

# TAX REFORM: ENSURING THAT MAIN STREET ISN'T LEFT BEHIND

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## HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS

UNITED STATES

HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

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HEARING HELD  
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## **TAX REFORM: ENSURING THAT MAIN STREET ISN'T LEFT BEHIND**

**WEDNESDAY, APRIL 15, 2015**

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

The Committee met, pursuant to call, at 11:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Steve Chabot [chairman of the Committee] presiding.

Present: Representatives Chabot, Luetkemeyer, Rice, Gibson, Brat, Knight, Curbelo, Bost, Hardy, Velázquez, Chu, Hahn, Meng, and Moulton.

Chairman CHABOT. The Committee will come to order.

Good morning. I want to thank everyone for being here. A special thanks to our witnesses, who have taken time away from their undoubtedly busy schedules to be with us. Today is the day that nobody looks forward to, except maybe the IRS, Tax Day. I expect most of us have already filed our returns while struggling to figure out our liabilities and deductions and credits. We do this all the while trying to discern what, exactly, the terms “adjusted basis” and “imputed interest” mean and sifting through a myriad of instructions or even the most basic of tax returns. Without question, the middle of April can be miserable for a lot of us. Taxpayers face a tax code that has become intensely complex and truly temporary with tax relief being extended for one year, months at a time, or even retroactively sometimes.

America’s 28 million small business owners, taxpayers themselves, repeatedly complain that this uncertainty has made it difficult to plan and grow their companies. In fact, a recent survey by the National Small Business Association found that the pure complexity of the tax code is actually a more significant problem for America’s small businesses than the overall tax liability. Imagine that. Businesses are so fed up with not knowing what to do and how to do it that they care less about what they have to pay the IRS. Unfortunately, the current U.S. tax code has become one of, if not the most significant hurdles to the growth of existing businesses and creation of new firms.

But it does not have to be that way. Over the past few years, there has been a renewed effort in Congress to reform our tax code to make it easier, fairer, and more stable. Here in our Committee, we are working to identify the aspects of the code that are most troublesome to small business formation. We have already held hearings, met with trade associations, and most importantly, we have talked with our constituents back home. The message we hear

is always the same. We have got to make it simpler, and flatter, and fairer. And taxpayers want Congress to enact changes in the code earlier in the year, or better yet, make certain beneficial tax provisions permanent so they can plan ahead. Unfortunately, Washington usually does things at the last minute or even makes changes sometimes retroactively.

Another critical aspect of the tax reform debate is making sure we are not leaving Main Street behind. Some people may not realize that the vast majority of small businesses in the United States are organized as pass-through entities, meaning they pay no corporate income tax. Instead, business profits are passed through to the owner or owners to be reported and taxes paid on their individual returns. Our entire tax system needs to be revamped, not just half of it.

There is no doubt that we must reform our corporate tax structure. We have the highest corporate income tax rates in the industrialized world, but as our Committee has identified numerous times before, our small businesses are the backbone of our economy. They create 70 percent of the new jobs in this country and represent over 99 percent of all employers in the United States. Because so many of these enterprises file and pay their taxes on their individual return, we cannot, and must not, ignore them as we move forward with any tax reform debate.

It is time for Washington to get serious about helping American families and small businesses. It is not just about helping them keep more of their hard-earned money, as important as that is, but about making April 15th not such a nightmare. Nobody likes to pay taxes, but the convoluted system we have now is simply too much of a burden. Reforming our tax code in its entirety will unleash the true potential of our economy. Our constituents deserve better than the mess Washington has given them.

Again, I want to thank each of our witnesses for taking the time to be with us today, especially my constituent, Scott Lipps, who is from Franklin, Ohio, which is in the First Congressional District, my district, and another Ohioan, Dan McGregor. And we will do further introductions in a few minutes, but I would now like to yield to the ranking member, Ms. Velázquez, for her opening statement.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. And I, too, want to thank all the members of the panel for being here, especially Dr. Toder, our witness.

Spurred largely by Main Street growth, the American economy is as strong as it has been in years. However, our nation has also managed to outgrow many tax policies. For small firms, these outdated and increasingly complex provisions create an obstacle to success, rather than a means of fostering expansion and job creation. This committee is well aware of the challenges created by the Internal Revenue Code and the major complications it has on business planning.

Modernizing our code to reflect new business reality will assist in providing simplicity, fairness, and permanency to businesses of all sizes. The last major reform of the code took place in 1986, making an overhaul long overdue.

But we cannot go forward without input from small business owners. These entities are a vital part of that equation as they are responsible for most new job growth and business income. As such, they are a major part of our economy, and an important aspect of today's discussion, but too often, their tax reform concerns are lost in broader debates. Today's hearing will allow us to start a dialogue between the small business community and policymakers regarding the best tax policies supporting the success of small firms. They are the drivers of the nation's economy, and we cannot afford to put the cost of collecting taxes on them, which is what a corporate-only approach will do. It is clear that small businesses can thrive and continue to improve our economy if we approach tax reform in a comprehensive manner, rather than a piecemeal approach. Comprehensive reform will have immediate benefits for small businesses, while also serving our nation's economic objective of promoting pro-growth policies.

Focusing reform efforts to a complete overhaul of the code ensures the small business community no longer has to worry about keeping up with constant tax changes. It also guarantees small business owners will not be the cause of lowering corporate rates alone. Such an approach also reflects the growth of tax reform simplicity, certainty, and fairness.

I stand committed to working in a bipartisan way to revise policies that stifle entrepreneurship and innovation. A real opportunity exists to implement long-lasting reforms, and doing so will have immediate benefits for small businesses.

With that, Mr. Chairman, I yield back.

Chairman CHABOT. Thank you very much. The gentlelady yields back.

If Committee members have opening statements, we would ask that they submit them for the record.

And I will just briefly explain the five-minute rule, which is you get five minutes. We will give you a little bit of leeway there. But there is a lighting system. The yellow light will come on when you have a minute to wrap up, and the red light, we would ask you to wrap up as close to that as possible. As I say, there is a little flexibility.

And I would now like to introduce our panel. I will begin with our first witness this morning. Our first witness will be Scott Lipps, who is the owner of Sleep Tite Mattress Factory in Franklin, Ohio. He happens to be a constituent, as I mentioned before, in the First Congressional District. Scott started a business manufacturing institutional mattresses in 1989, and after four successful years, he and his wife, Debbie, and their five employees, merged with Sleep Tite, a company that was founded in 1947. Now producing both institutional and home bedding, Sleep Tite has grown to 18 total employees. In addition to running Sleep Tite, Scott also served for 15 years on the Franklin City Council and two terms as the city's mayor.

Scott, thank you for being here today.

And our second witness will be Pete Sepp, who is the president of the National Tax Payers Union. In this role, he leads the NTU's government affairs, public relations, and development activities. He also oversees the research and educational operations of the Na-

tional Tax Payers Union Foundation. He has been with the NTU since 1988. He received his degree in History and Political Science from Webster University, and we thank you for your testimony here shortly.

And our third witness is Dan McGregor, chairman of the board of McGregor Metalworking Companies in Springfield, Ohio. Also a Buckeye. Dan started his career with Morgal Machine Tool. Machine Tool Company in 1968, the first of the McGregor Metalworking Companies. Dan worked with other family members and created five different business units, focusing on six metalworking specialties. In June 2010, Dan retired as president of McGregor Metalworking Companies and now serves as Chairman of the Board. He graduated from Lehigh University in 1965 and served three years in the Navy, and we thank you for your service to our country. And thank you for being with us today.

And I will now yield to the ranking member to introduce our fourth witness.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

It is my pleasure to introduce Dr. Eric Toder. He is an institute fellow at the Urban Institute and co-director of the Urban Brookings Tax Policy Center. Mr. Toder previously held a number of positions in tax policy offices in the U.S. government and overseas, including serving as deputy assistant secretary for Tax Analysis at the United States Treasury Department, director of Research at the IRS, and deputy assistant director for Tax Analysis at the Congressional Budget Office. He is the author and co-author of numerous papers on tax policy, tax administration, and retirement issues. Welcome to the committee.

Chairman CHABOT. Thank you very much. The gentlelady yields back.

And we will now go to our witnesses. And Mr. Lipps, you are recognized for five minutes.

**STATEMENTS OF SCOTT LIPPS, OWNER, SLEEP TITE MATTRESS FACTORY; PETE SEPP, PRESIDENT, NATIONAL TAXPAYERS UNION; DAN MCGREGOR, CHAIRMAN OF THE BOARD, MCGREGOR METALWORKING COMPANIES; ERIC TODER, INSTITUTE FELLOW, URBAN INSTITUTE, CO-DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER**

**STATEMENT OF SCOTT LIPPS**

Mr. LIPPS. Good morning, Chairman Chabot, Ranking Member Velázquez, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB).

Our family owns Sleep Tite Mattress Factory and Showroom and has been a member of NFIB since 1995. I also currently serve on the NFIB-Ohio Leadership Council. Thank you for holding today's hearing, "Tax Reform: Ensuring that Main Street Is Not Left Behind." The current tax code negatively impacts small and closely-held businesses in several important ways, so I appreciate the invitation to be here today to discuss these important issues from the perspective of a small business owner.

The NFIB is the nation's leading small business advocacy organization. The typical NFIB member employs about 8 to 10 employees with annual gross receipts of about \$500,000. All of NFIB's members are independently owned, which is to say none are publicly-traded corporations. While there is no one definition of a small business, the problems NFIB members confront, relative to tax code, are most representative of small businesses. A few consistent concerns are raised regardless of the trade or industry in which the small business is engaged.

As part of representing small business owners, NFIB frequently conducts surveys of both NFIB members and small business population as a whole, and taxes consistently rank as one of their greatest concerns. In the most recent publication of the NFIB Research Foundation's Small Business Problems and Priorities, 5 of the 10 small business concerns are tax-related. In fact, the February 2015 Small Business and Economic Trends report ranks taxes as the number one problem small business owners currently face. Right now, taxes are a bigger problem than poor sales, the cost and quality of labor, and government regulation.

I would like to spend the rest of my time telling you about my personal experience. Sleep Tite Mattress Factory and Showroom was founded in 1947, by Stan Rothman. In 1990, our family founded an institutional (acute and long-term care) bedding company, HomeCare Mattress. In 1992, we merged HomeCare and Sleep Tite. We started with four employees and now have 15 full-time employees. We are currently structured as a C corporation, but we started as a pass-through. While oftentimes a struggle, we are very proud to offer our team members health insurance, a 401K program, paid sick leave, paid vacation time, and more benefits. Aggressive tax rates and compliance efforts directed to fulfill intrusive regulations severely impact our ability to offer this full-time benefits package that our employees need and deserve.

We are proud of Sleep Tite Mattress Factory. We think you would be, too. As I mentioned, we strive to offer our team members a positive work environment that offers a learning experience, the ability to make decisions, career opportunities, and full benefits.

Beyond that, we believe community involvement is critical. Small businesses are the "fabric of the community." For example, across America, you will find small businesses sponsoring school plays, pee-wee football teams, cheerleading squads, and church youth group programs. The list goes on. The small business owner works in the community, lives in the community, and hires in the community. Sleep Tite Mattress has been recognized by our schools for involvement and won our area Chamber of Commerce Business of the Year Award in 1999. That makes us feel good. What makes us feel even better is seeing our employees grow and build their lives and stay with our company for years. To serve our employees and community, we must have lower tax rates, fewer regulations, and a less confusing, less complex tax code.

We have been in business in our community for over 24 years. I witnessed and experienced what punitive local, state, and federal laws were doing to the business community in Franklin, so in 1999, I did something about it. I ran for city council and won a seat. After encouraging a few fellow business owners and business peo-

ple to run for council, I was honored to serve as mayor for two terms. We concentrated on fixing problems a bloated bureaucracy and out-of-touch government had levied on our city.

Our council addressed local incentive programs that unfairly assisted large corporations but did not offer incentives to small business. We instituted a “Downtown Improvement Program” (DIP) that offered grants and low interest loans to small businesses locating or expanding within our community. We met with local zoning, planning, and building officials and redesigned zoning laws to assist businesses with fewer or less restrictive regulations. For example, sign ordinances and requirements. Not every small business person can run for elected office. Instead, Congress should work to reform our tax code in order to help small businesses get back to doing what they should be doing—running their small business. Over 85 percent of NFIB members agree that Congress should fundamentally reform the tax code.

As Congress considers tax reform, I would encourage you to keep these most important goals in mind. Achieving these goals will greatly enhance the ability of small and closely-held businesses to thrive in the 21st century—permanently keep the tax rates low, do not create disparity between the corporate rate and individual rate, reduce complexity, and not separate the business owner from the business. NFIB members are willing to make tradeoffs necessary to lower taxes, such as reducing or eliminating deductions, credits, or exclusions.

Should Congress enact comprehensive tax reform that achieves these goals, small business owners would no longer face one of their most consistent complaints—arbitrary and inconsistent tax preferences, constant change, and complexity in the current federal code.

Small businesses truly are the engine of economic growth. This is not just a slogan, as small businesses created two-thirds of the net new jobs over the last decade. Small business owners are risk-takers and entrepreneurs. They are the last businesses to lay off employees when business declines, and slow to rehire when business picks up. The owners work additional hours until they can take it no more. When small businesses hire an employee, it is their intent to keep them for the long run.

The current tax code has become a confusing and unpredictable challenge for the vast majority of small business owners. Our tax laws should not deter or hinder the ability of small business owners to create or expand their business. Taxes are a major issue for all small business owners. Tax law can dictate the business decisions an owner must make, whether it is the type of structure to adopt, whether to make an investment in programs or machinery, to expand their facility, or to hire employees.

After decades of patchwork changes, Congress needs to make major adjustments to our tax laws to reduce the complexity and confusion of business growth. I appreciate Congress taking a serious look at reforming the tax code and urge you to keep in mind the unique challenges that face small businesses.

Thank you for having me here today, and I am happy to answer any questions.

Chairman CHABOT. Thank you very much.

Mr. Sepp, you are recognized for five minutes.

**STATEMENT OF PETE SEPP**

Mr. SEPP. Mr. Chairman, Madam Ranking Member, Members of the Committee, National Tax Payers Union (NTU) is honored to have been invited to this hearing. And I could discuss at length very technical changes to the tax laws itself to go on and on about rates and bases and JCT scores and econometric analyses, but I want to focus my brief remarks here on one issue—administrability.

To us, with the tax laws as they affect small businesses, administrability means reducing complexity in the system that businesses encounter every day. It also means increasing the access to justice that businesses have should they find themselves in a dispute with the IRS.

One interesting statistic about the complexity costs that small businesses face—I give a number of them in my testimony—but the National Association of Manufacturers determined that for businesses with fewer than 50 employees, the burden per worker of tax compliance alone is more than 50 percent higher than all other businesses. It is a regressive burden, and it is a costly burden.

What we want to do here is try to identify the areas of the tax code that are the most complex for small businesses and legislate in those areas accordingly. There are some instructive studies here that I think could help us.

One that was taken by the IRS Statistics of Income Division, measuring the tax compliance burden of small business, identified areas of business activity and tax return activity where businesses encountered unduly harsh burdens of time or money. Those were things like using the accrual accounting method, having foreign operations, filing returns in multiple states, keeping records for alternative minimum tax liabilities, completing an end-of-year inventory to comply with various tax requirements. These are areas where Congress needs to focus its attention in simplifying the law. How do we do that? Well, I think that for one, foreign operations of businesses need to be scrutinized with an eye towards reducing the number of forms and instructions. The Taxpayer Advocate's office has the astounding statistic that there are for U.S. businesses conducting economic activity abroad, 43 publications with 1,212 pages referring to other publications with over 13,000 additional pages, 1,500 pages of forms. No small business can possibly shoulder a burden like that without the owner just throwing up his hands saying "why bother to expand abroad?" And yet that's precisely what we want small businesses to do—conduct more activity abroad.

I will confine the remainder of my remarks to a very important and overlooked topic, and that's taxpayer rights in the appeals processes and the special problems that small businesses encounter. We heard hearing after hearing back in the 1980s and 1990s from businesses that were literally shut down just by the audit procedure itself. They simply could not conduct their operations while the IRS was going through their records. We enacted laws, especially a very comprehensive one in 1998, to try to improve the appeals process, give businesses more opportunities to remain self-

supporting during the examination and the appeals and collection process. We need to make modifications to those laws now.

There is a set of proposals introduced on the Senate side by Senator Cornyn, called the Small Business Taxpayer Bill of Rights. This has some improvements to the current laws, such as introducing alternative dispute resolution to the process for appealing audits. This would be a fantastic tool. It would be lower cost. It would be a quicker resolution. And it would help to address some of the problems that the taxpayer advocate herself has identified in the examination process. She is saying, for example, that examiners, revenue officers, are not being given the latitude to make offers and compromise and approve them with businesses in audit situations quickly enough. The businesses end up suffering, the collection activities go on, and ironically, the government hurts itself because these businesses are basically dissolved under tax problems and they're on longer contributing to the Treasury. That serves no one's interests.

In short, ensuring that Main Street does not get left behind means ensuring that the tax system does not crush the entrepreneurial spirit. And that entrepreneurial spirit is not something you find when a small business owner confronts the rates and bases and minutia of the tax system. It is what they confront when they face hours upon hours, thousands upon thousands of dollars trying to fill out tax returns, and the very real fear that if the IRS questions an item on that return, they might as well pay up rather than fight it, even if they think they are right, because the expense to them personally and to their business is just too great. We have to change that situation. We came together in a bipartisan fashion, not only in 1986, but in 1998, with the IRS Restructuring and Reform Act. Let us do it again. NTU and its members are ready to assist in that task.

Thank you.

Chairman CHABOT. Thank you very much, Mr. Sepp.

Mr. McGregor, you are recognized for five minutes.

