, is vital to job creation and economic growth in the roofing industry.

If the withholding law is not repealed, roofing contractors performing government work will face serious repercussions. The mandated three percent of the contract that is withheld is taken off the total value of that contract, not the profit earned on the project. Given that three percent or less of the total contract is the average profit margin in our industry, withholding could eliminate contractors’ profits on many projects, thus severely limiting the ability of contractors to grow their business and create jobs.

While the contractor may collect the three percent that is withheld at the end of the year, cash-flow and operating capital disruptions caused by withholding will be a tremendous burden, particularly for small businesses. The bookkeeping systems of many small businesses are not set up to account for such large amounts withheld from invoices. Withholdings will also complicate tax filings and the need to accurately determine tax liability, especially since tax software has not been developed in this area. This new complexity will create added compliance costs on businesses and thus will further impair efforts to create jobs. Many roofing contractors will be

forced to stop bidding on government contracts in order to avoid these added complexities. Also, contractors continuing to perform government work may be forced to pass additional costs created by withholding along to the government and taxpayers.

The Government Withholding Relief Coalition, of which NRCA is a member, recently released a cost impact study of the three percent withholding law. The study estimates implementation costs for federal, state, and local governments to be about \$20.2 billion over five years. Given that the Joint Committee on Taxation estimated in 2006 that the withholding tax will raise roughly \$7 billion over five years, it does not make good fiscal sense to allow the withholding requirement to take effect, even from the point of view of the government.

NRCA *strongly* urges Congress to quickly repeal this requirement, which further complicates the tax filing of contractors and stifles job creation. Without immediate action by Congress, the withholding will begin impacting contractors soon, as businesses must begin tailoring their bookkeeping systems in anticipation of the provision taking effect at the beginning of 2012.

Completed Contract Method Reform

NRCA supports bipartisan legislation (H.R. 6097) introduced in the 111th Congress to modify the tax code to expand the number of construction contractors who may utilize the completed contract method of accounting when dealing with long-term construction contracts.

Under current law, construction contractors cannot use the completed contract method if average annual gross receipts exceed \$10 million, a threshold that has not been adjusted for inflation since 1986. Contractors who cannot utilize the completed contract method must use the percentage of completion method of accounting, which often does not accurately reflect results due to the required use of cost estimates. The percentage of completion method is a major paperwork/compliance burden for small and mid-sized contractors because they have to estimate the percentage of a completed project and then retroactively amend those filings in subsequent years based on the actual numbers. Like the three percent withholding tax, this system represents an impediment to business growth and job creation, as increasingly more time and resources must be devoted to tax compliance.

H.R. 6097 would increase the threshold for using the completed contract method, index it for inflation, and also provide relief from the Alternative Minimum Tax and “look-back” provisions in the tax code. This legislation would significantly reduce the complexity of the tax code for many construction employers. NRCA looks forward to working with Congress on this issue of importance to the construction industry going forward.

Conclusion

Again, NRCA urges Congress to address the alarming 20 percent unemployment rate in the construction industry by moving forward with these and other initiatives to reduce tax complexity, which will help boost economic growth and create jobs. NRCA looks forward to working with the members of the committee in this regard. Thank you for your consideration of NRCA’s views on these matters.

Written Testimony of

Monty W. Walker, CPA

**Before the Committee on Small Business of the
United State House of Representatives**

**How Tax Complexity Hinders Small Business:
The Impact on Job Creation and Economic Growth**

April 13, 2011

Monty W. Walker's Written Testimony
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Introduction

Chairman Graves, Ranking Member Velázquez, and members of the Committee, thank you for the invitation and opportunity to appear before the U.S. House of Representatives Committee on Small Business and to offer my testimony on how tax complexity hinders small business and the resulting impact it has on small business job creation and economic growth.

I am an independent tax and consulting practitioner with a national practice. My practice focus is in the support of entrepreneurs with a primary emphasis in business ownership transition planning and support services and a secondary emphasis in retirement planning specifically in plan design, administration and fiduciary services.

Small Businesses and Their Owners

For a small business, the division between the small business and the small business owner often becomes blurred because every business decision has a direct and often significant impact on the small business owner and the small business owner's family. This is because the business is often at the epicenter of a small business owner's life.

A small business impacts the life of a small business owner in a significant way. Small business owners learn to adapt to the demands required of a small business and the sacrifice that comes with small business ownership.

This sacrifice can be summed in the following five life segments:

- **Family:** A small business absorbs the precious and limited time available to enjoy being with family. Vacations, attending kid's school activities, spending good conversation time with a spouse, or simply going to the park on a weekend are all controlled by the business.
- **Friends:** A small business often makes outside relationships with friends challenging and sometimes almost impossible. In fact, the friendships which can develop frequently occur with people met as a result of the business.
- **Free Time:** A small business can tie a person to the business. Small business owners often have no time for themselves let alone time for others. Pursuing hobbies, taking time off or just finding quiet time are, in many instances, put on hold for another day in order to tend to the needs of the business.
- **Finances:** A small business quite often impacts all of a business owner's financial decisions. The business most often is the center of a family's financial infrastructure providing the majority, if not all, of the family's current and future income.
- **Future:** A small business sets the direction for a business owner's future opportunities.

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Where a business owner and a business owner's family will be in the future can be traced to the success and / or failures of the business.

For the small business owner these life segments are often a challenge to manage simply because the small business regularly takes precedence over them or the small business is the driving force behind other life options.

The burdens of owning a small business expand exponentially when the confusion and complexity of the tax system is introduced to the small business ownership equation. Maintaining compliance with the various governmental regulatory bodies is extremely time consuming and this is especially true for tax compliance. Additionally, maintaining tax compliance comes at cost and for many small business owners this cost can be quite significant.

The cost to properly maintain regulatory compliance is really the small business owner's opportunity cost associated with expending the same resources on business operations and business development. These resources include both money and time. Between the money spent on tax professionals and time focused on maintaining compliance as opposed to spending the same time running the business, a small business owner's opportunity cost can be quite significant.

Compliance Time + Compliance Fees = Business Opportunity Cost

Based on a non-statistical poll, conducted in preparation for this hearing, of 20 small business owners with businesses ranging in revenue from \$1,000,000 to \$5,000,000, the average amount of time and fees extended to maintain tax compliance is 1) Time = 104 to 156 hours per year and 2) Professional Fees = \$5,000 to \$15,000 per year.

Note: When considering penalties and interest associated with a failure to maintain compliance, business opportunity cost grows even larger.

Small business owners often start their business on a passion based foundation doing something they enjoy only to quickly learn that running a small business has many complex and confusing compliance requirements. Mail received from the various regulatory bodies becomes overwhelming. Unfortunately, many small business owners get out of tax compliance simply due to a failure to interpret correspondence being received from the IRS. This is especially true for small business owners who cannot afford the services of a tax professional.

Understanding tax matters is confusing and tax compliance comes at a cost. This cost results in lost resources that could have been used for business operations and business development.

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The Changing Entrepreneurial Landscape

Small Business Ownership is taking on a new look. Over the past 20 to 30 years entrepreneurialism has been ruled by youth primarily due to advancements in the technology sector. Now though new business ownership is moving the way of experience as people in their 40s, 50s, 60s and older are becoming entrepreneurs.

This entrepreneurial trend is part of a major societal influence underway which is the aging of the baby boomers, the approximately 79 million people born in the United States from 1945 to 1965. This generation has about 27 million more people than the one that preceded it, and about 10 million more than the one that follows.

For decades, the academics and economists have been postulating that the baby boomers would revolutionize retirement in America. The workers in this generation have been portrayed as being healthy energetic retirees with few worries and having the ability to improve their communities by the giving of their time after retirement.

Well, the baby boomer generation has received a wake-up call and many members of the traditionalist generation, the generation just prior to the baby boomers, have also received this same call. This call is the realization that a paradigm shift is required regarding the concept of retirement. Retirement was once viewed as a destination received as the reward for years of hard work and sacrifice. Retirement though for many people is now nothing more than a life event leading to a change of employment but not a removal from it.

Many factors have led to this realization including:

- The downturn of the economy and its impact on retirement savings accounts
- Corporate downsizings resulting in job loss
- Excessive personal debt
- Significant declines in housing prices resulting in reduced net worth
- Costs associated with health care coverage and direct medical expenses
- Financial requirements to care for parents or children who return home
- Increasing prices of food, gasoline and utilities

Becoming an entrepreneur is the decision being made by many people as they decide to take control of their own destiny by starting or buying a business. Owning a small business is an important means by which many people will either prepare for retirement or by which they will afford retirement.

Since most people will likely enter into a nonagricultural related business, the best representation of the type of entrepreneurial growth being experienced from those in the baby boomer generation or earlier is the increase in self-employed people in nonagricultural industries.

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Self-employed people in nonagricultural industries by age				
Change between Year 1990 and Year 2010				
(in thousands)				
Age	Year 1990	Year 2010	Change	% Change
16 to 19	76	71	-5	-6.6%
20 to 24	341	302	-39	-11.4%
25 to 34	2,486	1,773	-713	-28.7%
35 to 44	3,718	3,182	-536	-14.4%
45 to 54	2,821	4,077	1,256	44.5%
55 to 64	1,811	3,156	1,345	74.3%
65 and older	799	1,324	525	65.7%
Total	12,052	13,885	1,833	15.2%

Source: U.S. Bureau of Labor Statistics

This chart clearly shows that between Year 1990 and Year 2010 the baby boomer generation and the earlier generation, those 45 years of age and up, have embraced entrepreneurship.

Between Year 1990 and Year 2010, self-employment among people age 45 to 54 increased 44.5%, age 55 to 64 increased 74.3% and age 65 and older increased 65.7%. The aggregate increase among this age group of people 45 and up is 57.6%.

The decision to own a small business generally comes down to the economics surrounding the decision. For example, a person with \$300,000 of money in various market investments can hope to make \$15,000 to \$24,000 at best per year in the stock market with the risk of seeing the principal decline or a portion of these funds can be used to start a small business which can be developed to generate \$100,000 to \$300,000 or more in cash flow per year. As can be seen, the annual cash flow from the small business far outweighs the results of placing the same funds in the market. Additionally, the business in this example, depending on its specific industry, may be able to be sold for as much as \$900,000 or more.