#### **STATEMENT OF DAN MCGREGOR**

Mr. MCGREGOR. Chairman Chabot, Ranking Member, and other Members of the Committee. Thank you for the opportunity to testify here today. I recognized my timeliness when my cab driver asked me this morning if I had paid my taxes. And he went on to complain about his taxes.

Chairman CHABOT. The ranking member asked me the same thing when I got up here.

Mr. MCGREGOR. This year is the 50th year—

Chairman CHABOT. And I did, by the way.

Mr. MCGREGOR. This year is the 50th anniversary of McGregor Metalworking.

Back in 1965, my family purchased a small eight-man tool and die shop. Today, we employ 375 workers in four locations in Springfield, Ohio, and one in Aiken, South Carolina. These are good-paying manufacturing jobs in areas that need them.

Our business is contract metal forming, and our major customers are in transportation, auto, lawn and garden, and agriculture.

In support of my written testimony, I would like to accentuate the following important points. First, pass-through status is essential for a family-owned business. In 1986, we changed from C corp to S corp. This change fit our desire to grow our business and still be able to reward our shareholders. Last week we had our semi-annual family shareholder meeting where we reviewed the results of 2014 and our plan for 2015. This is important so that the shareholders understand the impact of their pass-through earnings on their tax filing, recognizing that when the earnings are reported, they have to pay their taxes and pay estimates the following year.

Second, lower taxes mean higher retained earnings allowing the company to grow. After the big recession of 2008 and 2009, we were faced with two bank covenants—a requirement tying debt service to free cash flow, and a cap on our total debt to equity. Taxes play an important role here since our ability to retain earnings is limited by how much tax we pay. Prior to 2013, we paid about 34 cents of every dollar to cover shareholder taxes. Today we pay about 42 cents. This is a huge increase and it limits both our ability to borrow and our ability to increase employment. In my business, \$30,000 in retained earnings can mean the addition of a new job.

Third, the R&E tax credit. Because our business is technical in nature, we rely on the R&E tax credit to develop new processes. Some of our shareholders are unable to use this credit because of the alternative minimum tax. Changing that rule to allow taxpayers under the AMT to get the R&E tax credit would fix that. The total elimination of AMT would be even better.

Fourth, the estate tax. The 2012 increase in the estate tax exemption to \$5 million was a positive step for closely-held businesses, but any family that grows their business beyond this exemption must constantly make this part of their business strategy. Often, this is contrary to the best interest of the business and the family members. Transition of ownership in privately held businesses is never easy and the estate tax is often the death knell of family business continuance.

And finally, tax return. Our family business started 50 years ago and has become a significant employer in our community of 65,000 people. The population of Springfield is gradually declining and needs jobs to help retain citizens. Tax reforms that incentivize business growth and retention are essential to our community.

So I will close with three recommendations for tax reform going forward. A, it should be comprehensive and improve the tax treatment of pass-through businesses and corporations alike. B, parity should be restored for the top rates paid by pass-through entities and corporations. And C, it should reduce or eliminate the double tax paid by C corporations.

Reform that follows these principles would help McGregor Metalworking and other employers in our area continue to succeed and create jobs.

Thank you, Mr. Chairman and ranking member for this opportunity to testify. I look forward to answering any questions.

Chairman CHABOT. Thank you very much.

Dr. Toder, you are recognized for five minutes.

**STATEMENT OF ERIC TODER**

Mr. TODER. Thank you very much.

Chairman Chabot, Ranking Member Velázquez, and Members of the Committee. Thank you for inviting me to appear today to discuss the effects of tax reform on small business. The views I am expressing are my own and should not be attributed to the Tax Policy Center or to Urban Institute, its board, or its funders.

There is a growing consensus that our current system of taxing business income needs reform and bipartisan agreement on some main directions of reform, although not the details. The main drivers for reform are concerns with a corporate tax system that discourages investment in the United States, encourages U.S. companies to retain profits overseas, and places some U.S.-based companies at a competitive disadvantage. At the same time, the corporate tax raises relatively little revenue compared to other countries, misallocates scarce capital by providing selected preferences to favorite assets and industries, and allows some U.S. multinationals to pay very low tax rates by shifting reported profits to low tax countries. No one is happy with this state of affairs.

President Obama's framework for corporate reform shares important features with the tax reform proposal introduced last year by former Ways and Means Chairman Dave Camp. Both would reduce the corporate tax rate, pay for the lower rate by cutting back major business tax preferences, and reform international tax rules.

Corporate tax reform, however, cannot proceed in isolation from the individual income tax system. The base broadening needed to pay for a lower corporate rate would affect all businesses, including pass-through entities that pay no corporate income tax but instead report income to their owners who pay individual income tax. A reform that pays for a corporate tax rate cut by reducing business tax breaks will raise taxes on these business owners. Businesses affected include partnerships, subchapter S corporations, and sole proprietorships. Many of these are small businesses. Tax reform proposals therefore must address the concerns of small business owners.

A large and growing number of U.S. businesses are organized as pass-through entities. In 2011, 95 percent of U.S. businesses were either sole props or pass-throughs and received 38 percent of business receipts. Most partnerships in S corps are small businesses, but 95 percent of their net income and business receipts comes from large and mid-size businesses with assets greater than \$10 million.

Pass-throughs are taxed more favorably than taxable corporations because they face only a single level of tax, where profits from taxable corporations face both the corporate tax and the individual tax when companies pay dividends or shareholders receive capital gains. A lower corporate rate would create a more level playing field between corporations and pass-throughs.

Less than 4 percent of individual taxpayers who receive most of their income from business are in the two highest tax brackets. These taxpayers receive 65 percent of business income, but much of this does not come from small businesses. A broader tax reform that reduced marginal tax rates and eliminated tax preferences, which I might prefer for both individuals and corporations, need

not raise taxes on pass-throughs, but to maintain revenue and distribution on neutrality, such a reform would have to cut back on popular tax preferences, such as the deductions for home mortgage interest, charitable deductions, state and local taxes, and the exemption of health insurance premiums from tax. Even then, as in the Camp proposal, an additional surtax at the highest incomes might be required to meet the revenue and distributional targets.

Congress should shield most businesses from the adverse effects of business-only tax reform through targeted relief. This might include extending and expanding the higher section 179 expensing limits that expired at the end of 2014, or increasing the width of the 15 percent corporate rate bracket. A special tax rate for pass-through income, however, would create unequal treatment between high income individuals with business income and those with labor compensation, and would create market distortions as businesses seek ways to compensate highly paid employees as independent contractors and engage in other transactions to recharacterize income.

In conclusion, the corporate tax reforms now under discussion raise concerns about the treatment of pass-throughs, many of which are small businesses. These concerns are best addressed through targeted relief for truly small businesses instead of general tax rate cuts for income from pass-throughs, and I would point out some of these forms of relief, like expensing, would also be a major simplification.

Thank you.

Chairman CHABOT. Thank you very much, Dr. Toder. And I would like to thank all the panel for their excellent testimony here this morning. And now the members of the Committee will have five minutes to ask you questions. And I will begin with myself recognized for five minutes.

Scott, let me begin with you. You mentioned the NFIB's recent Small Business Problems and Priorities survey and that 5 out of the top 10 concerns in that survey relate to taxes. Could you talk a little bit about where taxes fall on your list as a business owner and how that has changed over the past 25 years that you have been in business?

Mr. LIPPS. Well, the most important part to us is we are only 15 employees. We do not have a compliance officer to assist with taxes. So just keeping up with the code and investing—we have to hire outside help. So that is an expense to the corporation that the tax burden is creating. So a less confusing regulation would allow us to continue to offer more benefits, for example.

I mean, I was very proud to tell you we offer a full range of benefits. We even have paid healthcare for our employees. We have paid sick time, paid vacation, but our 401K, something had to give, and jobs are so important to us that we no longer can match. So, example. If we were not paying or fighting an aggressive tax code or a confusing tax code, I think we would be able to do things like restore our match to the 401K.

Chairman CHABOT. Thank you very much.

Mr. Sepp, I will go to you next. At a hearing that we conducted last month, we focused a lot on the fact that for the last six years, the number of business deaths, or businesses going out of exist-

ence, small businesses, has outpaced the number of business births. And apparently, that is the first time in American history according to what we were told. This is a very troubling statistic. Do you feel that the problems with our tax code could be a factor in the fact that we do see businesses going out of existence more, you know, dying than rising?

Mr. SEPP. Oh, I definitely think so. In the metaphysical sense, we have businesses thinking about the burdens of complexity, not only at the federal level but even at the state level in complying with taxes. That is not really something that Congress can deal with, but it is a consideration in every business owner's everyday operations. But even in the more practical narrow sense, there may be an issue with the IRS's own collection procedures here in that the taxpayer advocate has noted several times that all too many cases involving small business tax debts are being thrown into the automated collection system rather than being kept at levels where there might be an efficient resolution to the problem to keep the business self-supporting.

So again, we sort of have a bifurcated problem here, one that is systemic in terms of how the tax laws are written, and one that is operational in terms of how the IRS is approaching resolutions with businesses.

Chairman CHABOT. Thank you.

Let me turn to you next, Mr. McGregor.

You also mentioned the death tax in your written testimony, Federal Inheritance Tax. We call it the death tax around here now. This week we are voting once again on the floor on legislation to eliminate it. Your family has had businesses for several generations now. Could you talk a little bit about how the death tax impacts a small business, plans that you make, and how many employees you can hire and what you have to go through in planning for that?

Mr. MCGREGOR. I think the real issue is the extenuation of the business down into the next generation. In our particular case, we gave stock to the next generation, which may or may not be a great idea. It has worked out well for us but we have continually worked around this issue and tried to prepare to be able to move it forward. So it is really more of a cost of planning and making a mistake that damages the business.

Chairman CHABOT. And we have been told for years that the two entities that are most directly affected by the death tax are small businesses because of the difficulty in passing to the next generations and family farms are the two that it affects most directly.

I am almost out of time, so in the time that I have left here, let me just ask the question. We have talked about—I think we are probably—it is a bridge too far now, but we have talked about going to either a flat tax or a flatter tax. Or to a national sales tax and getting rid of the IRS and getting read of income taxes all together. And I would just like to see a show of hands because I do not have a lot of time. Can I see how many of you think that we ought to go to a flatter or a flat tax? Just a show of hands. Three out of four.

And how about if we could get rid of income tax and IRS all together and go to a sales tax, can I see how many would be supportive of that? Okay. So I am seeing two of the four there. Okay. It is interesting. I appreciate that very much.

And I will now yield to the ranking member, Nydia Velázquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Toder, the last time broad based tax reform took place, one of the driving principles was tax neutrality. Today, as we move forward on tax reform, there is also concern with the long-term budget; what principles should be included in our effort to overhaul the code while also minding current fiscal realities.

Mr. TODER. That is a very good question. We certainly could have a revenue-neutral tax reform that would not address the long-term budget efforts. I think it is difficult. The problem with doing that is a true tax reform would cause so many special interests to be hurt and so many people would object to it that it is a very hard political lift to do without also making some contribution to the long-term budget effort. So that is my reservation, but I think that would be a positive step to do revenue-neutral tax reform.

With regard to the long-term budget, you really have to address the issue of entitlements and the growth of entitlements and do something on the spending side. So I think the revenue probably would fall short and we would need more revenue as well, but those two things really need to be handled simultaneously.

Ms. VELAZQUEZ. Thank you.

The administration stated that its intention is to lower corporate rates from 35 to 28, and 25 for manufacturers. The tax code already has specific provisions for certain industries and sizes of businesses, so this idea is nothing new. However, should we be moving away from picking winners and losers as we move forward to reform the tax code? Is having special tax treatment inevitable to ensuring Main Street businesses can compete on a level playing field as their larger counterparts. Where do we draw the line?

Mr. TODER. Well, I think my view is we should have as little special tax treatment as possible. And we would be much better off with lower tax rates for all forms of businesses rather than trying to have the government pick winners and losers. I do not think the government is very good at that.

Some people talk about the research credit, so there might be some argument for keeping that, but I am not even necessarily persuaded of that. And there might be some proposals, such as small business expensing, which are aimed at the very high compliance costs that small businesses face relative to their level of revenue or profits. And so I think easing those compliance costs may require—does require some special provisions. But generally, the answer, yes on the level playing field.

Ms. VELAZQUEZ. Thank you.

Mr. Lipps, one of the goals of tax policies is providing business owners with certainty when it comes to taxes. Adding to this uncertainty is the ongoing debate on tax reform. What effect does this have on your business success?

Mr. LIPPS. I think it would allow us to become more of the fabric of the community. Any dollars that we have we use to sustain the corporation and improve our benefits package. We support our

local school system. We give our employees, as I mentioned earlier, a 401K match back. So I feel like a small business owner has a responsibility to be part of the fabric of their community. Tax assistance, of course, will help us with that.

Ms. VELAZQUEZ. If we do not take affirmative action on comprehensive tax reform, what effect will that have in terms of you being able to hire, to make business investments?

Mr. LIPPS. It will limit our ability, and we may have to look at other options, like reducing how much we contribute towards our company health policy. It will help some small businesses in the sense that we have to pay a local tax preparer, so fees are going to go up as it becomes more confusing, so the local tax person is probably going to say, "Scott, send a check."

Ms. VELAZQUEZ. Thank you.

I would like to ask this question to each of the panel. Many members on this committee have been adamant that comprehensive tax reform legislation get passed this year. I think quick action could send an important message to the business community, yet there is widespread pessimism that anything will evolve anytime soon because some difficult compromises must be made. If we could accomplish only corporate tax reform and not individual, is this something the small business community could accept? I heard almost all of you saying comprehensive tax reform. Or would you rather see nothing get done until a complete overhaul can be completed?

Chairman CHABOT. The gentlelady's time has expired but you can all answer the question.

Ms. VELAZQUEZ. Yes, Mr. McGregor.

Mr. MCGREGOR. I would rather hold out. I would like to see comprehensive.

Ms. VELAZQUEZ. Thank you.

Mr. MCGREGOR. Thirty percent of my competitors are C corporations and I would be at a big disadvantage.

Ms. VELAZQUEZ. Mr. Sepp?

Mr. SEPP. Well, the last thing we want to see is some kind of C corp reform effort that severely disadvantages pass-through entities. We might be able to create some kind of safe harbor for pass-throughs while the C corp reform is going on. I also think there are other reforms that can be made incrementally to benefit both small businesses and large ones that would lead toward comprehensive reform in the next Congress. I recount some of them in the testimony.

Ms. VELÁZQUEZ. Yes. But my question was if all we can do is corporate tax reform, would you be supportive?

Mr. SEPP. Not comprehensive enough.

Ms. VELAZQUEZ. Mr. Lipps?

Mr. LIPPS. We are a C. We were a pass-through and we are a C now. So removing the individual story, I would say I fear removing the business owner and the small business and causing separation there.

Ms. VELÁZQUEZ. Thank you.

Mr. Toder?

Mr. TODER. I cannot speak for the small business community, but I can say that our international and corporate rate structure

relative to the rest of the world is so problematic these days that I think we have to address those issues. And in doing so, we will inevitably affect other businesses and we will have to take some measures to deal with that.

Ms. VELAZQUEZ. Thank you.

Thank you, Mr. Chairman.

Chairman CHABOT. Thank you. The gentlelady's time has expired.

The gentleman from Missouri, Mr. Luetkemeyer, is recognized for five minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. And thank all of you for being here today. I appreciate your testimony.

I want to start out with a situation. I know that the tax extenders that we passed at the end of last year, you know, we waited until the eleventh hour to do that and it is kind of interesting. I had one of my constituents who sells a lot of equipment to rock quarries and people who are in that business, and he sold five particular pieces of equipment, all the rest of the year, but when we passed the tax extenders at the end of the year with accelerated depreciation in it, suddenly he sold six more pieces of equipment in the last two months of the year.

What tax extenders are important to you? The first part of the question. And the second part of the question is with complex tax reform or comprehensive tax reform, will you be willing to give all that up if we can go back to a flatter tax?

Mr. Lipps, let us start with you.

Mr. LIPPS. We use section 179 small business expenses. I think that is a tax extender. We also have the bonus depreciation program we use, so that is important to us. Obviously, section 199.

I think that tax extenders are critical today because of the current tax code we are living under. However, if you flatten that tax code out or do a comprehensive reform that addresses all of our measures, I believe that small businesses are much, much—very willing to give that up.

Mr. LUETKEMEYER. Mr. Sepp, what do you see?

Mr. SEPP. Well, section 179 is obviously very important for small businesses. It takes us in the direction of full expensing, which should be the ultimate goal of tax reform for all businesses. That is probably a long way off, very difficult to achieve. But among other extenders, there are only perhaps a handful. The R&E is one that comes to mind that would be worth preserving in many situations. Here again though, taking them all and trading them for rate reduction in a simplified system might be worthwhile. Your colleague, Congressman Pompeo had an excellent bill in the last Congress to take about a dozen very narrowly drawn energy credits and direct the secretary after their repeal to put that into rate reduction. That is an incremental approach we might want to take.

Mr. LUETKEMEYER. Perfect.

Mr. McGregor?

Mr. MCGREGOR. We do use the R&E tax credit and it takes a lot of effort to create that data. So it is nice to know in advance that it is going to happen, because to do it for a year and not get it.

As far as tradeoffs, that is an expectation. You know. I am not a huge bonus depreciation person. We are heavy, you know, heavy investment and it can pay off beautifully. And if we have it, it is wonderful, but you know, so that would be on the table.

Mr. LUETKEMEYER. Perfect. Thank you.

Mr. Lipps, you are representing NFIB today, and quick question for you here with regards to, you know, the chairman made reference a while ago to the fact that we have lost more businesses in the last several years than we have actually created. And so I was wondering if you have an idea of how many businesses were lost due to the complexity of the tax code or how many were not started. Is there some sort of information out there? That is a pretty nebulous question there but I am just curious if you have seen some trends perhaps that you could tell me that were based on the tax code.