Motivating people to self develop retirement resources has been on the U.S. Government's agenda for years. The straining of the social security system, the elimination of pension plans in favor of 401(k) plans and an overindulgent lifestyle have caused many people to be ill-prepared

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for retirement. Small business opportunities are becoming and will continue to become an important means by which many people will develop retirement resources.

Tax simplification will enhance an entrepreneur's ability to achieve business success which in turn will increase an entrepreneur's ability to develop retirement resources.

Complexities of the Tax System

The complexity of the tax system is as perplexing as a foreign language. For most small business owners, understanding their tax compliance requirements is beyond their reach. Due to limited discretionary cash flow, many small business owners do not have the ability to retain the services of a tax professional on an ongoing basis. As a result, many small businesses are attempting to maintain a substantial amount of required compliance through the efforts of untrained and unknowledgeable tax advisors; these advisors being themselves. A lack of funds for ongoing professional assistance and a misinterpretation of the regulations often lead to failed compliance.

The ever growing tax code along with its temporary provisions and interpretations make it increasingly difficult for small business owners to do any substantial long-term planning. This leads to small business owners being placed in the position to make decisions in a vacuum due to the unknown results which may occur. Almost every decision made in a small business has some form of tax implication. Since the tax system directly impacts so many decisions, small business owners will standby on making business development and new hire decisions when they have a lack of confidence in what will occur due to unknowns in the tax system. This, in part, has added to and is currently adding to the soft business expansion and a lack of new hiring which is desperately needed as a part of the United States' current economic recovery.

Due to the provisions of the tax code which impact small businesses being so numerous, it's impossible to reference all of them. Accordingly, the following are some select burden and complexity examples which adversely affect small businesses and their willingness and often ability to expand or hire new employees:

Patient Protection and Affordable Care Act Form 1099 Reporting

The Form 1099 reporting requirements of the Patient Protection and Affordable Care Act requiring that all payments from businesses aggregating \$600 or more in a calendar year to a single payee, including corporations, be reported is an excellent example of the burdens and complexity placed on small businesses under the tax system. Although the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 repealing the Form 1099 reporting requirements has been passed by both the House and Senate and is waiting to be signed into law by the president as of the preparation of this testimony, small businesses felt the impact while it was in the regulations. The time and money spent to start getting prepared for the reporting requirements has been quite considerable for many small businesses.

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In gathering information for this hearing I learned from several small business owners that they spent in excess of 100 hours getting prepared for the Form 1099 reporting requirement. The repeal of this reporting requirement is needed but the opportunity cost it created is significant.

Employee vs. Contractor

With business success comes a decision crossroad for many small businesses. The need to hire people develops and with the decision to hire people can come a set of complex compliance regulations. The question to be answered is whether to classify someone as an employee or as a contractor. If a new hire is misclassified as a contractor, penalties can be assessed and back due wages and benefits will be due. If a new hire is misclassified as an employee, unnecessary tax payments and benefits will be paid by the small business.

So, who is an employee? Unfortunately, there is no uniform definition of the term. Under the common-law rules an individual generally is an employee if the enterprise he works for has the right to control and direct him regarding the job he is to do and how he is to do it. Otherwise, he is an independent contractor.

To help determine whether an individual is an employee under the common-law rules, the IRS has identified 20 common-law factors. These factors, sometimes called the 20 factor test, indicate whether sufficient control exists to result in employee classification. The IRS developed these 20 factors based on examination of earlier cases and rulings considering worker classification. These 20 factors outlined in Revenue Ruling 87-41, attempt to identify the extent of a business's legal right to control how the worker performs the job.

Because of the complexity and ambiguity that arises when trying to properly class a new hire, the path chosen by some small business owners is to just stay small and not hire people as opposed to expanding and becoming exposed to regulatory compliance brought on by hiring people.

Section 179 Deduction

The Section 179 Deduction is a special tax provision that allows small businesses the option of claiming a deduction in the first year for the entire cost of such qualifying business assets limited to a maximum deductible amount which is set annually. This applicable amount is then further limited and reduced, but not below zero, by the amount of the total cost of all Code Section 179 property placed in service during the year that exceeds the threshold limitation. The maximum deductible amount is \$500,000 for Year 2011.

For a C corporation, the Section 179 deduction is fully available based on the annual maximum deductible amount. A small business owner who owns interests in two or more pass-through entities (i.e., partnerships or S corporations) could be allocated Section 179 deductions for 2011 totaling more than \$500,000. If this occurs, the small business owner's allowable Section 179 deduction is still limited to just \$500,000. Any excess Section 179 deduction amounts allocated from pass-through entities can potentially be permanently lost without proper planning.

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Unfortunately, under Section 179 a small business owner can actually be penalized for owning various businesses when each of them takes advantage of the available Section 179 deduction. Being limited and potentially penalized is a disincentive to make capital purchases. Losing the ability to take a Section 179 deduction reduces cash flow by increasing tax and this in turn impacts other expansion decisions such as hiring people.

Capitalize vs. Expense

Whether particular business expenditures should be capitalized or expensed is one of the most common tax questions encountered. Certainly, an expenditure that results in the acquisition or enhancement of a separate and distinct asset with a useful life of more than a year should be capitalized.

Generally, repair expenditures are deductible in the year incurred as ordinary and necessary business expenses under IRC Section 162 if they neither materially add to the value of the property nor appreciably prolong its useful life, but merely help to maintain the property in an ordinary efficient operating condition.

The final decision as to whether an expenditure, especially a repair related expenditure, should be capitalized or written off as a period expense will be based on the facts of the specific expenditure. Whether an expenditure should be capitalized or expensed is left up to interpretation because there is no absolute on how to apply the characteristics of what is or is not a capital expenditure.

Conclusion

Small businesses face many obstacles. Buying or starting a small business is often one of the most significant financial events ever experienced by an entrepreneur. Entrepreneurs approach the process with a hope and desire of creating something better for their future while often exposing themselves to a large investment and debt. For many entrepreneurs their small business is the center of their family's financial infrastructure providing the majority, if not all, of their family's current and future income.

This hearing is not just about small business tax complexities. Nor is it just about how tax complexities hinder small business job growth. Nor is it just about how tax complexities hinder small business economic growth.

It is about enhancing the opportunity for small businesses to achieve success which in turn results in job and economic growth. Lowering the burdens and barriers caused by the tax system is a positive step in the support of small businesses.

Congresswoman Yvette Clarke (NY-10)
Submitted for the Record
April 13, 2011

The New York Times

March 24, 2011
G.E.'s Strategies Let It Avoid Taxes Altogether
By DAVID KOCIENIEWSKI

General Electric, the nation's largest corporation, had a very good year in 2010.

The company reported worldwide profits of \$14.2 billion, and said \$5.1 billion of the total came from its operations in the United States.

Its American tax bill? None. In fact, G.E. claimed a tax benefit of \$3.2 billion.

That may be hard to fathom for the millions of American business owners and households now preparing their own returns, but low taxes are nothing new for G.E. The company has been cutting the percentage of its American profits paid to the Internal Revenue Service for years, resulting in a far lower rate than at most multinational companies.

Its extraordinary success is based on an aggressive strategy that mixes fierce lobbying for tax breaks and innovative accounting that enables it to concentrate its profits offshore. G.E.'s giant tax department, led by a bow-tied former Treasury official named John Samuels, is often referred to as the world's best tax law firm. Indeed, the company's slogan "Imagination at Work" fits this department well. The team includes former officials not just from the Treasury, but also from the I.R.S. and virtually all the tax-writing committees in Congress.

While General Electric is one of the most skilled at reducing its tax burden, many other companies have become better at this as well. Although the top corporate tax rate in the United States is 35 percent, one of the highest in the world, companies have been increasingly using a maze of shelters, tax credits and subsidies to pay far less.

In a regulatory filing just a week before the Japanese disaster put a spotlight on the company's nuclear reactor business, G.E. reported that its tax burden was 7.4 percent of its American profits, about a third of the average reported by other American multinationals. Even those figures are overstated, because they include taxes that will be paid only if the company brings its overseas profits back to the United States. With those profits still offshore, G.E. is effectively getting money back.

Such strategies, as well as changes in tax laws that encouraged some businesses and professionals to file as individuals, have pushed down the corporate share of the nation's

tax receipts — from 30 percent of all federal revenue in the mid-1950s to 6.6 percent in 2009.

Yet many companies say the current level is so high it hobbles them in competing with foreign rivals. Even as the government faces a mounting budget deficit, the talk in Washington is about lower rates. President Obama has said he is considering an overhaul of the corporate tax system, with an eye to lowering the top rate, ending some tax subsidies and loopholes and generating the same amount of revenue. He has designated G.E.'s chief executive, Jeffrey R. Immelt, as his liaison to the business community and as the chairman of the President's Council on Jobs and Competitiveness, and it is expected to discuss corporate taxes.

"He understands what it takes for America to compete in the global economy," Mr. Obama said of Mr. Immelt, on his appointment in January, after touring a G.E. factory in upstate New York that makes turbines and generators for sale around the world.

A review of company filings and Congressional records shows that one of the most striking advantages of General Electric is its ability to lobby for, win and take advantage of tax breaks.

Over the last decade, G.E. has spent tens of millions of dollars to push for changes in tax law, from more generous depreciation schedules on jet engines to "green energy" credits for its wind turbines. But the most lucrative of these measures allows G.E. to operate a vast leasing and lending business abroad with profits that face little foreign taxes and no American taxes as long as the money remains overseas.

Company officials say that these measures are necessary for G.E. to compete against global rivals and that they are acting as responsible citizens. "G.E. is committed to acting with integrity in relation to our tax obligations," said Anne Eisele, a spokeswoman. "We are committed to complying with tax rules and paying all legally obliged taxes. At the same time, we have a responsibility to our shareholders to legally minimize our costs."