Mr. LIPPS. I am usually spending my time trying to run my small company and understand the tax code. So NFIB studies the numbers. But I would certainly tell you a personal situation. I have a daughter who actually asked to sit down in our company and say, "How do I resign when my dad is the president?" She wanted to start her own company. And we found it so much more difficult than just 25 years ago. It was so complex for her that we had trouble even helping her do that, and we were so proud she wanted to be an entrepreneur, but it is a very difficult and daunting situation when you first analyze it.

Mr. LUETKEMEYER. I think, you know, that is one of the problems that we have is that there are so many disincentives now to starting a small business, and the statistics bear it out. When you look at the number of businesses that are not being started compared to the ones that are losing, it should send up some alarms here.

Just very quickly, Mr. Sepp, you made a comment a while ago with regards to business being able to expand abroad and to use tax incentives to do that. Do you have some ideas?

Mr. SEPP. Well, I think that making the switch to a territorial tax system versus the worldwide one we have would be a step in the right direction. That is a very comprehensive—

Mr. LUETKEMEYER. Do you think if you went to like a flat tax that would that be helpful or would that be hurtful?

Mr. SEPP. That would be helpful in my opinion. There are lots of other smaller steps we have to take, but most importantly, even if we are to live under the current system, we have got to simplify the structure of forms and reporting for smaller businesses that have activities abroad. One way we might want to do that is through a quadrennial simplification process. That was something that was brought up when we were debating the IRS Restructuring and Reform Act back in 1998. You bring in a bunch of volunteers from the public and private sector to go through the code and the regulations, make a list of recommendations, have an up or down vote on them. That would be a way to resolve some of this.

Mr. LUETKEMEYER. Well, it would certainly be great if we could simplify the tax code because I know 15–20 years ago I did my business's taxes and it was like eight or 10 pages, and now my

taxes, I cannot do them any longer and they are at least an inch and a half thick. So we need to do something.

Thank you very much for your testimony.

Chairman CHABOT. The gentleman's time is expired.

The gentleman from Massachusetts, Mr. Moulton is recognized for five minutes.

Mr. MOULTON. Thank you, Mr. Chairman.

Gentlemen, there is broad consensus on this panel and certainly in the room that we need to have comprehensive tax reform. And I just want to get at that a little bit more.

Mr. Lipps, from your position, not just as a small business owner but also from your position at NFIB, from your perspective, what is holding us back in being able to tackle this issue? And you can answer that both in terms of what your view of the problems in Congress is but also why is there not more pressure from the small business community to really get this done?

Mr. LIPPS. I think the small business community is so committed to its job to daily making payroll that we—we are not protestors. We do not have time. So we do at local town halls when Congressman Chabot appears in Franklin, believe me, we ask him to help us with this issue. But I really think it is a time factor. If we take time away from our company, who is going to do the job while we are out trying to fight for tax reform? So sometimes our voices may be muffled.

Mr. MOULTON. That is a good question.

Is there anyone else who would like to comment on that? Dr. Toder, do you have any thoughts in particular?

Mr. TODER. Well, you know, the tax system is very complicated, and changing it is also very complicated. There are many moving parts and there are many people who will be affected, some of whom will be affected adversely. You get lower rates down by eliminating benefits for some groups of taxpayers. They are not just small loopholes. They are things like home mortgage interest and charitable contributions. And without saying that necessarily that is a bad thing to trade off lower rates for eliminating benefits, it is not easy to do.

And I testified at a hearing on the home mortgage interest and suggested ways which I thought it could beneficially be cut back, and I was not surprised that the total lack of interest from members of the Ways and Means Committee in those ideas. So it is difficult.

Mr. MOULTON. Mr. Sepp?

Mr. SEPP. I would say there is a problem of follow through at the granular level of small business input about the tax system. The taxpayer advocacy panels, for example, that are meeting around the United States, take all kinds of suggestions from small business owners about everything—how to improve the look of forms, the ease of compliance and the like. Some of those are adopted by the IRS. Others are cast by the wayside. The same thing happens with the Taxpayer Advocate's Report to Congress. If you look through the report cards that follow subsequent to each one of those, there are just a whole list of recommendations the advocate made, and the IRS's responses. More often than not, the IRS refuses to implement them. One thing that might be helpful would

be for Congress to put policy riders, frankly, and appropriations bills instructing the IRS to pay more attention to these recommendations and try to implement them.

Ms. VELAZQUEZ. Would you yield for a second?

Mr. MOULTON. Yes.

Ms. VELAZQUEZ. You do not think that budget has any implication in terms of the lack of staff at the IRS?

Mr. SEPP. I think budget does have somewhat of an implication, though I would point out that between 2005 and the present, if you take a look at the three major categories of the IRS budget, taxpayer service has been declining at the expense of enforcement and administrative costs. So that is a priority problem, too.

Ms. VELAZQUEZ. I thank the gentleman for yielding.

Mr. MOULTON. Thank you.

Mr. MCGREGOR. Can I just say a word?

Mr. MOULTON. Mr. McGregor, yes, sir.

Mr. MCGREGOR. The big C corporations are squealing loudly because of global competitiveness, and you are hearing them. We are starting to squeal because we do not want to be left behind. So that is my answer for you.

Mr. MOULTON. So there is broad consensus among many people on the principle of a simpler tax code where we are able to reduce overall rates in exchange for eliminating loopholes. The problem, Dr. Toder, as you referred to, is that everybody has at least three or four loopholes that he or she wants to hang on to. From the small business perspective, what are the carve outs that are most important if you were to just pick two that you think are most important to preserve in a reform that would eliminate many of the loopholes overall?

Mr. Sepp?

Mr. SEPP. I would say the provisions regarding expensing because they take us as close as we can to the full expensing ideal that we want in a tax system.

Mr. MOULTON. Mr. Lipps?

Mr. LIPPS. I would say for our situation, the 179 has been most beneficial. And I would certainly look at the death tax because I have so many family farms in my area that it is a bigger problem for the family farm than small businesses because you have got the \$5 million carve out right now.

Mr. MOULTON. Mr. McGregor?

Mr. MCGREGOR. You are asking what do we not want to give up?

Mr. MOULTON. Exactly.

Mr. MCGREGOR. I would say state and local taxes as a deduction.

Mr. MOULTON. Great.

Dr. Toder?

Mr. TODER. Well, I am not sure I am—

Mr. MOULTON. That is all right. My time is expired.

Mr. TODER. I am not giving anything up, I guess.

Mr. MOULTON. Thank you.

Mr. TODER. I mean, I have my benefits but they are not business benefits.

Chairman CHABOT. The gentleman's time is expired. Thank you.

The gentleman from New York, Mr. Gibson, is recognized for five minutes.

Mr. GIBSON. Thanks, Mr. Chairman. I appreciate the panelists' informative hearing. I appreciate your testimony.

Mr. Sepp, a couple of data-related questions. The first one, if you can, if possible, I would be interested in your report and analysis in terms of 1987 to 2015, if that is available. First question is compliance cost as a percentage of business. Any data you have on that and sort of looking at it from 1987 to 2015.

Mr. SEPP. Well, there have been attempts to quantify the costs of the federal tax system going back something on the order of 70 years, and depending on what you count in the estimates, the burdens have been figured at anywhere between 1 percent and over 11 percent of actual tax collections. There was one conducted back in 1993 by Professor James Payne, who suggested that for every additional dollar of tax raised on the federal level, there was a 65 cent deadweight loss. Now, my review, and I am certainly not in academia, but my brief review of the literature says that is the edge of the envelope as far as costs go.

Mr. GIBSON. Is there any sense in terms of what the opportunity costs—have you seen any follow-on studies there? In other words, it comes disproportionately at capital investment, or it comes disproportionately at wages and benefits? Is there any sense on what the opportunity costs are?

Mr. SEPP. It tends to come proportionately on new investment. That is what a lot of the literature says. Not all of it, certainly. There is also this problem we have, I think, in identifying precisely that point, the opportunity cost. Payne attempted to do that, which is why his estimate is so high. We have a difficulty trying to figure out how you quantify something that has never really happened. And I think that given the fact the last study I was able to find of small business tax burdens was 2011 for the SBA Office of the Advocate, this is something Congress might want to explore, is having some kind of symposium between SBA, private sector professionals, and the like, and really drill down on this question of opportunity cost.

Mr. GIBSON. Thank you.

And then the second data-related question. It might not have empirics on it but maybe intuition or speculation anyway. It has to do with 1987 to 2015 IRS approach in terms of education and compliance. Have you noted any significant changes there in terms of approach, whether or not they are spending sufficient time helping small businesses who may be not knowingly complying versus coming in and penalizing them?

Mr. SEPP. I think it is a matter of peaks and valleys. In the late 1980s, you had Congress engaged in activity like Taxpayer Bill of Rights I. In 1996, you had the second TBR. In 1998, the IRS Restructuring and Reform Act. And the 1998 act is what really put the emphasis on reorganizing the agency retraining employees toward customer service, and thinking more about the ability of allowing businesses to remain self-supporting while they were going through collection due process. The taxpayer advocate though has

noted that increasingly they are relying on the automated collection system to handle a lot of these things, and I think we probably hit a peak on the emphasis on proactive service in resolving these problems somewhere in 2005–2007. It has been downhill since.

Mr. GIBSON. And do you think that as we proceed as a Committee, it may be worthwhile for us to sort of recapture that essence of trying to be helpful?

Mr. SEPP. Absolutely.

Mr. GIBSON. Yeah. And then finally, just from the panel, given the 1986 reform, a lesson learned. Something that you think we should—certainly, a lot of people think it was a good reform, but what should we try to stay away from? One each.

Mr. TODER. All right. I will start.

I think it was a good reform, but in terms of meeting certain targets, they did something, things that they should not have done, like the Individual Alternative Minimum Tax in its current form is really a product of 1986 reform and trying to get a few more dollars to hit targets. And so I think you have got to be careful that you do not put time bombs into the system.

Mr. SEPP. That is good.

Mr. MCGREGOR. I would say that they may have done a few things wrong but that would be the target going forward.

Mr. SEPP. I would have to agree with Dr. Toder about AMT. That was a major mistake.

Also, in the current draft—well, the draft from the last Congress, some of the methods, such as repealing LIFO accounting might have been a step too far and deserve reexamination.

Mr. LIPPS. In 1986, we were not in business yet. We had a dream of being in small business. So I am going to yield to my esteemed colleagues.

Mr. GIBSON. Yeah. Thank you. This is very helpful.

Thanks, Mr. Chair.

Chairman CHABOT. Thank you very much. The gentleman's time is expired.

Ms. Meng, the gentlelady from New York, is recognized for five minutes.

Ms. MENG. Thank you, Mr. Chairman. Thank you, ranking member. Thank you to the witnesses for being here today.

I believe that certainty and clarity are necessary to improve the tax code for small businesses, and complications stem from the various temporary, unstandardized deductions and credits. However, many of these credits do serve a valuable purpose in incentivizing financial activities useful for the public, such as student loans, first time homebuyers, R&D investment, charity, and so forth. Do you have any ideas that simplify the tax code while still maintaining a system of positive incentives for small businesses? And anyone can answer.

Mr. TODER. I will make a comment on that. I think it would be very desirable for the Congress to reexamine these proposals once and for all that you call extenders. Decide which ones you want to keep and which ones you want to get rid of so we do not have this uncertainty in this process every single year which creates difficulty for taxpayers, difficulty for the IRS, difficulties for the tax system. I mean, there are probably some of those benefits that you

want to make permanent but there are many that we would be better off without.

Ms. MENG. On another note, our current tax code is not a progressive tax system because there are many with greater ability to pay do not always pay a higher rate. Is there more room in our tax code, and if you have any ideas to reflect the progressive personal income tax structure.

Mr. TODER. All right. Well, I will comment on that, too. I think we actually do have a very progressive personal income tax structure. And to the extent that that does not apply to everybody and there are some very high income people who are not paying a large share of tax because of certain tax benefits, I think the solution to that is to remove those tax benefits and try to lower rates in compensation as we did in 1986. But, you know, you may want the system to be more progressive, but I think it is progressive.

Mr. SEPP. I would just add the concern that while we think a lot about longitudinal fairness in the tax system looking up and down the income scale, we need to keep looking sideways on the income scale, making sure that people with roughly the same amount of income or profit pay roughly the same amount of tax. And the answer in this system is nowhere close. There was actually a study by Quantria Strategies for Small Business Administration which took a look at compliance burdens by industry for sole proprietorships and the fluctuations were wild depending on business models and activities. Some like mining, agriculture, transportation, and warehousing, they had complexity burdens in terms of hours spent and money spent that were 500 percent or more higher. Gigantic differences.

Ms. MENG. Thank you. I yield back.

Chairman CHABOT. Thank you. The gentlelady yields back.

The gentleman from California, Mr. Knight, is recognized for five minutes.

Mr. KNIGHT. Thank you, Mr. Chairman. I will just make a couple comments before question.

You know, coming from California, our biggest concern from small business is not so much the whole complexity of everything but how much we change. Changing the rules every year seems to be the number one concern of small businesses. I cannot do a five-year plan or a 10-year plan if you are going to change it 5 or 10 times on me, and I cannot invest a certain amount of money if you are going to change the rules in the next few years on me.

So let me ask just a broad question about that, about the Federal Government. How much does certainty help the small business, especially when it comes to taxes and regulations as we move forward, and how much has that been changed since the reforms in the late 1990s?

Mr. LIPPS. It is the most critical part of us deciding to invest in new facilities, infrastructure, or machinery. If we know what we are facing and we face it on time—sometimes the extenders are a little late—if we know what is ahead of us, we know how much risk can be taken to protect the jobs that we currently have.

Mr. SEPP. Last month there was an interesting study conducted by Institute for Policy Innovation where they reviewed reports from Federal Reserve Bank of Kansas City and employment reports

from the media, and they determined that the retroactive extension of section 179 expensing was so sudden and created a level of certainty after so much uncertainty that it did not have its intended effect of helping investment. There was not a measurable rise as expected at least in things like agricultural equipment investments. It came too little, too late.

Mr. MCGREGOR. I think the example we heard about bonus depreciation clearly affects major purchases of capital equipment. And it can be very damaging.

Mr. TODER. I would like to actually commend the Congress. You have made great progress since a few years ago when you had all the Bush tax cuts being expired or extended, and at least you have settled on big parts of the tax code. You have these remaining expiring provisions and I would agree bonus depreciation is very important. Having an investment incentive that you give after the year is over does not really do very much for investment. So either keep it, or get rid of it, or modify it.

Mr. KNIGHT. And I think, you know, several of the members have hit on a couple of the items that make it very important for us. You know, if we talk about an overhaul, I am an optimist, and I would like to see that but I am also a realist, that there are tens of thousands of people employed by the government and there are close to a million people employed that do taxes, that do preparation, that do attorney work on taxes, and it is very difficult to do an overhaul when you are talking about close to a couple million jobs across the country. So I would ask that you have a little bit of an open mind, too, when we are talking about little pieces that we can do that will help small business especially, and we can get them through, especially in Congress where we do not agree all the time. And getting something that is bipartisan that moves forward, that gets signed by the president is very important, especially when we are talking about the entrepreneurs that are hiring people that are expanding that are helping our economy like no one else can. So, those are the comments that me, as a freshman, would like to move forward with and especially the optimism of getting something done in my first session.

So I yield back the balance of my time. Thank you, Mr. Chair.

Chairman CHABOT. Thank you. The gentleman yields back.

The gentleman from Nevada, Mr. Hardy, who is chairman of the Subcommittee on Investigations, Oversight, and Regulations is recognized for five minutes.

Mr. HARDY. Thank you, Mr. Chairman.

You know, as a small business owner myself in the past, the opportunity to employ is a great thing. And as a business, you want to have to pay taxes because that means you are going in the right direction, not the other. Tax deductions or tax losses is not a good thing.

But through that process, Mr. Sepp, you talked about manufacturers costing them—large manufacturers costing somewhere around \$960,000 a year to prepare for those taxes. And I know that you are correct when you talk about one and a half or bigger for smaller businesses that employ under 50, that it costs us more. Can you give me an idea why that is? I know why but I would like to have you explain that.

Mr. SEPP. Well, just that there are certain inescapable base costs to tax compliance that no business can really avoid, has to deal with filing. If we are talking about C corps, well, we have a variety of schedules and whatnot that have to be filed, but the basic 1120 return takes a lot of time and effort. If you are looking at Schedule C filers of any size, the Schedule C might become complicated the larger the business is, and especially if it does business abroad. But even if there is no activity abroad, the filing of the Schedule C has a base cost in time and money that really cannot be avoided. The National Society of Accountants publishes a whole list of those costs by form. Also, of course, if you are distributing the costs over your employees, obviously, fewer employees, greater costs per employee, that is going to run the math up as well.

Mr. HARDY. I would like to also now go back to Mr. Knight's discussion. I think he is right on point that business has a challenge with knowing what the Federal Government is going to continue to do, what new creative idea they are going to come up with the tax code. Has anybody wondered whether a lot of the loss of those businesses over the last eight or so years, or six to eight years, might have been because businesses invested in some of those write-offs that they had early opportunities to do and the change in our economy had us deeply in debt as businesses because nobody predicted this collapse, but that because of tax codes actually caused people to do things that might otherwise have been more prudent to go some other direction? Does anybody care to touch on that one?

Mr. LIPPS. It caused us to be more conservative than I think we would have been. We are risk takers. That is the pure heart of an entrepreneur. However, if you jump in the water and then you do not make the necessary changes, I am still in the water. And so I think that it has created a situation where entrepreneurs have taken less risks. Honestly, in my opinion, I believe that means that we have hired fewer people as an aggregate.