The assortment of tax breaks G.E. has won in Washington has provided a significant short-term gain for the company's executives and shareholders. While the financial crisis led G.E. to post a loss in the United States in 2009, regulatory filings show that in the last five years, G.E. has accumulated \$26 billion in American profits, and received a net tax benefit from the I.R.S. of \$4.1 billion.

But critics say the use of so many shelters amounts to corporate welfare, allowing G.E. not just to avoid taxes on profitable overseas lending but also to amass tax credits and write-offs that can be used to reduce taxes on billions of dollars of profit from domestic manufacturing. They say that the assertive tax avoidance of multinationals like G.E. not only shortchanges the Treasury, but also harms the economy by discouraging investment and hiring in the United States.

"In a rational system, a corporation's tax department would be there to make sure a company complied with the law," said Len Burman, a former Treasury official who now

is a scholar at the nonpartisan Tax Policy Center. “But in our system, there are corporations that view their tax departments as a profit center, and the effects on public policy can be negative.”

The shelters are so crucial to G.E.’s bottom line that when Congress threatened to let the most lucrative one expire in 2008, the company came out in full force. G.E. officials worked with dozens of financial companies to send letters to Congress and hired a bevy of outside lobbyists.

The head of its tax team, Mr. Samuels, met with Representative Charles B. Rangel, then chairman of the Ways and Means Committee, which would decide the fate of the tax break. As he sat with the committee’s staff members outside Mr. Rangel’s office, Mr. Samuels dropped to his knee and pretended to beg for the provision to be extended — a flourish made in jest, he said through a spokeswoman.

That day, Mr. Rangel reversed his opposition to the tax break, according to other Democrats on the committee.

The following month, Mr. Rangel and Mr. Immelt stood together at St. Nicholas Park in Harlem as G.E. announced that its foundation had awarded \$30 million to New York City schools, including \$11 million to benefit various schools in Mr. Rangel’s district. Joel I. Klein, then the schools chancellor, and Mayor Michael R. Bloomberg, who presided, said it was the largest gift ever to the city’s schools.

G.E. officials say the donation was granted solely on the merit of the project. “The foundation goes to great lengths to ensure grant decisions are not influenced by company government relations or lobbying priorities,” Ms. Eisele said.

Mr. Rangel, who was censured by Congress last year for soliciting donations from corporations and executives with business before his committee, said this month that the donation was unrelated to his official actions.

Defying Reagan’s Legacy

General Electric has been a household name for generations, with light bulbs, electric fans, refrigerators and other appliances in millions of American homes. But today the consumer appliance division accounts for less than 6 percent of revenue, while lending accounts for more than 30 percent. Industrial, commercial and medical equipment like power plant turbines and jet engines account for about 50 percent. Its industrial work includes everything from wind farms to nuclear energy projects like the troubled plant in Japan, built in the 1970s.

Because its lending division, GE Capital, has provided more than half of the company’s profit in some recent years, many Wall Street analysts view G.E. not as a manufacturer but as an unregulated lender that also makes dishwashers and M.R.I. machines.

As it has evolved, the company has used, and in some cases pioneered, aggressive strategies to lower its tax bill. In the mid-1980s, President Ronald Reagan overhauled the tax system after learning that G.E. — a company for which he had once worked as a commercial pitchman — was among dozens of corporations that had used accounting gamesmanship to avoid paying any taxes.

“I didn’t realize things had gotten that far out of line,” Mr. Reagan told the Treasury secretary, Donald T. Regan, according to Mr. Regan’s 1988 memoir. The president supported a change that closed loopholes and required G.E. to pay a far higher effective rate, up to 32.5 percent.

That pendulum began to swing back in the late 1990s. G.E. and other financial services firms won a change in tax law that would allow multinationals to avoid taxes on some kinds of banking and insurance income. The change meant that if G.E. financed the sale of a jet engine or generator in Ireland, for example, the company would no longer have to pay American tax on the interest income as long as the profits remained offshore.

Known as active financing, the tax break proved to be beneficial for investment banks, brokerage firms, auto and farm equipment companies, and lenders like GE Capital. This tax break allowed G.E. to avoid taxes on lending income from abroad, and permitted the company to amass tax credits, write-offs and depreciation. Those benefits are then used to offset taxes on its American manufacturing profits.

G.E. subsequently ramped up its lending business.

As the company expanded abroad, the portion of its profits booked in low-tax countries such as Ireland and Singapore grew far faster. From 1996 through 1998, its profits and revenue in the United States were in sync — 73 percent of the company’s total. Over the last three years, though, 46 percent of the company’s revenue was in the United States, but just 18 percent of its profits.

Martin A. Sullivan, a tax economist for the trade publication Tax Analysts, said that booking such a large percentage of its profits in low-tax countries has “allowed G.E. to bring its U.S. effective tax rate to rock-bottom levels.”

G.E. officials say the disparity between American revenue and American profit is the result of ordinary business factors, such as investment in overseas markets and heavy lending losses in the United States recently. The company also says the nation’s workers benefit when G.E. profits overseas.

“We believe that winning in markets outside the United States increases U.S. exports and jobs,” Mr. Samuels said through a spokeswoman. “If U.S. companies aren’t competitive outside of their home market, it will mean fewer, not more, jobs in the United States, as the business will go to a non-U.S. competitor.”

The company does not specify how much of its global tax savings derive from active financing, but called it “significant” in its annual report. Stock analysts estimate the tax benefit to G.E. to be hundreds of millions of dollars a year.

“Cracking down on offshore profit-shifting by financial companies like G.E. was one of the important achievements of President Reagan’s 1986 Tax Reform Act,” said Robert S. McIntyre, director of the liberal group Citizens for Tax Justice, who played a key role in those changes. “The fact that Congress was snookered into undermining that reform at the behest of companies like G.E. is an insult not just to Reagan, but to all the ordinary American taxpayers who have to foot the bill for G.E.’s rampant tax sheltering.”

A Full-Court Press

Minimizing taxes is so important at G.E. that Mr. Samuels has placed tax strategists in decision-making positions in many major manufacturing facilities and businesses around the globe. Mr. Samuels, a graduate of Vanderbilt University and the University of Chicago Law School, declined to be interviewed for this article. Company officials acknowledged that the tax department had expanded since he joined the company in 1988, and said it now had 975 employees.

At a tax symposium in 2007, a G.E. tax official said the department’s “mission statement” consisted of 19 rules and urged employees to divide their time evenly between ensuring compliance with the law and “looking to exploit opportunities to reduce tax.”

Transforming the most creative strategies of the tax team into law is another extensive operation. G.E. spends heavily on lobbying: more than \$200 million over the last decade, according to the Center for Responsive Politics. Records filed with election officials show a significant portion of that money was devoted to tax legislation. G.E. has even turned setbacks into successes with Congressional help. After the World Trade Organization forced the United States to halt \$5 billion a year in export subsidies to G.E. and other manufacturers, the company’s lawyers and lobbyists became deeply involved in rewriting a portion of the corporate tax code, according to news reports after the 2002 decision and a Congressional staff member.

By the time the measure — the American Jobs Creation Act — was signed into law by President George W. Bush in 2004, it contained more than \$13 billion a year in tax breaks for corporations, many very beneficial to G.E. One provision allowed companies to defer taxes on overseas profits from leasing planes to airlines. It was so generous — and so tailored to G.E. and a handful of other companies — that staff members on the House Ways and Means Committee publicly complained that G.E. would reap “an overwhelming percentage” of the estimated \$100 million in annual tax savings.

According to its 2007 regulatory filing, the company saved more than \$1 billion in American taxes because of that law in the three years after it was enacted.

By 2008, however, concern over the growing cost of overseas tax loopholes put G.E. and other corporations on the defensive. With Democrats in control of both houses of Congress, momentum was building to let the active financing exception expire. Mr. Rangel of the Ways and Means Committee indicated that he favored letting it end and directing the new revenue — an estimated \$4 billion a year — to other priorities.

G.E. pushed back. In addition to the \$18 million allocated to its in-house lobbying department, the company spent more than \$3 million in 2008 on lobbying firms assigned to the task.

Mr. Rangel dropped his opposition to the tax break. Representative Joseph Crowley, Democrat of New York, said he had helped sway Mr. Rangel by arguing that the tax break would help Citigroup, a major employer in Mr. Crowley's district.

G.E. officials say that neither Mr. Samuels nor any lobbyists working on behalf of the company discussed the possibility of a charitable donation with Mr. Rangel. The only contact was made in late 2007, a company spokesman said, when Mr. Immelt called to inform Mr. Rangel that the foundation was giving money to schools in his district.

But in 2008, when Mr. Rangel was criticized for using Congressional stationery to solicit donations for a City College of New York school being built in his honor, Mr. Rangel said he had appealed to G.E. executives to make the \$30 million donation to New York City schools.

G.E. had nothing to do with the City College project, he said at a July 2008 news conference in Washington. "And I didn't send them any letter," Mr. Rangel said, adding that he "leaned on them to help us out in the city of New York as they have throughout the country. But my point there was that I do know that the C.E.O. there is connected with the foundation."

In an interview this month, Mr. Rangel offered a different version of events — saying he didn't remember ever discussing it with Mr. Immelt and was unaware of the foundation's donation until the mayor's office called him in June, before the announcement and after Mr. Rangel had dropped his opposition to the tax break.

Asked to explain the discrepancies between his accounts, Mr. Rangel replied, "I have no idea."

Value to Americans?

While G.E.'s declining tax rates have bolstered profits and helped the company continue paying dividends to shareholders during the economic downturn, some tax experts question what taxpayers are getting in return. Since 2002, the company has eliminated a fifth of its work force in the United States while increasing overseas employment. In that time, G.E.'s accumulated offshore profits have risen to \$92 billion from \$15 billion.

“That G.E. can almost set its own tax rate shows how very much we need reform,” said Representative Lloyd Doggett, Democrat of Texas, who has proposed closing many corporate tax shelters. “Our tax system should encourage job creation and investment in America and end these tax incentives for exporting jobs and dodging responsibility for the cost of securing our country.”

As the Obama administration and leaders in Congress consider proposals to revamp the corporate tax code, G.E. is well prepared to defend its interests. The company spent \$4.1 million on outside lobbyists last year, including four boutique firms that specialize in tax policy.