Mr. HARDY. Well, along with my comment on that, I guess back in 2004, 2005, 2006, 2007, 2008, things were moving along. You got major tax deductions trying to get the economy moving again prior to that. You got major tax deductions on equipment in the construction industry, mining industry, and other industries that you wanted to utilize that opportunity when you are spending millions of dollars in taxes and providing that opportunity. And then the collapse came, which you still owe that debt but you cannot even make the tax. So now you turn a different direction. So do you believe there is any cause? Because there is uncertainty in taxes, the direction they went, and how they changed in that short of a time.

Mr. LIPPS. Earlier you mentioned that a lot of people did not see it coming. The government did not see it coming. We did not see it coming. And 2009 was the first time in our career we ever had to lay anyone off. If I fire you, that is different. It does not matter. You earned the right to be fired. But if we lay you off because we missed something, it was the most horrible situation our family ever went through because those team members to us, that is gold. That is our number one asset.

Mr. HARDY. That is the toughest thing you will ever do.

Mr. LIPPS. It was horrible.

Mr. HARDY. Thank you. My time is expired.

Chairman CHABOT. Thank you. The gentleman yields back.

The gentleman from South Carolina, Mr. Rice, who is chairman of the Subcommittee on Economic Growth, Tax, and Capital Access is recognized for five minutes.

Mr. RICE. Thank you.

I want to start with Mr. Lipps and Mr. McGregor because you are all in business. Mr. Lipps, is your business exposed to international competition?

Mr. LIPPS. We are really not. The mattress industry is semi insulated. If you look at the cubic foot, the size of a mattress product coming from a foreign country, it takes up so much room in a cargo container that because of not necessarily weight but because of cubic feet, we are a little more insulated than many of our small business brethren.

Mr. RICE. Mr. McGregor?

Mr. MCGREGOR. We do a fair amount of business with Husqvarna in South Carolina. And they buy pullies from us. And some year we get it and other years we do not, but China is our competitor there. And we are scheduled to lose that business. We have not lost it yet, maybe because of the dock strike. I am not sure.

Mr. RICE. Do you think that our tax code makes you more or less competitive with your competition in China?

Mr. MCGREGOR. Well, I spent some time in China, and I know their cost. I think that the tax code is definitely a factor in our pricing. I am not sure it is enough to make a difference.

Mr. RICE. Basically, I look at the taxes, the price you pay to keep the government open, and if you are paying more for your government than they are paying for their government, does that not put you at a competitive disadvantage?

Mr. MCGREGOR. Their government is putting them in business.

Mr. RICE. Mr. Sepp and Mr. Toder, define—Mr. Toder, would you define a loophole for me? I keep hearing people throw around the term “loophole.” Like every deduction is a loophole. What is a loophole?

Mr. TODER. I do not call those provisions loopholes. I call them tax subsidies, tax benefits, tax expenditures. To me, a loophole is something that is enacted in the dark of night by somebody that only a few people benefit from that most people do not know about, sneaky things. That is why I do not use the word loophole. I prefer to say a tax preference, which means something which gives your form of income or your form of activity more favorable treatment than somebody else.

Mr. RICE. Would you not say that most of these things in the tax code are intended to promote certain activity and were enacted with well-intentioned ideas?

Mr. TODER. Absolutely. That does not mean they are good policy, but absolutely.

Mr. RICE. Mr. Sepp, would you agree with that? What is a loophole in your mind?

Mr. SEPP. That is an impossible definition because a loophole to one person is a subsidy or a tax relief provision to another. I would say though that some things that qualify for a tax provision being

less desirable than more desirable is it is very narrowly drawn. It is temporary in nature. It has claw backs built into it that might specifically exclude some industries from availing themselves of it. So those are things to look for in formulating better tax benefits.

Mr. RICE. Is the mortgage interest deduction a loophole?

Mr. SEPP. For a write-off for housing, that is a social goal that Congress has settled on as something that is desirable for many people. I do not think it necessarily has to be in the tax code if it is properly—

Mr. RICE. Is the capital gains rate a loophole?

Mr. SEPP. No. Because capital gains taxation is a form of double taxation in many cases.

Mr. RICE. I have a question for you. Would you characterize our tax code for us? Is it internationally competitive or noncompetitive?

Mr. SEPP. Noncompetitive in a number of ways. We have talked a little bit about—

Mr. RICE. I am running out of time so I have to cut you off.

Mr. Toder, competitive or noncompetitive?

Mr. TODER. I think our system places some of our companies at a disadvantage, but it places some of our companies at an advantage. It is really a case by case situation.

Mr. RICE. I want to follow up with that—on that with you a little later. I am just running out of time.

Would you characterize our tax code, Mr. Toder, as modern or outdated?

Mr. TODER. I think it is outdated.

Mr. RICE. Mr. Sepp?

Mr. SEPP. Outdated.

Mr. RICE. Would you say, Mr. Sepp, that our tax code promotes or stifles economic growth in this country?

Mr. SEPP. Stifles it.

Mr. RICE. Mr. Toder?

Mr. TODER. I do not think it stifles it. I think we could have a tax code which is more friendly to economic growth, but I do not think it is a major factor.

Mr. RICE. I think we can do a lot better. I think it actually stifles economic activity, and I want to end my little presentation by apologizing to all of you gentlemen that we do not have leadership on both sides of the aisle here that are willing to put forth bold ideas about tax reform. So I think we could do a lot better for this country, and we could do a lot better to promote economic activity.

Thank you very much.

Chairman CHABOT. Thank you. The gentleman's time is expired.

The gentleman from Virginia, Mr. Brat, is recognized for five minutes.

Mr. BRAT. Thank you, Mr. Chairman. I thank you all for coming before us today. It is a pleasure to have you with us.

I have been listening, and several things are merging. I want you to put on your marketing hats right now. I recently ran for federal office, knocked on a thousand doors, whatever. My district is all small business. And you go door to door to door, and small business says, "No one listens to us." I have got cattlemen, ranchers, farmers, a bunch of small business community bankers are by far and

away the majority, and some of them are almost conspiracy minded in terms of the system is rigged against them. And so at the end of this I will just give a couple ideas and just put a few of the phrases I have been hearing forward.

But at the end of this, if you have 30 seconds of messaging on behalf of small business person across the country, what would your messaging be to Congress? And a lot of the folks—Mr. Lipps has been saying over and over and over, that most small businesses are too busy doing their own thing to spend significant time thinking about messaging when it does matter in terms of getting the right policy. And you have kind of got to get the current moving in the right direction so us politicians can jump in later and help you, but the current has got to be moving and it is not moving. And so I always ask my small business people, hey, start writing in the local papers. Not political pieces, but with this tax rate, with this regulation, I cannot stay in business. I am going to go out of business. My people are going to lose their jobs. Just so you know.

I just want to get you thinking that way in terms of—I will come back. We have been mentioning depreciation, expensing, tax rates, what is the message? What should we be hitting on there? I have got a tax foundation. Published a piece on economic and budgetary effects of full expensing of investment. Mr. Sepp was getting at that. It sounded like if you could hit that, that was pay dirt. Found cutting corporate tax rate 10 points would increase GDP about 2 percent, but full expensing would boost GDP about 5 percent. I am just kind of asking. Total federal tax revenue would be \$97 billion a year. Also, benefits accrue disproportionately to low end of the income scale due to job growth, productivity, wages. I am just kind of throwing those kind of three out—tax rates, depreciation, expensing, regulatory burden, just as a set up.

Thirty seconds to everybody. Why do we not start with Mr. Lipps? If you had to message to the country, you are going on TV, what would you say for small business?

Mr. LIPPS. I would start by agreeing with your initial comments, that many small businesses have thrown their hands up and said their voice is not being heard. Earlier in our testimony you heard someone say that there is not an outcry, an upswell from the small business community. We are working. That is why you do not hear that. But a lot of them will tell you they have no say, so why are they going to invest that time when they could have been building one more mattress. So that is my first point.

My second point is I do not hear small businesses saying find us loopholes or advantages. I find them saying make it easy enough that I can understand it. I will pay my taxes and I will go back to work and create a job. So I do not think we are looking for advantages. I think we are looking for less complexity.

Mr. BRAT. Good. Good. Thank you.

Mr. Sepp?

Mr. SEPP. My message would be get more involved in the tools that are available and use them to your advantage. Volunteer for the taxpayer advocacy panels. That is where tax complexity is addressed at the most basic level. Also, have more committees outside of Ways and Means Committee get involved in tax complexity analysis. There was a requirement in the 1998 law that we have an

analysis of complexity accompanying every major tax provision coming out of Ways and Means or Finance. We have not adhered to that rule. We have got to have more coordination between those panels and the IRS's taxpayer advocate to get these suggestions into the policymaking stream so that businesses do feel their concerns are being taken seriously.

Mr. BRAT. Right.

Mr. McGregor?

Mr. MCGREGOR. I would echo simplicity, permanence, rates designed for growth and acknowledged by everyone that that is the intent. As far as expensing, I see that as more of a deferral so I am not as excited about that.

Mr. BRAT. Mr. Toder, sorry, 19 seconds.

Mr. TODER. Okay. I agree with my fellow panelists on simplicity. You know, I think everyone should be paying taxes commensurate with their income, but we should make it easy for them to do that and we should have a lower rates rather than special benefits.

Mr. BRAT. Thank you all for being with us. Thank you.

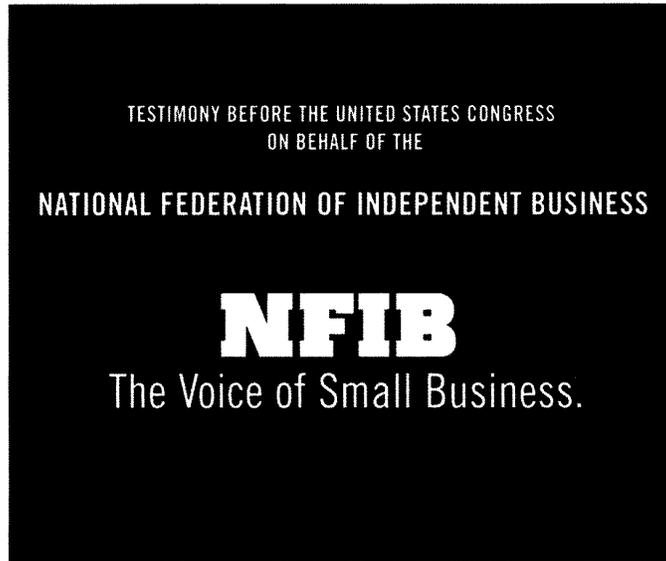
Chairman CHABOT. Thank you. The gentleman yields back.

I would like to thank our distinguished panel here, both this morning and this afternoon, because we are afternoon now. I think you all did an excellent job, and I think some of the stuff we already inherently knew but you said it so well that it is going to stick. And I think one of the things you said is how significant it is that we not only reform our corporate tax code but also the individual. It has to go hand in hand, and we need to simplify it. There was consensus on a lot of things here, and we intend on this Committee to work with Paul Ryan and the Ways and Means Committee as we move forward on any reform package.

And I want to thank the ranking member and minority members of the Committee also for participating today. And I would ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record. And if there is no further business to come before the Committee, we are adjourned. Thank you very much.

[Whereupon, at 12:30 p.m., the Committee was adjourned.]

**APPENDIX**



Testimony of Scott Lipps,  
House Committee on Small Business  
April 15, 2015

*Tax Reform: Ensuring that Main Street Isn't Left Behind*

Good morning, Chairman Chabot, Ranking Member Velázquez, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB). Our family owns Sleep Tite Mattress Factory & Showroom and has been a member of NFIB since 1995. I also currently serve on the NFIB-Ohio Leadership Council. Thank you for holding today's hearing, "*Tax Reform: Ensuring that Main Street Isn't Left Behind.*" The current tax code negatively impacts small and closely-held businesses in several important ways, so I appreciate the invitation to be here today to discuss these important issues from the perspective of a small business owner.

The NFIB is the nation's leading small business advocacy organization. The typical NFIB member employs about 8 to 10 employees with annual gross receipts of about \$500,000. All of NFIB's members are independently owned, which is to say that none are publicly traded corporations. While there is no one definition of a small business, the problems NFIB members confront, relative to the tax code, are representative of most small businesses. A few consistent concerns are raised regardless of the trade or industry in which the small business is engaged.

As part of representing small business owners, NFIB frequently conducts surveys of both the NFIB membership and the small business population as a whole, and taxes consistently rank as one of their greatest concerns. In the most recent publication of the NFIB Research Foundation's *Small Business Problems and Priorities*, 5 of the top 10 small business concerns are tax-related.<sup>1</sup> In fact, the February 2015 *Small Business and Economic Trends* report ranks taxes as the number one problem small business owners currently face. Right now, taxes are a bigger problem than poor sales, the cost and quality of labor, and government regulation.<sup>2</sup>

I would like to spend the rest of my time telling you about my personal experience. Sleep Tite Mattress Factory & Showroom was founded in 1947, by Stan Rothman. In 1990, our family founded an institutional (acute and long term care) bedding company, HomeCare Mattress, Inc. In 1992, we merged HomeCare Mattress, Inc with Sleep Tite. We started with 4 employees and now have 15 full-time employees. We are currently structured as a c-corporation, but we started as a pass-through. While often times a struggle, we are VERY proud to offer our team-members health insurance, a 401K program, paid sick leave, paid vacation time, and more benefits. Aggressive tax rates, and compliance efforts directed to fulfill intrusive regulations, severely impact our ability to offer a full benefits package that our employees need and deserve.

We are proud of Sleep Tite Mattress Factory. We think you would be, too. As I mentioned, we strive to offer our team members a positive work environment that offers a learning experience, the ability to make decisions, a career opportunity and full benefits. Beyond that, we believe community involvement is critical. Small businesses are the "Fabric of the Community." For example, across America you will find small businesses sponsoring school plays,

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<sup>1</sup>[nfib.com/problems&priorities2012](http://nfib.com/problems&priorities2012)

<sup>2</sup>[nfib.com/sbet](http://nfib.com/sbet)

peewee football teams, cheerleading squads, and church youth group programs—the list goes on. The small business owner works in the community, hires in the community and LIVES in the community. Sleep Tite Mattress has been recognized by our schools for our involvement and won our area Chamber of Commerce Business of the Year Award in 1999. That makes us feel good. What makes us feel even better is seeing our employees grow and build their lives and stay with our company for years. To serve our employees and our community, we must have lower tax rates, fewer regulations and a less confusing, less complex tax code.

We have been in business in our community for over 24 years. I witnessed and experienced what punitive local, state and federal laws were doing to the business community in Franklin, Ohio, and in our surrounding communities. So, in 1999, I did something about it. I ran for city council and won a seat. After encouraging a few fellow business owners, and business people, to run for the city council, I was honored to serve two terms as Mayor of Franklin. We concentrated on fixing the problems a bloated bureaucracy and out-of-touch government had levied on our city.

Our Council addressed local incentive programs that unfairly assisted large corporations but did not offer incentives to small business. We instituted a “Downtown Improvement Program” (“DIP”) that offered grants and low interest loans to small businesses locating or expanding in our community. We met with local zoning, planning and building officials and redesigned zoning laws to assist businesses with fewer *or* less restrictive regulations (example: sign ordinances and requirements). Not every small business owner can run for elected office. Instead, Congress should work to reform our tax code in order to help small business owners get back to doing what they should be doing: running their small business. Over 85 percent of NFIB members agree that Congress should fundamentally reform the tax code.<sup>3</sup>

As Congress considers tax reform, I would encourage you to keep these most important goals in mind. Achieving these goals will greatly enhance the ability of small and closely-held businesses to thrive in the 21st century: 1) permanently keep the tax rates low, 2) do not create disparity between the corporate rate and individual rate, 3) reduce complexity, and 4) do not separate the business owner from the business. NFIB members are willing to make the tradeoffs necessary to lower tax rates, such as reducing or eliminating deductions, credits, or exclusions.<sup>4</sup>

Should Congress enact comprehensive tax reform that achieves these goals, small business owners would no longer face one of their most consistent complaints: arbitrary and inconsistent tax preferences, constant change and complexity in the current federal code.<sup>5</sup>

Small businesses truly are the engine of economic growth. This isn't just a slogan, as small businesses created two-thirds of the net new jobs over the last decade. Small business owners are risk tak-

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<sup>3</sup> [nfib.com/taxsurvey](http://nfib.com/taxsurvey)

<sup>4</sup> *Ibid.*

<sup>5</sup> *Ibid.*

ers and entrepreneurs. They are the last businesses to lay off employees when business declines and slow to rehire when business picks up. The owner works additional hours until they can take it no more. When small business hires an employee, it is their intent to keep them on for the long run.

The current tax code has become a confusing and unpredictable challenge for the vast majority of small business owners. Our tax laws should not deter or hinder the ability of small business owners to create or expand their businesses. Taxes are a MAJOR issue for ALL small business owners. Tax law can dictate the business decisions that an owner must make, whether it is the type of structure to adopt, whether to make an investment in programs or machinery, to expand their facility, or to hire employees.

After decades of patchwork changes to the tax code, Congress needs to make major adjustments to our tax laws to reduce complexity and confusion and encourage business growth. I appreciate Congress taking a serious look at reforming the tax code and urge you to keep in mind the unique challenges that face small businesses.

Thank you again for having me here today and I'm happy to answer any questions you may have.



**Statement of**

**Pete Sepp**

**President**

**National Taxpayers Union**

**Prepared for**

**The Committee on Small Business  
United States House of Representatives**

**Regarding the Committee's Hearing on**

**Tax Reform: Ensuring that Main Street Isn't Left Behind**

**Submitted April 15, 2015**

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### **Introduction**

Chairman Chabot, Ranking Member Velázquez, and Members of the Committee, I am honored to have been invited to present comments today for your hearing, "Tax Reform: Ensuring that Main Street Isn't Left Behind."