“We are a diverse company, so there are a lot of issues that the government considers, that Congress considers, that affect our shareholders,” said Gary Sheffer, a G.E. spokesman. “So we want to be sure our voice is heard.”



Statement submitted to record of the April 13, 2011 hearing, "How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth" held by the House of Representatives, Committee on Small Business

The Tax Burdens Faced by Unincorporated Startup Businesses

Thank you, Chairman Graves and Ranking Member Velázquez, for this opportunity to submit a written statement for the record of the hearing “How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth” to the Committee on Small Business. We present findings and recommendations on the obstacles that the complexity of the tax code creates for new entrepreneurs and unincorporated startup businesses. Even though unincorporated business formation is the single most important form of business startup, this perspective is largely unrepresented in policy discussions.

The Corporation for Enterprise Development (CFED) is a national nonpartisan, nonprofit organization dedicated to expanding economic opportunity to include all people. We believe such economic opportunity will bring greater social equity, alleviate poverty and lead to a more sustainable economy. As a leader in economic development for three decades, CFED brings together community practice, public policy and private markets in new and effective ways.

The Self Employment Tax Initiative (SETI) is a CFED program that works to ease the tax challenges faced by low- and moderate-income business owners who are pursuing the American Dream of economic success through entrepreneurship. For five years, SETI has partnered with local nonprofit tax preparation services that have prepared business tax returns for over 30,000 low-income business startups. Our research and analysis includes report data, surveys and interviews with local partners and the business owners to whom they provide tax assistance. We focus on how tax code complexity affects sole proprietorships, particularly the estimated 1.6 million sole proprietorships that pay business taxes for the first time every year.

SETI has developed six policy recommendations which address the tax code barriers that hinder the growth and success of unincorporated startup businesses:

1. Reduce the complexity of the home office business deduction.
2. Raise the net profit threshold at which payroll taxes are triggered.
3. Reduce the payroll tax rate for businesses in their first two years of filing.
4. Make the self-employment tax deduction for health insurance costs permanent.
5. Expand the IRS Schedule C pilot.
6. Develop and implement an education campaign to help new entrepreneurs understand and meet their tax liabilities.

SETI estimates that these proposals will have an impact on between 1.6 to 3 million startup businesses annually.

Background: Sole Proprietor formation and taxation

The Internal Revenue Service (IRS) reports that between 2004 and 2006 there were an average of more than two million new sole proprietors reporting business income for the first time each year. This figure is somewhat inflated because it includes “hobby businesses” and misclassified employees. Based on surveys conducted in 2009 and 2010, SETI estimates that 1.6 million are intentional startup businesses.

So-called “pass-through” businesses, including partnerships, Subchapter S corporations and sole proprietors, encompass a wide range of business ages, types, sizes and experiences. There is an important distinction between the impact of taxation on sole proprietorships that is lost when these businesses are simply categorized as pass-throughs along with partnerships and S Corporations. Partnerships and S Corporations require deliberate, legal acts to acquire those legal statuses. Typically, this involves the assistance of legal counsel and financial advisors who calculate and compare the tax consequences of each business structure.

By contrast, sole proprietorship is the country’s “default” business structure. An unincorporated entrepreneur can start a business and have no legal paperwork confirming its establishment until she files an income tax return and reports self employment earnings. Many new entrepreneurs do not even realize when they cross a business-defining legal threshold. This is especially true of “necessity entrepreneurs” who are motivated by lost jobs or other distressed circumstances. For the typical startup sole proprietor, there is no deliberate, advisor-facilitated act of formation. Rather there is a gradual accumulation of business activities that cause the enterprise, often unknowingly, to cross one of a number of local, state or federal thresholds that technically trigger formal recognition of the business.

The most consequential federal threshold is reached when a sole proprietor business has a net profit of \$400 in a calendar year. This triggers Social Security and Medicare payroll tax liability—tax that is owed even when the business owner has no income tax liability. Most new sole proprietor business owners learn for the first time that they must pay payroll taxes twice, as both an employee and an employer, when they first file an annual tax return that includes business income. This means that 15.3%¹ of net profit is taken off the top, although the business owner often did not anticipate the tax. Worse still, because the tax was due over the course of the calendar year, the tax filer is considered to be paying late and therefore owes an additional penalty.

¹ For 2011 only, as part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (PL 111-312), employees’ payroll tax rates are reduced by 2%. Owners of sole proprietorship businesses receive the rate reduction only on the employee half of their payroll taxes, bringing the total rate to 13.3% in 2011.