My name is Pete Sepp and I am President of National Taxpayers Union (NTU), a non-partisan citizen group founded in 1969 to work for less burdensome taxes, more efficient, accountable government, and stronger rights for all taxpayers. One of NTU's greatest honors was having its then-Executive Vice President David Keating named to the National Commission on Restructuring the Internal Revenue Service (IRS) in 1997, a federal panel whose recommendations later became the basis for the most extensive IRS overhaul in a generation. More about our work as a non-profit grassroots organization, and the thousands of members we represent across the nation, is available at [www.ntu.org](http://www.ntu.org).\*

Throughout our 46-year history NTU has held a special concern for small business and self-employed taxpayers, who make up a somewhat larger proportion of our membership than would be represented in the general working population of the United States. Although we advocate for many structural changes to the tax system, from the comprehensive to the incremental, one common aspect on which NTU often specifically focuses is the *administrability* of such proposals. As policymakers define the rates, bases, deductions, credits, and other features of a tax system, what will the practical impact be on taxpayers' lives and their rights?

As NTU has discovered firsthand, few sectors can be more deeply affected by the answer to this question than small business. In the 1970s and 1980s, many of the first Americans to approach NTU's advocacy staff and share "horror stories" of harsh treatment by the Internal Revenue Service were small business owners. In the 1980s and 1990s, the surge of start-ups and independent contractors began changing the nature of the workforce, and once again NTU participated in attempts to adapt the tax system to new times. In the 2000s and 2010s, the increasingly interconnected global economy, along with relatively short-lived tax policies, has presented new complexity challenges to NTU's members.

Accordingly, the following testimony will include recommendations not only for redesigning technical elements of the tax law, but also creating a framework for implementation and enforcement that is efficient for the economy and respectful toward the citizens it serves.

Before exploring these recommendations, it is helpful to put some of the biggest challenges facing small business taxpayers into historical and statistical perspective.

Members of the Committee are well aware of many figures and anecdotes that detail the complexity, uncertainty, and fear of harsh enforcement that can characterize the taxpaying experience of the small business community. A few bear repeating here.

### **The Challenge of Complexity**

It is no secret that the act of *filing* taxes can be a significant and distinct burden from the act of *remitting* taxes. This is true for many segments of the population, particularly businesses of all sizes. According to an annual study, "A Complex Problem: The Compliance Burdens of the Tax Code"

*\*As a matter of organizational policy National Taxpayers Union neither seeks nor accepts any kind of grant, contract, or other funding from any level of government.*

published by our research affiliate National Taxpayers Union Foundation, the federal personal and corporate tax system extracted 6.1 billion hours and \$233.8 billion out of the economy this past year (a trend that has been worsening). Other analyses suggest that two-thirds or more of these sums would be attributable to the business sector, including corporations, partnerships, and sole proprietorships. Such statistics should, on their own, be cause for alarm among policymakers, but there are more specific examples that deserve attention.

Perhaps the most extreme individualized illustration of the complexity load that businesses bear is General Electric's 2006 tax return, which would have amounted to over 24,000 pages had it been printed on paper. GE's tax return may be even longer today. When NTU's researchers contacted GE's media relations staff in 2010, they were told that the firm's tax department had stopped counting after the filing documents routinely exceeded the 24,000-page mark every year.

Companies such as GE, with hundreds or even thousands of employees laboring to fulfill tax requirements, are forced to pass along their costs in the form of higher prices, lower shareholder returns, or fewer employment opportunities. Small businesses must do the same. Yet, it is clear that even in tax compliance, economies of scale can sometimes occur, making the chore of meeting tax obligations disproportionately more difficult for small businesses and self-employed individuals. At the same time, their ability to exercise "pass along" options is more limited.

How can the impact of tax compliance and complexity on small businesses in particular be expressed? There are numerous possibilities, but the following are, in my opinion, most instructive:

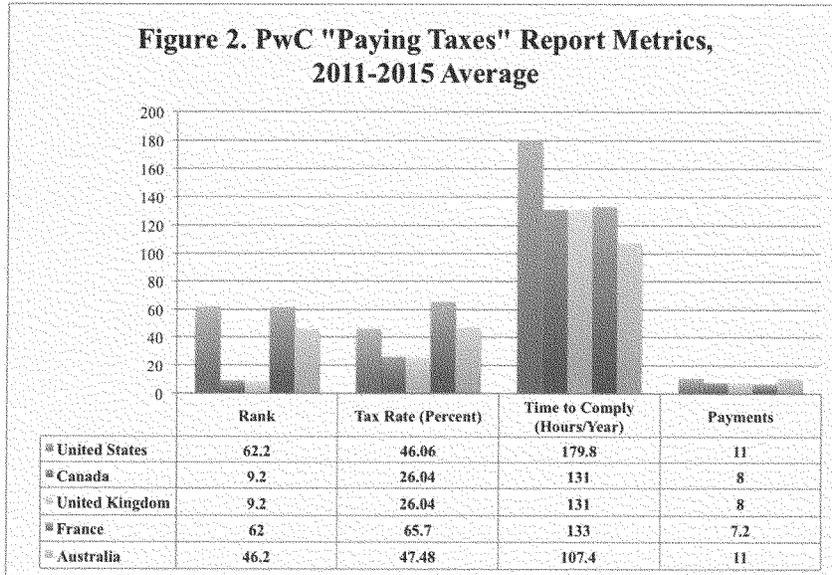
- A September 2014 report for the National Association of Manufacturers calculated that the regulatory cost *per worker* for all tax compliance activities in firms of any size was a whopping \$960 (using 2012 data and expressing in 2014 dollars). For companies with fewer than 50 employees, the tab was much worse – over 50 percent more, at \$1,518 per worker.
- According to the National Society of Accountants, the average fee for an itemized 1040 long form return with Schedule A and a state return this year will be \$273. A Schedule C filer will pay an extra \$174, plus (if applicable) \$126 for Schedule E (rental income) and \$115 for Schedule D (gains and losses). Woe to the S Corporation founder, who will shell out an average of \$778 for completion of Form 1120S.
- A September 2011 analysis by Quantria Strategies for the Small Business Administration's Office of Advocacy determined that for sole proprietorships – the most common form of small business – the average monetized 1040 filing burden for firms with receipts of under \$25,000 was \$474, compared to \$909 for those with receipts of \$5,000,000 to under \$10,000,000. This suggests there is an inescapable compliance expense that functions in a near-regressive manner.
- Business owners themselves are not oblivious to this expense, and they apparently believe the price tag is mounting. The National Federation of Independent Business has long conducted a survey of small firms' outlook on the economy. One question asks business owners to identify the single most important problem facing their operation, such as poor sales, insurance, interest rates, taxes, the cost of labor, government requirements, etc. During the past four years the problem of taxes has risen sharply as the top concern, from 19 percent in December of 2010 to 27 percent in December of 2014. Government requirements comprised the greatest worry among just 13 percent of respondents in 2010, but had jumped to 22 percent in 2014. Throughout that time the problem of poor sales was tumbling from the top spot.
- Some of this apprehension is likely due to the implementation of the Affordable Care Act (ACA) of 2010. Earlier this month National Taxpayers Union Foundation's researchers visited the IRS's special website section devoted to ACA, and determined that the online destination offered 3,322 pages of regulations, Treasury decisions, revenue procedures, and other guidance. While this

information was designed for numerous constituencies, small businesspeople are likely left as confused as anyone over the direction that ACA will take in the future.

One important question surrounding these statistics is, how do they compare with the experience of firms in other countries who are considered our competitors? The answer is not cause for celebration.

For 10 years, the annual "Paying Taxes" analysis has served as a respected benchmark for measuring the administrative aspects of income and employment taxes at all levels of government among all the nations of the world. Currently published by PricewaterhouseCoopers in consultation with the World Bank, "Paying Taxes" creates a compliance scenario based on a hypothetical company formed as the most common limited liability entity under local laws, with a total of 60 employees engaged in "general industrial or commercial activities."

PwC bases its rankings on hours per year spent complying with the country's tax filing procedures, the number of payments in connection with such procedures, and the overall tax rate the business would face, constructing an "ease of payment" index that weights those metrics. NTU's research arm selected PwC's five most recent reports (2011-2015), and compared the average results for the U.S. and four other Organization for Economic Cooperation and Development (OECD) countries often regarded as close competitors. The figure below, reproduced directly from "A Complex Problem," depicts the findings.



PwC's data indicate that the U.S. ranks worst among the five OECD countries compared in terms of the total time a business spends complying with the Tax Code and overall ease of payment. Such findings underscore how U.S. small businesses can be trapped within a tax administration structure that is more obtuse than those found in many other developed countries.

### **The Challenge of Fair Enforcement**

Some six thousand years ago, an inscription found in the ancient city of Lagash (in modern-day Iraq) lamented that "you can have a lord, you can have a king, but the man to fear is the tax collector." This alone is a testament to the trepidation that taxpayers have felt throughout the history of civilization over the power of tax enforcers. During its own institutional history, NTU has been involved in an ongoing effort to rein in the worst abuses of the tax agency and establish oversight procedures. This has taken place largely through three pieces of legislation enacted in 1988, 1996, and 1998; the latter, the IRS Restructuring and Reform Act, implemented the most sweeping changes. Through it all, and years following, NTU has encountered IRS "horror stories" too numerous to repeat here.

Prior to reforms enacted in the 1988-98 period, taxpayers had only a few options in disputing an IRS assessment that did not involve considerable expense and time. Even if they decided to go to U.S. Tax Court or a Federal District Court, the most citizens could recover if they were victorious was \$75 an hour in attorney fees. The 1988 law allowed taxpayers to sue for damages if they could prove an IRS employee "recklessly or intentionally" disregarded the law. The cap on attorney fees was raised to \$125 per hour. Yet, these provisions were still paltry to a taxpayer, especially a business owner, contemplating months or years of lost time, a large up-front out-of-pocket expense, and a tax bill that kept accruing interest and penalties.

It was no wonder that many businesspeople told lawmakers in hearings during the 1980s and 1990s that they believed the cost of disputing an IRS tax bill – even if they knew the agency was wrong – simply became too prohibitive. To be sure, there were appeal and abatement processes for audits that have improved over time in terms of accessibility and affordability for taxpayers without extraordinary means. Unfortunately, even into the mid-1990s, many Americans facing IRS demands felt helpless. According to a 1995 study by tax litigation expert Daniel J. Pilla:

The average individual face-to-face tax audit led to the assessment of \$4,780 in additional tax and penalties, not including interest. However, just 5 percent of those found to owe more money appealed. The 5 percent number is significant in this way: the GAO has proven that the IRS's computer notices are wrong 48 percent of the time. Still, 95 percent of the public is persuaded that IRS audit results are correct or not worth fighting. That testifies to the degree to which the IRS has the public convinced that it cannot win when challenging an audit.

In short, all too many Americans thought it was cheaper to pay what the IRS said they owed rather than fight.

A review of more recent tax enforcement statistics from the IRS Data Book (Publication 55) still paints a daunting picture for small businesses:

- Over the past ten Fiscal Years, the IRS Chief Counsel's Office has typically closed over 70,000 "tax enforcement and litigation" cases per year. Roughly ¾ of those cases fell under the category of "Small Business and Self-Employed." No other area of practice – large businesses, criminal issues, or even general legal services – comes close.
- While it is true that "small corporations" filing the 1120 form are less likely to have their returns scrutinized than larger firms, the majority of business entities declare their profits and pay their

taxes using 1040 forms. Thus, it is more relevant to analyze the experiences of businesses in the latter situation. A comparison of 1999, 2004, 2009, and 2014 data (every fifth year of available statistics online) shows that the examination coverage rate for *all* taxable individual income tax returns ranged from 0.8-1.0 percent. However, over that same period the rate for business tax returns within this category reporting gross receipts of under \$200,000 was between 1.0 and 4.2 percent.

Some might argue that statistics such as these – and many others – merely show that small businesses are likelier to be cheating on taxes, and so they have invited more attention from authorities. I would assert that this characterization is oversimplified. In NTU's near-four-decade experience of detailed work on taxpayer rights legislation, one common theme we have encountered is "the fear factor" that taxpayers experience when encountering the IRS. Small business owners, especially, are able to tally the costs of contesting an IRS bill they know to be wrong versus simply "settling up" and carrying on. In too many instances, small businesses facing long odds of prevailing choose the latter option.

Consider, for example, the average additional recommended tax in 2014 resulting from field audits of business 1040 tax returns with receipts between \$25,000 and \$100,000 – a total bill of \$8,756 per return. Imagine the decisions this audited business owner – the very definition of "the little guy" – would face. If he or she hires a tax professional for representation at an audit, the average fee, according to the National Society of Accountants would be \$144 per hour. It would not be unusual for the accountant to spend 10 hours on this stage of the audit. Should the initial examination go against the owner, he or she could choose to retain the accountant for the administrative appeals process, perhaps involving an additional 10 hours of time. Meanwhile, the owner could have easily spent 10-20 hours of time gathering records, reviewing paperwork, etc., at an average compensation amount (according to the National Association of Manufacturers study mentioned previously) of \$48.80 per hour.

To get this far into the audit process, the owner could have already spent close to \$3,900, nearly half the contested bill. Should the administrative route fail, the owner then has broad options to file a Tax Court petition or try to litigate in federal court. While many Tax Court petitions never advance, and often lead to settlements, this process could easily consume another 10 hours of a legal professional's time (at likely a higher rate of compensation). Should litigation actually take place, a qualified tax attorney might demand \$300 per hour or more. If the owner prevails, his or her ability to recover the entirety of fees like these remains doubtful. The maximum hourly amount that can be awarded is barely \$200 per hour, and only if the court determines the IRS's position was not "substantially justified." In a 2013 *Wall Street Journal* article, respected tax lawyer Robert Wood estimated that over the past decade, he identified at least 22 taxpayers involved in IRS disputes who received some kind of attorney compensation or litigation costs from courts, "although some rewards may later have been reduced."

All along this difficult road, the owner must also take account for the damage that eventual liens or levies could have on his or her business reputation, not to mention lost productivity diverted from keeping the company profitable.

Confronted with this type of calculus, it is little wonder that many business owners who are innocent (or in many cases just made an honest mistake) are intimidated into capitulating completely to the IRS's position or making a compromise that substantially weakens their balance sheets. The latter course can actually backfire on the government, should the business become so infirm that it no longer is able to deliver receipts to the Treasury.

Granted, IRS reforms have expanded both the number and the usability of appeals avenues to taxpayers, the availability of Taxpayer Assistance Orders, as well as safeguards against hasty or capricious liens and seizures. Nonetheless, the IRS came under new scrutiny last fall regarding its collection policies, amid revelations from *The New York Times* that the agency had made hundreds of tax-

related seizures in 2012 by creatively employing civil asset forfeiture laws. As the *Times* observed (with historical relevance in my opinion), “The government can take the money without ever filing a criminal complaint, and the owners are left to prove they are innocent. **Many give up** [emphasis added]. ... The median amount seized by the I.R.S. was \$34,000, according to [an] Institute for Justice analysis, while legal costs can easily mount to \$20,000 or more.”

The IRS has pulled back from this controversial strategy, but the National Taxpayer Advocate’s report to Congress from last year suggests that the “fear factor” alluded to earlier has consisted of more than a collection of sensational stories. She noted that:

- “Collection Due Process” hearings still place too much emphasis on “collection” and not enough on “due process” for taxpayers;
- The IRS’s automated case selection system too often fails to arrive at satisfactory resolutions of cases at reasonable collection yields; and
- The agency does not give sufficient consideration to installment agreements or offers in compromise to resolve business tax deficiencies in the way it does for individual tax liabilities.

Clearly, Congress and the IRS have more work to do in this often-overlooked dimension of tax reform.

### **The Challenge of Uncertainty**

A vague and often complex tax law, along with still-vast IRS enforcement powers, combine on their own to create a harsh, uncertain environment in which the small business owner must make plans for investments, hiring, and a host of other actions. Consider just one astounding example.

According to the 2011 “report card” on the IRS National Taxpayer Advocate’s recommendations to Congress, there are a total of 43 federal tax publications adding up to 1,212 pages pertaining to “U.S. businesses involved in economic activity abroad.” Incredibly, these documents in themselves “refer to other publications comprising 13,346 pages, 1,500 pages of forms, and another 5,018 pages of form instructions.”

The IRS, at last count in 2014, sponsored over 3,700 events designed to provide “outreach for small business and self-employed taxpayers” as well as logged more than 708,000 small business electronic newsletter subscriptions to owners, payroll providers, and tax professionals. Even with this admirable effort at providing clarity for tax laws affecting both domestic and international operations (on top of thousands of private-sector services spending billions of dollars), America’s small businesses will continue to suffer a competitive disadvantage until a major simplification effort provides a more readily navigable – and certain – path through the tax maze.

Yet, there is a third factor that contributes to uncertainty: the legislative process itself. Research appears capable of attempting to quantify this phenomenon:

- A March 2012 study by the Stanford Institute for Economic Policy Research developed an index to track U.S. economic policy uncertainty since 1985. The authors concluded that such uncertainty was “close to its all-time high,” which was “a key factor stalling the recovery and threatening a return to recession.”
- As the 2012 “fiscal cliff” approached, and with it the prospect of a return to pre-2001 tax rates, executives at a plethora of firms, from Honeywell to Northeast Wealth Management (a small business advisory company), remarked that hiring and expansion moves were being put on hold due to uncertainty over the direction Washington would take.

- A March 2015 analysis by the Institute for Policy Innovation (IPI) examined the impact on business decision-making around the up-and-down turmoil of the Section 179 small business expensing limit over the past few years. The wild fluctuations of the limit – between \$25,000 and \$500,000 – and its retroactive extensions were, according to IPI, particularly difficult for the agricultural sector. Citing evidence of equipment sales from the Federal Reserve Bank of Kansas City and employment news from manufacturers, IPI observed that “[i]t is reasonable to link the drop in agricultural investment and the resultant job cuts to the failure of Congress to renew the higher Section 179 allowance early enough in 2014 to have its intended incentive effect.”