New, unincorporated businesses are ill-prepared for understanding tax responsibilities. Starting with little understanding of their tax responsibilities and confronted with double tax liabilities and penalties, first-time filers desperately need sound advice. The owners do not have an automatic, employer-based link into the IRS tax payment system, nor can they rely on the IRS or even the many professional tax preparers for assistance. National Taxpayer Advocate Nina Olson has listed the absence of small business outreach in her *Annual Reports to Congress* nearly every year. In her 2006 report to Congress, she found that many small businesses “cannot afford professional advice, and the IRS’s Small Business/Self-Employed division (SB/SE) is not adequately helping them understand and comply with their tax obligations.” In her most recent 2010 report, she expands on one of the most serious issues faced by first-time business filers, “There are more self-employed taxpayers than ever, many of them in marginal businesses – with the attendant difficulties of paying estimated income and self-employment taxes.” Confounding the absence of IRS or other federal assistance for these startup entrepreneurs, many large-scale commercial tax preparers do not see themselves as part of the solution. Commercial tax preparers charge \$300-500 per Schedule C return, and their “assembly line” and “one-size fits all” approach to tax preparation fails to ensure that the business owner truly understands their tax liabilities and responsibilities. In the end, most new, unincorporated businesses tend to develop an evasive mindset toward business taxes and do not learn how to manage those liabilities constructively into the future.

One potential bright spot is that the IRS has recently launched a Schedule C Pilot effort, which for the first time allows selected sites in the Volunteer Income Tax Assistance (VITA) program to complete Schedule C returns for low-income business owners. SETI has worked with many of these programs to help them develop “Tax Prep Plus” strategies—business development and asset-building service offerings—that can optimize tax time as a teaching moment and asset-building opportunity. Federal investment in low-cost and free tax preparation services for the self-employed is an excellent strategy to ease the burden of tax code complexity.

Policy Recommendations:

SETI proposes six policy recommendations that will ease the tax burdens on new entrepreneurs so that they can grow their businesses and create jobs. The recommendations align with SETI’s goal to ensure that every entrepreneur has a fair and better chance to succeed so that their active participation in the economy will deliver critical benefits in the form of jobs, income, wealth and innovation.

Recommendation 1: Reduce the complexity of the home office business deduction so that more small businesses will take advantage of its benefits in reducing their tax burden.

We agree with the recommendation of the National Taxpayer Advocate, Nina Olson, that there should be an optional standard home office deduction. The burdensome paperwork

and complicated rules inherent in the current home office business deduction prevent many entrepreneurs from utilizing it. Thus, it is a largely wasted tax benefit and a missed opportunity to encourage growth of startup businesses by reducing their tax liability and freeing up resources for business activities.

Recommendation 2: Raise the net profit threshold at which payroll taxes are triggered.

Unincorporated startup businesses owe federal payroll taxes once they reach \$400 of net earnings. Raising the threshold would allow businesses to incubate to where they are stronger, more stable and more able to comply with the double payroll tax requirement.

Recommendation 3: Permanently reduce the payroll tax rate for new businesses in their first two years of filing. A reduced payroll tax rate in the first two years of filing will help new entrepreneurs survive the challenges of sustaining a business in its first few years. In addition to encouraging business growth by reducing the tax liability for startups, reducing the tax rate for the first two years will decrease startup businesses non-filing of Schedule C and enhance accurate self-employment reporting into the future, thereby reducing the tax gap.

Recommendation 4: Make the self-employment tax deduction for health insurance costs permanent. For tax year 2010, the self-employed did not have to pay payroll taxes on their health insurance costs. Because the self-employed pay 15.3 percent in payroll taxes, this is a substantial tax reduction for many entrepreneurs. As all other business entities receive this tax benefit every year, in effect it is a disincentive for a person to start his own business. The self-employment tax deduction for health insurance costs should be permanent to ensure that the self-employed are not penalized for purchasing health coverage. The deduction for health costs would lower the tax liabilities of many entrepreneurs, allowing them to retain more resources to generate business growth.

Recommendation 5: Expand the IRS Schedule C pilot. New entrepreneurs often lack the resources to pay tax preparers, but also cannot navigate the complex and intimidating Schedule C form on their own. Tax compliance is in the best interest of entrepreneurs as it allows them to access credit and loans and averts the possibility of long-term debt caused by tax arrearages. IRS' Schedule C pilot program allows qualified VITA sites to provide free Schedule C preparation to low-to-moderate income entrepreneurs. The program should be expanded from its 15 pilot sites to more VITA sites nationwide and extended to AARP's Tax-Aide tax preparation program for older Americans. SETI believes that "starting your business right" through tax compliance enhances the business's chances of success and additional job creation.

Recommendation 6: Develop and implement an education campaign to help new entrepreneurs understand and meet their tax liabilities. Because sole proprietors pay taxes

as individuals, nearly all current tax credits that apply to unincorporated business income are seldom if ever marketed as tax cuts for unincorporated businesses. As a result the business impact and motivation is watered down. To correct this and with the proposals to simplify the home office deduction, reduce the payroll tax rate and make permanent the self-employment deduction for health costs, we believe there should be a campaign to help get the word out on the availability of existing credits and the proposed tax reforms, all of which are intended to give new and businesses more resources to spur business growth and job creation.

We submit our findings and recommendations in the interest of advancing further conversations about how the tax code can be improved for the U.S. economy's primary job creators, new startup businesses. SETI sees this as an area ripe for Congressional action and would be happy to meet with members of the Committee or their staffs to discuss policy options that would ease the tax burdens on the 1.6 million unincorporated businesses that are started each year. If we can provide any additional information that would be useful to the Committee, please contact Nancy Stark, Director of Enterprise and Economic Development for CFED, at nstark@ced.org (202) 207-0158.