A few words of caution are in order at this point. It is obviously worse to make bad policy with an ironclad degree of certainty than it is to tolerate uncertainty with the prospect of a better outcome for taxpayers. The “tax cliff” compromise of 2012 was, after all, not ideal. Harsh tax rates on upper earners, which hit many thousands of pass-through businesses, amounted to one undesirable consequence of that legislation. Furthermore, Section 179, a highly important provision of tax law, has often been rolled up in “extenders” packages that contain a number of narrowly-drawn, economically distortionary items. NTU continues to commend Members of the House, both in the last Congress and the current one, for attempting to “unbundle” these parts of the Tax Code and consider each on their own merits. The recent passage by a solid bipartisan margin of H.R. 636, which would make the \$500,000 expensing limit permanent, is an encouraging sign.

### **Meeting the Challenges: Recommendations for Reform**

Although it is not the primary tax-writing body of the House of Representatives, the Committee on Small Business is uniquely equipped to provide a holistic view of the taxpaying experience in the most dynamic part of our economy. The Committee is likewise uniquely qualified to inform the debate over federal tax policy in a constructive manner. The following recommendations, both general and specific, are offered in the hope of assisting the Committee in its advice and communications with those directly involved in the reform process.

#### **1) Maximize Economic Opportunities for Businesses.**

Obviously, a wholesale replacement of the tax system could be designed to benefit all taxpayers, including small businesses. It bears mentioning that NTU has long supported two such approaches to scrapping the Tax Code: a flat-rate income tax, which for businesses would apply a single rate of tax on profits remaining after a streamlined set of deductible overhead costs is applied, or a national sales tax levied on goods and services for final retail sale. These concepts are embodied H.R. 1040, the Flat Tax Act, and H.R. 25, the Fair Tax Act, respectively.

Absent such sweeping measures, major tax reform could take the direction of reducing the corporate tax rate below the currently uncompetitive 35 percent level, reducing rates and brackets for individuals and pass-throughs, and simplifying the tax base. Here again, small businesses could, like all other taxpayers, benefit from a comprehensive exercise in tax reform.

One particular way to deliver those benefits is by reducing the cost of capital and investment; H.R. 636, mentioned above, is an example. Along with making the Section 179 limit permanent, the bill would protect S Corporations from extended periods of punitively high taxes as a result of tax status conversion or asset acquisition. In addition, making bonus depreciation permanent as well as the 15-year straight-line depreciation for certain improvements would send helpful signals to businesses considering investments in new equipment and jobs.

Allowing taxpayers to account for inflation when calculating the gain on the sale of an asset would likewise be a boon to small businesses. Such an option has received far too little attention and discussion in tax policymaking bodies up to this point.

The Ways and Means Committee's tax reform draft from the 113<sup>th</sup> Congress made several excellent strides toward reducing tax burdens on small businesses, but some elements of the plan deserve reevaluation and caution going forward. For instance, the Section 199 deduction for manufacturers would wind down from 9 percent (6 percent for oil and gas) in 2014 to 3 percent for all industries in 2016. At that point the top corporate income tax rate would still be 31 percent. By 2017, the deduction would have been eliminated, yet the rate would have been set at 29 percent. The lower, 25 percent corporate tax rate would not take effect until 2019, which means many businesses could experience substantial tax increases during the phase-in period.

Furthermore, as Raymond Keating, Chief Economist for the Small Business and Entrepreneurship Council noted, Section 179 expensing would have reverted to parameters in place during 2008-2009 (a limit half as large as was put in place retroactively for 2014). In Keating's estimation, "depending on one's perspective, either no real headway would be made on the expensing front, or ground would actually be lost."

One definite area of "lost ground" in the draft would be the end of the so-called "last in, first out" (LIFO) method of accounting, which over one-third of companies large and small have employed. While some may view this move as simplification, in practice it would require massive restructuring of business models, especially those depending on large inventories. Owners of smaller firms rightfully expressed concern that they could be hurt as well.

Still, one of the most pressing issues with the Ways and Means draft concerns parity between "C" corporations and pass-through entities. The latter businesses, paying taxes on the individual schedule, would be subject to a top marginal rate of 35 percent, which is higher than the proposed corporate rate of 25 percent. This potential problem is ameliorated by exempting "qualified domestic manufacturing income" – a very broadly defined concept in the draft – from the 35 percent rate, but the implementation of the change could still disadvantage several classes of small businesses.

All of these matters must be carefully weighed as the 114<sup>th</sup> Congress seeks to improve upon the good work of its predecessor.

## **2) Keep Administrability in Mind.**

The need to reduce compliance costs in the tax system is a paramount concern for small businesses. Yet, where should Congress focus its attention? An examination by Donald DeLuca, et al., published in 2005 by the IRS's Statistics of Income Division, provides some useful guidance, even though the tax laws have changed since then.

In the study, "Measuring the Tax Compliance Burden of Small Business," DeLuca and his colleagues identified "special characteristics" that increased the time and money small businesses spent in preparing income and employment tax documents. The following factors produced the most acute effects:

- Used the accrual accounting method
- Had foreign operations
- Filed returns in multiple states
- Kept records in case of Alternative Minimum Tax (AMT) liabilities
- Completed an end-of-year inventory to comply with tax rules

- Put depreciable assets into service
- Maintained a business mileage log

As far as employment taxes were concerned, these areas, though not as impactful as income taxes, still added to the compliance load relative to the entire sample of businesses:

- Filed returns in multiple states
- Managed tip income
- Declared compensation subject to special tax rules
- Had employees with the Advance Earned Income Credit
- Had special withholding situations, such as nonresident aliens

Among these, having foreign operations presented the most headaches, by boosting time burdens an average of 739 percent and costs by an average of 1,132 percent above overall baselines. Accrual accounting and AMT issues were also among the most serious obstacles for businesses seeking to minimize compliance headaches.

There is very little Congress can do to ease the pain of having to file tax returns in multiple states. Nonetheless, many opportunities for small-business-oriented tax reform present themselves as a consequence of these findings. The Quantria study mentioned previously is also instructive in showing that among industries, small businesses of various forms of incorporation working in transportation, warehousing, mining, and agriculture all cope with much higher-than-average filing burdens.

First, Congress must make progress in streamlining the reporting and recordkeeping rules for small businesses engaged in international activities, over and above any reforms that attempt to move the tax system from the current “worldwide” model to a “territorial” one. (See the previous section on uncertainty regarding the mountain of paperwork small businesses with activities abroad confront.)

Second, Congress must resist attempts to require accrual-based accounting for a greater portion of the small business community. This is an issue the Committee has explored in-depth. Last year Randy McIntyre, a partner at a Wilmington, North Carolina-based accounting firm, explained why a plan in Congress that expanded the availability of cash accounting to some businesses while denying it to personal service businesses could use retooling:

Such a law would result in catastrophic financial and compliance burdens for those service businesses. This would force these businesses to pay taxes on accounts receivable, which has been called “phantom income,” before they actually collect it. This tax on accounts receivable would be partially offset by the fact that the taxpayer should be able to deduct accounts payable – bills the business owes but hasn’t yet paid. The problem is that for a profitable business, receivables are normally much higher than payables. Many businesses may have to borrow money to pay the taxes on receivables that they may not collect until sometime down the road, if ever. Any business owners who have tried to borrow money from a bank recently know how difficult this process is.

Third, Congress must make expensing, depreciation, and investment rules as simple as possible. Although steps such as bonus depreciation and higher Section 179 limits can aid small businesses, ultimately a better solution would be to allow for full expensing for firms of all sizes. Economic efficiency and non-discrimination among industries are two primary reasons for moving to such an arrangement. As the Tax Foundation’s Stephen Entin has noted, the deductive value for tax purposes of a \$1 investment can shrink to as little as 37 cents due to the current laws. In a 2015 paper arguing for full

expensing, Mercatus Center scholars Jason Fichtner and Adam Michel cite many persuasive sources, and point out that simplification would also be one of the biggest dividends:

To the extent that expensing might simplify the tax code, there are also great benefits to simplifying the tax code by lessening administrative costs. ... Nobel laureate and economics professor Vernon L. Smith notes in a paper titled “Tax Depreciation Policy and Investment Theory” that “perhaps the most valuable advantage of fully expensing capital outlays is that of introducing administrative and clerical simplicity where there has tended to exist great complication.” In an article in *Harvard Business Review*, Allen Auerbach and Dale Jorgenson comment on the efficiency gains from removing the administrative burden of depreciation. They note that businesses could eliminate entire sections of their tax accounting staff if they were no longer required to factor tax depreciation into yearly tax liability reporting and long-run investment decisions.

Fourth, although Congress has commendably embedded income-based protections from the AMT in permanent law, the tax will still continue to affect several million filers directly each year. Millions more will suffer even though they don't owe the AMT, because they will be forced to compile mounds of paperwork to ensure they are staying on the “right side” of the tax and its exemptions. Repealing the AMT in its entirety would be a wise decision.

Finally, lawmakers should remember that payroll tax rules, though not as big a consideration as income taxes, should still be subject to the same types of simplification efforts.

### **3) Make Tax Simplification Systematic ... and Automatic.**

NTU's Senior Counselor David Keating, who as our Executive Vice President at the time served on the National Commission on Restructuring the IRS, has on many occasions pointed out the lack of a process that would make tax simplification a habit rather than a rare activity for Congress. The IRS Restructuring and Reform Act of 1998, which was based on many Commission findings, nominally required a tax complexity analysis to at least be considered with revenue-related legislation. NTU believes that the tax-writing committees should be *required* to quantify and prominently publish the burdens of *all* proposals that add complexity or the savings from proposals that simplify the law.

But left on the proverbial cutting-room floor in 1998 was a much more powerful reform with great potential to keep the tax system in a trim condition: a quadrennial simplification process, implemented through legislation, which would evaluate all sections of the Internal Revenue Code with an eye toward simplification. The process could be extended to regulations as well. In 2014 Keating wrote in an NTU Policy Paper, “A Taxing Trend”:

The Commission [on Restructuring the IRS] found that many members of the private sector tax community were willing to volunteer substantial time to make suggestions for simplification.

A quadrennial simplification commission would do a more thorough job of harnessing volunteer activity and give a broad group of people on the inside and outside of government more incentive to work for the adoption of simplification rules. This quadrennial commission would also give the JCT [Joint Committee on Taxation] and the Treasury Department more incentive to suggest simplification of the law.

It is true that since 1998, the quantity of information and input on tax complexity from agencies and volunteer has improved. In 2002 the Treasury established Taxpayer Advocacy Panels (TAPs) with volunteers from all 50 states, the District of Columbia, and Puerto Rico who “are dedicated to helping taxpayers improve IRS customer service and responsiveness to taxpayer needs.” In our experience, TAPs

have provided valuable suggestions at the most granular level that could, if fully adopted by the IRS and Congress, make the taxpaying experience of all Americans (including small businesses) less troublesome. Among the 42 projects and 148 recommendations contained in TAP's most recently released annual report was detailed guidance to improve the quality of the IRS's Small Business Taxes Virtual Workshop.

The IRS National Taxpayer Advocate has also provided excellent suggestions that would better safeguard taxpayer rights and streamline administration procedures. Unfortunately, progress in getting the IRS and Congress to act on TAP and Taxpayer Advocate recommendations has been uneven.

To underscore this point, NTU reviewed the last three years of the Advocate's "report cards" on implementation of the recommendations contained in her Annual Reports to Congress. Although many of these suggestions are broad-based in that they would benefit all taxpayers, we could identify more than half a dozen key "Most Serious Problems" (MSPs) specifically pertaining to or citing small businesses, each of which contained multiple parts.

The results were not always encouraging. For instance, MSP Topic #12 from the 2013 report card noted that "IRS Collection Procedures Harm Business Taxpayers and Contribute to Substantial Amounts of Lost Revenue." This is primarily because the IRS has shunned a "proactive service-oriented approach" that would involve employees capable of quickly resolving trust fund tax delinquencies, in favor of throwing cases into the Automated Collection System. The Advocate outlined five specific steps the IRS could take to make a transition to the service-oriented approach, *none* of which the agency adopted.

The Advocate's 2012 report card examined the IRS's response to MSP Topic #20, the "Diminishing Role of the Revenue Officer," explaining that "particularly with tax debts involving small business taxpayers, the Revenue Officer's skill set should be used as critical to case resolutions that are in the best interests of the taxpayers and the United States." Once more, the Advocate made five specific suggestions involving such upgrades as allowing Revenue Officers to recommend acceptance of Offers in Compromise. Four of those suggestions had been ignored or rejected, and one had been partially adopted.

It is readily apparent that even with the introduction of a quadrennial simplification process on top of advisory tools such as TAPs and the Taxpayer Advocate reports, mechanisms need to be developed for timely consideration and implementation of reforms. The quadrennial simplification findings, for example, should require evaluation by tax-writing committees and an expedited vote process in Congress. TAP and Taxpayer Advocate guidance should be more closely monitored by Congress and, where warranted, built more fully into IRS appropriations bills as policy guidance.

#### **4) Measure Tax Compliance Burdens More Accurately.**

While attempts to assess the impact of U.S. tax compliance burdens on the private sector date back at least 70 years, the estimates of these deadweight losses have varied widely. In a 1984 review of literature for *National Tax Journal*, economists Joel Slemrod and Nikki Sorum found that most of these studies, focusing narrowly on completing individual tax returns, put the burden at the equivalent of between 1 and 3 percent of total income tax collections. Other studies based on public survey-techniques and wider definitions of compliance (including one by Slemrod and Sorum) ranged from 7 to 11.5 percent.

For its part the IRS considered the only measurable tax compliance burden to be associated with filling out the tax form, until the Paperwork Reduction Act prompted the tax agency to commission a study by Arthur D. Little in 1983. This analysis utilized advanced questionnaires of actual business and individual taxpayers in the IRS's database, and developed solid data on tax compliance, measured in hours. Subsequent models by Slemrod (with colleagues), the Tax Foundation, Donald DeLuca, and the study by Quantria Strategies for the Small Business Administration (mentioned earlier) have all improved

upon the Little approach, by refining survey techniques, monetizing the value of time spent completing returns, and aggregating data for business structure, size, and industry.

Yet, the need to constantly refine these methodologies remains vital. For example, however sophisticated the techniques may be for surveying taxpayers in developing time-to-completion estimates for forms, inaccuracies in self-reporting are a constant challenge. In his 1993 book, *Costly Returns: The Burdens of the U.S. Tax System*, Professor James L. Payne explains the potential “tendency to overlook many types of tax compliance activities when they take place in small, undramatic ways” with the following illustration:

Take the case of the free-lance writer and his postage receipts. It is most unlikely that he will recall and report the time spent asking for a receipt, since it involves an almost negligible ten seconds, let us say. Nor would he recall [the] time it took to go to his filing cabinet, take out the receipt, and put it in the correct folder, which might be another ten seconds. But these small activities add up. If this writer asks for and files 100 receipts a year, he has spent over half an hour on just this activity.

Though such an analogy today would likely apply to activities such as hitting the “send” button on emails, or downloading and archiving receipts electronically, the basic point is the same.

Payne also noted how other discrepancies in the Little study (sometimes applicable to its successors) could lead to underestimated compliance burdens. Respondents were told to not report recordkeeping hours for financial profit and loss statements, though many small business owners told researchers that a primary reason for preparing such information was for tax compliance. Even the act of learning about tax-law requirements isn’t always confined to studying IRS instructions prior to filing a form; numerous additional hours are spent in classrooms, or in personal discussions among professionals and laypeople alike.

Moreover, attempting to estimate the nebulous concept of “tax planning” is difficult. Accounting for an hour of time with a financial consultant seems straightforward, but what about the time stuck in traffic from the consultant’s office that caused a business owner to miss his meeting with a potential client? Or the magazine article on tax tips a business read in the airport, instead of time that could have been spent on another article regarding a new product promising to double her manufacturing productivity? Given these sorts of questions, the current time-burden estimates for a 1040 “business” filer – just 3 hours for tax planning as one example – seem quite low.

In another representation of how variable the projections of tax-system losses are, Payne estimated that for every additional dollar of revenue the government attempted to raise, compliance, enforcement, avoidance, and productivity disincentive costs rose by 65 cents. But such variability should only embolden lawmakers to seek more data.

The Committee should recommend that the IRS, in cooperation with SBA and other relevant agencies and private-sector experts, routinely undertake new research initiatives to measure the true burden of the current tax system on small businesses. This basic information is key to identifying problem areas and developing fitting legislative solutions.

##### **5) Don’t Overlook Other Tax Concerns of Small Businesses.**

One of the previous recommendations that mentioned payroll taxes raises a salient point about the topics that the Committee is exploring: small businesses face tax concerns of many types and at many levels.

It is worth briefly reminding ourselves, for example, that state tax systems can present small firms with all manner of compliance difficulties. The most recent example was brought to our attention through the Mackinac Center's *Michigan Capitol Confidential* newsletter. Senior Investigative Analyst Anne Schieber recounted the technical difficulties experienced by small businesses forced to use Michigan's new "Systems, Applications, and Products" (SAP) online portal for processing sales, use, and payroll taxes. Some users reported that the SAP registration process alone consumed hours, if not days, of time. Others complained of being unable to obtain timely assistance from state tax officials when they encountered payment problems.

As I noted earlier, there is a little that Congress can do to address these difficulties. However, federal lawmakers do have a role in interstate tax policy that could provide major relief and clarification for small businesses. Your colleagues on the House Judiciary Committee have recently been discussing issues surrounding taxable nexus in commerce that transcends state borders. In part due to the rise of the Internet and the integration of telecommunication technologies, states have been increasingly defining concepts of "physical presence" for tax purposes differently, leading to a confusing situation for businesses forced to contend with a patchwork of rules.

Additionally, for several years now legislation has been proposed that would permit states to require businesses to collect taxes on "remote sales" involving out-of-state buyers. In our opinion these schemes would, besides tearing down constitutional protections against predatory taxation and requiring complex reporting and remitting, subject businesses to the auditing and enforcement arms of other states on a massive scale. The so-called "small sellers" exemption built into this legislation is paltry and would provide little comfort to many catalog and online retailers that do not consider themselves to be large businesses. NTU believes Congress should not give its blessing to this concept, and should consider alternatives. One avenue to pursue would be "origin sourcing," whereby any business engaged in retail activity (online or "brick-and-mortar") would remit taxes on all sales to the jurisdiction in which the business is physically located.

Many legislative plans have been introduced in the previous and the current Congress to address other facets of taxable nexus and interstate tax matters. These include:

- The Business Activity Tax Simplification Act, which would establish a clear physical presence test to ensure that only businesses having employees or property physically present within a given jurisdiction are subject to those taxes.
- The Digital Goods and Services Tax Fairness Act, which would prevent multiple and discriminatory state and local taxes on items such as downloaded entertainment and mobile applications.
- The Multi-State Worker Tax Fairness Act and the Mobile Workforce State Income Tax Simplification Act, which would better define withholding and tax payment requirements for commuter-employees as well as workers traveling to states in which they do not permanently reside.
- The Permanent Internet Tax Freedom Act, which would forbid states and localities from imposing new discriminatory taxes on Internet access – a vital tool upon which small businesses depend.
- The Tax and Fee Collection Fairness Act, which would require that a "transactional nexus" exist between a buyer and seller before a state government could require the seller to collect taxes.

Virtually all of the items in the list above would have the salutary effect of reducing compliance and administrability problems that are becoming increasingly nettlesome.

#### 6) Time for a New Small Business Taxpayer Bill of Rights.

As this testimony has recounted, small businesses have suffered more than their share of woes from flawed administration of the federal tax system. Without constant attention to the problems small businesses encounter in defending their rights as taxpayers, other attempts at simplification and economic efficiency will be incomplete and ineffective.

Some proposed upgrades to the 1998 reforms would affect all taxpayers, but could be especially potent for small businesses. Perhaps the most ambitious of these would more fully unlock the courts as a means of preventative redress of grievances. Although the 1988 and 1998 taxpayer rights laws provided for certain exceptions, taxpayers still generally cannot enforce their rights in court until after they have been violated. Under Section 7421 of the Internal Revenue Code, no lawsuit can be brought by any person in any court for the purpose of restraining the assessment or collection of a tax, except under limited circumstances.

The case law around the Anti-Injunction Act further impedes the ability to restrain the collection of the tax. Injunctions can be granted where the failure to grant relief would result in irreparable damage to the taxpayer. But an injunction will only be allowed where it is clear that under no circumstances would the government prevail (or the taxpayer would not owe the tax). Otherwise only two remedies are available to the taxpayer: 1) Pay the tax, file a claim for refund, and sue for recovery if the claim is rejected; or 2) File a petition in Tax Court before assessment and within the short period of time allowed.

Moreover, the Declaratory Relief Act, which allows citizens to file a suit that can persuade a court to declare their rights, indicates that the law applies "except with respect to federal taxes." The Federal Tort Claims Act presents additional barriers to tax-related controversies.

NTU's David Keating has referred to these provisions as "the Berlin Wall Stopping Taxpayer Rights." The real Berlin Wall fell some 25 years ago; the one keeping taxpayers from court remains standing. Congress should give serious consideration to providing citizens with the limited ability to stop the IRS from violating their rights through litigation. Doing so will involve some level of controversy, and will no doubt prompt lengthy deliberation. Yet we remain convinced that small businesses would be especially well-served by such reforms. How could such a change be effected? A passage from NTU testimony before Congress in 1995 indicates a solid starting point, by amending the Anti-Injunction Act:

Taxpayers should be allowed to file suit in a federal district court to enjoin the IRS from enforcement action because: the deficiency assessment was made without knowledge of the taxpayer and without benefit of the appeal procedures provided by law; there has been an improper or illegal assessment; there has been an action in violation of the law or tax laws or regulations providing for procedural safeguards for taxpayers; the IRS has made an unlawful determination that collection of the tax was in jeopardy; the value of seized property is out of proportion to the amount of the liability if other collection remedies are available; or the IRS will not release the seized property upon an offer of payment of the U.S. interest in the property.

While Congress contemplates sweeping changes in this area of law, additional progress can be made for small businesses elsewhere. Seventeen years after the IRS Restructuring and Reform Act's passage, Congress has amassed a considerable body of experience and advice on potential improvements from sources such as the National Taxpayer Advocate, professional practitioners, and small businesses themselves. Future tax administration maladies could be prevented by enacting reforms like these:

- Creating an Alternative Dispute Resolution program for audits that will permit neutral third-party mediation in a cost-effective manner. Meanwhile, small case procedures and access to installment

agreements without fees should both be expanded, thereby providing taxpayers with more low-cost options for solving tax problems.

- Strengthening safeguards against taxpayer abuses, such as a ban on ex parte communications between IRS case employees and appeals officers, and a prohibition on new issues being raised during a taxpayer's appeal process.
- Providing more avenues for redress when the IRS recklessly or intentionally disregards the law, including increases in the cap on damages and more options to recover attorney fees.
- Delivering additional opportunities for spousal relief, such as more time for filing petitions and clarifying that Tax Courts must follow applicable appellate procedures when reviewing such petitions. For over two decades NTU has sought more equitable tax treatment for "innocent spouses" (usually divorced) who are wrongfully being pursued as "responsible and willful" parties to tax controversies involving the other spouse. Divorced spouses must often reconfigure their professional as well as their personal lives, and doing so can mean becoming self-employed. Making updates to this area of law would help many people in such a situation to remain on a sound financial footing.

These types of changes are thoughtfully incorporated in legislation known as the Small Business Taxpayer Bill of Rights, slated for introduction in this Congress today by Senator Cornyn. Some sections of the bill will overlap with the taxpayer rights legislation that the House is slated to vote on today as well. It is critical for Members of Congress to follow up these votes with the legislative energy necessary to get reforms to the President's desk as quickly as possible. The Small Business Taxpayer Bill of Rights has been introduced in previous Congresses; its many valuable protections should not languish for another two years.

### **Conclusion: Ensuring that Main Street Isn't Left Behind Means Ensuring Taxes Don't Crush the Entrepreneurial Spirit**

My singular hope in presenting this testimony is that Members of the Committee will think beyond the distributional tables, econometric analyses, JCT scores, and other dry topics that so often characterize discussions of tax policy. Rather, I urge you to consider the impact of tax laws *and their administration* on the very human quality that has animated our country since its founding: the entrepreneurial spirit of the small business owner.

That spirit, which makes our society more prosperous, offers more opportunities to disadvantaged constituencies, and delivers innovations that improve lives around the world, is a quality that can be nurtured for generations to come. But a bright future depends upon the willingness of tax administrators and Members of Congress to work together, in a bipartisan fashion, to strengthen the totality of the tax system ... so that it not only allows small businesspeople to pursue their dreams but also respects their rights as they do so. Please consider NTU to be your partner in this crucial undertaking.

I thank all of you for bearing with these lengthy remarks, and NTU stands ready to answer your questions or assist in any other way with your deliberations.

**TESTIMONY BEFORE THE COMMITTEE ON SMALL  
BUSINESS**

**UNITED STATES HOUSE OF REPRESENTATIVES**

**Hearing On:**

***Tax Reform: Ensuring that Main Street Isn't Left Behind***

**Dan McGregor, Chairman, McGregor Metalworking  
Companies**

**April 15, 2015**

Background

Thank you Mr. Chairman, I appreciate the opportunity to testify today on these important topics. My name is Dan McGregor and I am the Chairman of McGregor Metalworking Companies (MCGREGOR) and a board member of the S Corporation Association.

My family business began in 1965 as an investment with my father and 3 brothers. We purchased an 8 man tool and die shop in Springfield, Ohio. Since then, we gradually expanded to a total of four businesses in Springfield and another located in Aiken, South Carolina, employing a total of 375 workers spread across both states. These are good paying manufacturing jobs, with health insurance and retirement plans, in areas that need employment opportunities.

MCGREGOR is primarily engaged in contract manufacturing in the metalworking industry. We perform a wide variety of services such as metal stamping, spinning, welding, machining and assembly for customers in industries including locomotive, auto, agricultural, and law and garden companies. Our customers include General Electric, Honda, John Deere and many others.

We look at our taxes as another cost in a highly competitive, low-margin business. Almost all of our customers ask us for price decreases each year ranging from 1 to 3 percent. Contract manufacturing is under heavy competitive pressure from global and internal competition within our customer base.

Importance of the S Corporation to Family Businesses

From the beginning, MCGREGOR has been a family owned and run business. Our current shareholders are McGregor family members of the second and third generation. A central component of the success of our business has been our S corporation status.

When McGregor Metalworking was a C corporation, we paid out few dividends to our shareholders abiding by the minimum dividend payout rules. Growing the business was our objective and paying double taxation did not fit with our entrepreneurial spirit. This situation is often referred to as the “double tax” since the same business income is taxed twice. The prevalence of the double tax leading to minimization of dividends to shareholders causes family C-Corporation shareholders not active in the business to become less interested in the success of the business. This is not a healthy situation for closely held businesses being passed on to the next generation.

In 1986, anticipating Congressional action to overhaul the tax code, we converted to S corporation status. At the time, we thought that the opportunity to be taxed as a “pass-through” to eliminate the double corporate tax would allow us to reinvigorate our company and our shareholders. Sure enough, after nearly 30 years as an S corporation, I am positive there is no better way to organize a family business like my own.

So much has been written about the erosion of the corporate tax base in recent years that an essential reality has been lost—the business tax base is larger today than it was prior to 1986 tax reforms. It is true the corporate base has declined since 1986, but the growth of the pass through business sector has made up for it and more.

According to the Tax Foundation, when my company converted to an S corporation in 1986, pass-through businesses contributed only 1 percent to our GDP. Today, pass-through businesses make up 6 percent of U.S. income. As a result, the business tax base—combining corporate and pass through businesses—has expanded from 9 percent to 11 percent of our national income. The United States today is more entrepreneurial because of the 1986 tax reforms and the growth of the pass through business sector.

#### S Corporation Taxation & the Fiscal Cliff

There is much confusion about how S corporations are taxed. We pay tax on all our business income when it is earned and regardless of how much is distributed to our shareholders.

Since the tax is paid at the shareholder level, we make sure to distribute every quarter enough earnings for shareholders to pay their tax estimate. And since S corporations are allowed only one class of stock, those distributions must be equal to the highest marginal rate faced by any of my shareholders.

Prior to the fiscal cliff resolution, the top federal marginal rate was 35 percent and the business as a whole had a tax rate of about 33.3 percent taking into account federal deductions for section 199 and the R&E tax credit as well as state and local taxes. That meant that every quarter we would distribute at least 34 cents of every dollars we earned to pay the S corporation’s taxes.

Following the resolution of the fiscal cliff, the top tax rate on my shareholders increased to approximately 41.4 percent due to the higher 39.6 percent marginal rate plus, where applicable, the new

3.8 percent Affordable Care Act tax and the effect of the reinstatement of the Pease limitation on itemized deductions. As a result, today we have to distribute approximately 42 cents of every dollar earned so our shareholders can pay the federal, state and local S corporation tax.

This sharp increase has hurt our ability to compete, grow, and create jobs. Think about it this way—we are in a capital intensive business and have two sources of capital: what we can borrow from the bank and what we retain from our earnings. Unlike a large multinational, we simply do not have access to the public capital markets.

During the “big recession” of 2008 and 2009 our bank added two covenants to our loans: First, a **debt service coverage ratio** where free cash flow must cover bank payments by a multiple of 1.25 and, second, a cap on our **total debt to equity** not to exceed a multiple of two. In order for our companies survive and grow, we need retained earnings, but right now they are being depleted by our tax burden.

Prior to the fiscal cliff, we were able to retain up to 66 cents of every dollar we earned. Those retained earnings formed the core of our working and investment capital and over the years we used them to grow the business from 8 workers to 375. After the fiscal cliff, we have the option to retain only 58 cents of a dollar of earnings, depending on our annual budget and capital needs.

I use a rough estimate that it takes between \$30,000 and \$40,000 of after-tax earnings coupled with prudent bank debt to create the investment that will justify a new hire. Having MCGREGOR’s effective tax rate rise from 34 to 42 percent means lots of lost job opportunities.

### Tax Reform

I understand Congress is struggling with the challenge of reforming the tax code and making our approach to taxing business income more competitive. Part of this discussion is the need to reduce the tax rate imposed on C corporations. It’s hard to compete against foreign companies when you are paying significantly higher levels of tax. I am sympathetic to these concerns and I know that the S Corporation Association has been supportive of cutting the corporate rate to something more in line with the rest of the world.

But the same arguments that support cutting the corporate rate also apply to pass through businesses like my own. We face the same competitive pressures as C corporations, and we currently pay a higher tax rate than both the company headquartered overseas *and* the C corporation down the street.

Tax reform that broadened the tax base while reducing the tax rate on C corporations only would increase this disparity. Under the worst case scenario where MCGREGOR loses LIFO, the R&E tax credit, and the Section 199 deduction, I estimate our effective tax rate would rise from 42 to in excess of 46 percent. No amount of expensing or other band aide provisions would offset this hit.

A 2011 study by Ernst & Young reinforced this point. They found that corporate-only reform would raise taxes on my company and others like it by 8 percent per year or \$27 billion overall—and that does not include the effects of the 2013 fiscal cliff tax hike.

This recent history illustrates why the proposals for “corporate-only” tax reform are so troubling to me and other owners of pass-through businesses. Rather than provide needed rate relief to all businesses, corporate reform would reduce rates on C corporations only, increasing the differential between C and S corporation top rates from the current five to ten percentage points up to fifteen percentage points and more. It would return the tax code to pre-1986, when nearly all businesses were C corporations and tax considerations played a measurably negative role in their governance.

It also would leave S corporation owners with two equally painful choices. We could remain an S corporation and attempt to compete against domestic and foreign companies while paying significantly higher tax rates. Or we could convert back to C status to access the lower rate and, like most C corporations, stop paying dividends to avoid the double tax.

This inability to share our company’s earnings among family members would strike at the very heart of our identity as a family-owned business. Why own a private business if you are unable to share in its success? Under such circumstances, selling the business to a public corporation with no need to pay dividends and a ready market for its stock would become increasingly attractive. It would also mean that the business decisions affecting 375 workers in Springfield would now be made in a corporate boardroom someplace else.

As an alternative to corporate-only tax reform, the S Corporation Association and other allied trade groups have advocated for three key principles to be adopted in any tax reform effort:

1. Tax reform should be simplified, comprehensive and improve the tax treatment of individuals, pass through businesses and corporations alike;
2. Tax reform should seek to restore rate parity for the top rates paid by individuals, pass through businesses and corporations; and
3. Tax reform should seek to reduce or eliminate the double tax paid by C corporations.

These principles are articulated in a letter attached to the back of my testimony and supported by over 100 business groups, including the National Federation of Independent Business, the Precision Metalforming Association, the American Farm Bureau, and the National Restaurant Association.

#### Other Tax Considerations

Let me briefly mention three other tax issues of importance to MCGREGOR.

First, as a manufacturer, MCGREGOR engages in a significant level of research and development, and we therefore take advan-

tage of the R&E tax credit. The usefulness of the credit is limited, however, by the Alternative Minimum Tax (AMT). When the advantages and disadvantages of the pass through business structure are discussed, the role of the AMT rarely comes up, but it is significantly negative. Not only does the AMT raise the taxes of many of my shareholders, it also precludes them from benefiting from the R&E tax credit, thereby diluting the value of the credit to MCGREGOR. Allowing taxpayers paying the AMT to access the R&E tax credit would solve this problem. Getting rid of the AMT entirely would be even better.

Second, as a family owned business, succession and the estate tax are a constant challenge for MCGREGOR. The outcome of the fiscal cliff negotiations set the estate tax exemption to \$5 million and the marginal rate at 40 percent, but for a business the size of MCGREGOR, those levels mean we still have to deal with the effects of the estate tax as our shareholders grow older. Any family that grows their business beyond that exemption level must constantly made this tax part of their family business strategy. Often tax strategy is contrary to the best interests of the business and the family members. Transition of ownership in privately held businesses is never easy and the estate tax is often the death knell of family business continuance.

Finally, there are a number of smaller tax items improving the governance of S corporations that should be enacted and/or made permanent, including the shorter recognition period for built-in gains and leveling the tax treatment of charitable donations of S corporation stock. These provisions have been championed by Representatives Reichert (R-WA) and Kind (D-WI) for years and have already passed the House this year.

### Conclusion

McGregor Metalworking has been proud to provide quality, high paying jobs to workers in Springfield for over 50 years. S corporations around the country do the same thing, employing one out of four private sector workers and contributing significantly to our national income. The reforms enacted in 1986 helped MCGREGOR and other S corporations thrive by allowing us to operate in a significantly superior business structure. Any reform considered by Congress should seek to strengthen and grow the pass through sector. With the tax reform principles I have laid out today, I am confident that MCGREGOR and other pass-through businesses will continue to drive job creation and economic growth in communities like Springfield for years to come.

Thank you for your time and I am happy to answer any of your questions or even better I invite you to come to Springfield to visit our plants and see the results of reinvestment by S Corporations.



## TAX REFORM AND SMALL BUSINESS

Eric J. Toder \*

Institute Fellow, Urban Institute and Co-Director, Urban-Brookings Tax Policy Center

House Committee on Small Business

April 15, 2015

Chairman Chabot, Ranking Member Velazquez, and Members of the Committee. Thank you for inviting me to appear today to discuss the effects of tax reform on small business.

There is a growing consensus that the current system of taxing business income needs reform and bi-partisan agreement on some of the main directions of reform, although not the details. The main drivers for reform are concerns with a corporate tax system that discourages investment in the United States, encourages U.S. multinational corporations to retain profits overseas, and places some US-based multinationals at a competitive disadvantage with foreign-based companies, while at the same time raising relatively little revenue, providing selected preferences to favored assets and industries, and allowing some US multinationals to pay very low tax rates by shifting reported profits to low tax countries.

- The United States has the highest corporate tax rate in the Organization of Economic Cooperation and Development (OECD). This discourages investment in the United States by both U.S. and foreign-based multinational corporations and encourages corporations to report income in other jurisdictions.

*\*The views expressed are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders. I thank Leonard Burman, Donald Marron, and George Plesko for helpful comments and Joseph Rosenberg and John Wieselthier for assistance with the Tax Policy Center simulations.*

- The U.S. rules for taxing multinational corporations encourage U.S. firms to earn and retain profits overseas and place some companies at a competitive disadvantage, encouraging them to engage in transactions (called inversions) that shift their corporate residence overseas.
- In spite of its high corporate tax rate, the U.S. tax system generates less corporate revenue as a share of GDP than the OECD average, partly due to more generous business tax preferences in the United States than elsewhere, but also due to the relatively high share of U.S. business income that is not subject to the corporate income tax.

In response to these concerns, proposals for corporate tax reform by both former House Ways and Means Chairman Dave Camp and President Obama include the following elements:

- reduce the top federal corporate income tax rate (from 35 percent to 25 percent in the Camp proposal, and to 28 percent in President Obama's corporate reform framework);
- pay for the lower corporate income tax rate in part or in whole by eliminating or scaling back tax preferences for business income; and
- reform international taxation rules. The international tax reform proposals by Camp and Obama differ greatly in detail, but both include three major building blocks: 1) elimination of taxation of repatriated profits by U.S. multinationals, 2) a low-rate lump sum transition tax on past accrued foreign profits, payable over a number of years, and 3) going forward, a minimum or low rate tax on foreign profits in excess of a normal return on tangible assets.

While a main goal of business tax reform is to fix our broken corporate income tax, the base-broadening proposals needed to pay for a lower corporate rate will affect all businesses, whether organized as taxable corporations under sub-chapter C (C corporations) or as so called-flow through entities, such as partnerships and corporations taxed as pass-through entities under subchapter S of the Internal Revenue Code (S corporations). Most small businesses are organized as pass-through entities. These firms pay no corporate income tax, instead reporting their income annually to their partners and shareholders for inclusion in their taxable income under the individual income tax. Most sole proprietors also pay individual income tax on their business income. As a result, a combination of a lower corporate tax rate and reduced business tax preferences will raise taxes on partnerships, S corporations, and sole proprietors unless offset by other measures. Many of the companies potentially subject to higher taxes on their profits are small businesses, defined in terms of their asset size, their gross receipts, or their number of employees.

This potential for tax reform to raise taxes on flow-through businesses is a major hurdle that proponents of corporate tax reform need to confront. In this testimony, I discuss the extent of problems this may create for small businesses and comment briefly on possible ways of addressing it. I will first present some background data on the relation between tax changes on pass-throughs and small businesses and then make some comments about the implications of tax reform for small businesses. I make the following points:

- A large and growing number of U.S. businesses are organized as pass-throughs. Most pass-through entities are small companies, but much of the net income and business receipts of pass-throughs comes from large and mid-sized businesses.
- Pass-throughs are taxed more favorably than C corporations on average, even though the top individual rate is slightly higher than the top corporate rate because pass-throughs face only one level of tax on their profits, while profits earned in C corporations are taxed at both the corporate and individual levels.
- The overwhelming majority of taxpayers with business income are not in the top two tax brackets. Most business income is received by taxpayers at the highest income levels, but this income is not necessarily from “small” businesses.
- Business tax reform proposals that reduce the corporate tax rate and eliminate tax preferences would reduce the current law benefit of operating as a pass-through. Both pass-through firms and C corporations would lose some of their tax preferences, but pass-throughs would not benefit from a lower corporate tax rate. They could choose to become C corporations in response to a reduced corporate rate, but then they would face two levels of tax if they chose to pay dividends to shareholders.
- Large pass-throughs would be affected much more than small pass-throughs by the elimination of business preferences, unless Section 179 expensing was also repealed. Retention or expansion of the high limits for Section 179 expensing in effect through the end of 2014 would help all small firms, including small closely-held firms that incorporate. Closely-held corporate firms can also minimize the impact of the corporate double tax by delaying taxable dividends they pay to their owner-employees.

I discuss each of these points in turn and then make some concluding remarks about options that might make business tax reform more favorable to small businesses.

#### **IMPORTANCE OF PASS-THROUGHS AS A FORM OF BUSINESS ORGANIZATION**

The share of businesses organized as pass-throughs and their share of business profits has been growing since the early 1980s (Plesko and Toder 2013). Factors driving this growth have been the narrowing of the differential between top individual and corporate rates (70 percent compared to 46 percent in 1980; 39.6 percent compared to 35 percent today) and the large growth in opportunities for firms to organize either as sub-chapter S corporations or as limited liability partnerships and still receive the benefits of limited liability that were at one time only available to firms subject to the corporate income tax.

In 2011, pass-throughs accounted for 95 percent of all business tax returns (table 1). Large corporations continue to be dominant in many economic sectors, but pass-throughs in 2011 accounted for almost 40 percent of business receipts. And, in 2008, the last year for which published data on taxable profits were available for C corporations, pass-throughs, including sole proprietorships, accounted for over 65 percent of net business profits (Altshuler, Shay, and Toder 2015).

In 2011, by far the largest share of business returns were filed by sole proprietors, who accounted for 72 percent of returns (table 1). Sole proprietors, however, accounted for only about 4 percent of business receipts, with the remaining coming from C corporations (62 percent), S corporations (20 percent), and partnerships (14 percent).



**TABLE 1. DISTRIBUTION OF RETURNS FILED AND BUSINESS RECEIPTS BY BUSINESS RETURN TYPE, 2011**

	Sub-C Corporations	Partnerships	Sub-S Corporations	Sole Proprietorships	Total
Number of returns (in millions of dollars)	1.7	1.3	4.2	23.4	32.5
Business receipts (in billions of dollars)	19.1	4.5	6.1	1.3	30.9
Share of returns	5.1%	10.1%	12.8%	72.0%	100.0%
Share of business receipts	61.8%	14.4%	19.7%	4.1%	100.0%

Source: Internal Revenue Service, *Statistics of Income*, at <http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Data-by-Size-of-Total-Assets>; <http://www.irs.gov/uac/SOI-Tax-Stats-Nonfarm-Sole-Proprietorship-Statistics>; <http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book-U.S.-Total-and-Sectors-Listing>.

Although the C corporate form is still the dominant form of organization for large corporations, much of the business activity in S corporations and partnerships also comes from large and mid-sized companies, not small businesses (table 2). Among partnerships and S corporations combined, in 2012, 56 percent of returns were filed by businesses with assets of \$100,000 or less, but these firms accounted for only 9 percent of business receipts and 12 percent of net profits in excess of net losses. At the other end of the spectrum, 31 percent of business receipts (35 percent of net profits) of partnerships and S corporations came from firms with \$100 million or more in assets and 55 percent of receipts and net profits came from firms with \$10 million or more in assets, yet they comprise only 0.3 percent (2.1 percent) of total returns.

**TPC** TABLE 2. DISTRIBUTION OF PARTNERSHIP AND S CORPORATION RETURNS, BUSINESS RECEIPTS, AND NET INCOME BY ASSET SIZE (IN PERCENT)

	\$100,000 or less	\$100,000 to \$1 million	\$1 million to \$10 million	\$10 million to \$100 million	\$100 million or more
<b>Partnerships</b>					
Returns	46.8	28.7	20.2	3.6	0.7
Business receipts	8.1	7.2	15.3	18.3	51.0
Net business income*	8.4	7.5	10.9	18.4	54.8
<b>SCorporations</b>					
Returns	63.5	28.4	7.1	0.9	0.1
Business receipts	9.7	19.5	27.4	27.1	16.3
Net business income*	15.5	19.9	24.5	21.3	18.8
<b>Partnerships plus SCorporations</b>					
Returns	56.1	28.6	12.9	2.1	0.3
Business receipts	9.0	14.3	22.3	23.4	30.9
Net business income*	12.3	14.3	18.4	20.0	35.0

\*Equals net profits for firms with positive profits minus net losses for firms with losses

Source: Internal Revenue Service, Statistics of Income, at <http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Data-by-Size-of-Total-Assets>; <http://www.irs.gov/uac/SOI-Tax-Stats-Nonfarm-Sole-Proprietorship-Statistics>; <http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book-U.S.-Total-and-Sectors-Listing>

#### FAVORABLE TAX TREATMENT OF PASS THROUGHS COMPARED WITH C CORPORATIONS

Owners of pass-through businesses are taxed more favorably than owners of C corporations because they pay only the individual income tax, while the profits of C corporation shareholders are taxed at the both the corporate level and again at the individual level when paid out as dividends or realized as capital gains. For example, compare a business owner in the top income bracket receiving \$1 million of net taxable profits from shares in an S corporation with a similar business owner in a C corporation with \$1 million of taxable profits. The S corporation owner would report \$1 million of business income and pay a tax of \$396,000 at the top rate of 39.6 percent. There would be no additional tax if the S corporation distributes to her some of the profits.

The C corporation would first pay tax at a 34 percent federal rate (the rate applicable to \$1 million of corporate income), leaving \$660,000 to be either retained and reinvested or distributed to

the shareholder in the form of a dividend or stock repurchase. If the corporation never pays a dividend and the shareholders holds the stock until death or donates the proceeds of stock sales to charity, there will be no individual income tax on the profits and the C shareholder will be slightly better off than the S corporation shareholder because the corporate rate is lower than the top individual rate. If, however, the shareholder receives personal access to the profits, either in the form of a dividend or a realization of capital gains attributable to reinvestment of the profits, then there will be a second level of tax. For a taxpayer in the top federal tax bracket for dividends and capital gains (now 23.8 percent, including the high income investment income surtax), if all after-tax profits were distributed, that second level of tax would be an additional \$157,080 (23.8% of \$650,000), leaving a net profit of \$502,920. This would amount to a total federal tax rate of 49.7 percent on distributed profits. If only some profits are distributed, the tax rate would be somewhere between 34 percent and 49.7 percent.

The unfavorable treatment of C corporation income relative to flow-through income has two adverse consequences. First, it discourages the use of the C corporate form, which might be preferable for firms seeking to go public and gain access to wider pools of capital. Second, it tilts the playing field against activity in sectors of the economy in which publicly-traded corporations organized as C corporations are more prevalent. One of the goals of many tax reform proposals in the past has been to eliminate the bias against corporate investment by eliminating the double taxation of corporate income (see, for example, U.S. Treasury Department 1992).<sup>1</sup>

Other characteristics of the tax landscape also affect the relative burdens imposed on small compared with large businesses. Tax compliance places a large burden on small business per dollar of receipts or profits, reflecting economics of scale in tax compliance (Contos et al, 2012). In the other direction, however, IRS finds lower compliance rates for small businesses, especially those that can deal in cash, than for large corporations (Internal Revenue Service, 2012). Small businesses also benefit from several special provisions of the tax code, including Section 179 expensing, the use of cash accounting methods, graduated corporate tax rates, and some special preferences for capital gains on small corporate stock. These costs and benefits are discussed in more detail in Marron (2014), Gale and Brown (2013), and Toder (2007).

#### **WHO RECEIVES INCOME FROM PASS-THROUGH BUSINESSES**

I now summarize data on who receives income from pass-through businesses. For this purpose, I define “business income” as income reported on Schedule C (income from business and self-employment), Schedule E (partnership income, S corporation income, and rental and royalty income), and Schedule F (farm income) on individual income tax returns.

<sup>1</sup> The double taxation of corporate income has other adverse consequences including the encouragement of debt over equity finance, because interest but not dividends are deductible, and an incentive for corporations to retain and re-invest profits instead of paying out dividends or buying back shares.

For tax year 2015, the Tax Policy Center estimates that slightly fewer than 22 percent of tax units (including non-filers) will report some form of business income or loss (see table 3a). These returns include many individuals whose primary source of income is earnings or investment income (interest, capital gains, and dividends) and who may receive only a small amount of additional income from self-employment or a passive investment in real estate. Tax units who receive more than 50 percent of their income from business amount to less than 7 percent of all tax units. Overall, business income is about 9 percent of adjusted gross income (AGI).

The share of returns with business income and business income as a percentage of AGI increase as income increases. Only slightly more than 2 percent of tax returns with AGI between \$30,000 and \$75,000 receive more than half their AGI from business income, while 22 percent of taxpayers with AGI between \$500,000 and \$1 million and 32 percent of taxpayers with AGI of \$1 million or over receive more than half their income from ownership of businesses. Business income as a share of AGI is less than 3 percent for taxpayers with incomes between \$30,000 and \$75,000 and almost 30 percent of AGI for taxpayers with income over \$1 million.

Most taxpayers reporting business income have relatively modest incomes, but most business income is earned by very high-income taxpayers (table 3b). Almost 80 percent of tax units with half or more of their AGI from business have total AGI less than \$75,000 (compared with 96 percent of all tax units), but almost 75 percent of business income goes to tax units with AGI over \$200,000 (compared with about 35 percent of all income).

**TPC** TABLE 3A. CHARACTERISTICS OF BUSINESS INCOME BY INCOME GROUP, 2015

AGI group in \$ thousands	Share of Returns with Business Income	Share of Returns with Business Income Greater than 50% of AGI	Business income as percentage of AGI	Average AGI (dollars)	Average business income (dollars)
Less than 30	14.4%	7.3%	8.7%	10,978	955
30-75	20.1%	2.4%	2.7%	48,832	1,321
75-200	34.2%	3.7%	3.6%	115,057	4,119
200-500	53.1%	9.2%	9.7%	285,472	27,772
500-1,000	70.6%	21.8%	21.4%	686,107	146,813
1,000 and over	83.1%	32.4%	28.7%	3,174,553	911,996
All returns	21.6%	6.7%	9.0%	59,197	5,397

Source: Tax Policy Center simulations, unpublished, April 2015.

**TPC** TABLE 3B. DISTRIBUTION OF RETURNS WITH BUSINESS INCOME, 2015

AGI group in \$ thousands	Distribution of Returns	Distribution of Returns with Business Income	Distribution of Returns with Business income greater than 50 percent of AGI	Distribution of AGI	Distribution of Business Income
Less than 30	51.1%	34.8%	67.6%	9.2%	8.4%
30-75	26.9%	25.5%	11.7%	21.5%	6.1%
75-200	18.3%	29.6%	12.2%	34.6%	12.9%
200-500	2.9%	7.3%	4.9%	13.7%	13.9%
500-1,000	0.5%	1.6%	1.9%	5.3%	11.8%
1,000 and over	0.3%	1.2%	1.8%	15.7%	47.0%

Source: Tax Policy Center simulations, unpublished, April 2015.

Tax reforms that reduce both the top individual rate and the top business tax rate would lower the tax applied to most business income, but would not benefit most of the taxpayers who receive over half their income from business sources because 92 percent of them are currently in the 25 percent bracket or less while another 5 percent face a marginal tax rate of 26 or 28 percent under either the regular income tax or the individual alternative minimum tax (table 4). In contrast, the small percentage of returns currently facing the top individual marginal income tax rate of 39.6 percent accounts for 62 percent of business income reported on individual income tax returns.

**TPC** TABLE 4. DISTRIBUTION OF RETURNS WITH BUSINESS INCOME BY MARGINAL TAX RATE BRACKET, 2015

Marginal tax rate	Distribution of all returns	Distribution of returns with business income	Distribution of returns with business income greater than 50% of AGI	Distribution of AGI	Distribution of business income
25 percent or less	94.6%	87.9%	91.8%	61.2%	18.9%
26 or 28 percent*	4.6%	9.5%	4.8%	20.4%	16.1%
33 or 35 percent	0.3%	0.7%	0.8%	1.7%	3.2%
39.6 percent	0.5%	1.9%	2.6%	16.7%	61.7%

\*Includes taxpayers on individual alternative minimum tax.

Source: Tax Policy Center simulations, unpublished, April 2015.

**TPC** TABLE 5. REVENUE LOSSES FROM MAJOR CORPORATE TAX EXPENDITURES THAT ARE ALSO CLAIMED BY PASS-THROUGH BUSINESSES, 2015-24 (IN BILLIONS OF DOLLARS)

Tax Expenditure Line Item	Corporate revenue loss	Individual revenue loss	Total revenue loss	Individual share of cost (%)
Accelerated depreciation of machinery and equipment	194.8	112.0	306.8	36.5%
Deduction for US production activities	140.1	38.7	178.7	21.6%
Accelerated depreciation on rental housing	5.7	26.7	32.4	82.4%
Expensing of certain small investments	0.6	6.6	7.3	91.2%
Energy production credit	12.1	6.1	18.2	33.3%
Expensing of research and experimentation expenditures	70.3	5.3	75.6	7.0%
Credit for low-income housing investments	83.6	4.4	88.0	5.0%
Expensing of certain multi-period production costs, agriculture	0.3	4.2	4.6	92.8%
Expensing of percentage over cost depletion, fuels	10.9	2.7	13.6	20.0%
Expensing of certain capital outlays, agriculture	0.2	2.4	2.6	92.8%
Expensing of multi-period timber growing costs	2.6	1.5	4.1	26.7%
Expensing of exploration and development costs, fuels	5.0	1.2	6.2	19.8%
Tax incentives for preservation of historic structures	5.6	1.0	6.5	14.5%
Other corporate tax expenditures	35.3	4.8	40.1	11.9%

Source: Office of Management and Budget, *Budget of the United States Government 2016, Analytical Perspectives, Tables 14-2A and 14-2B*, and authors' calculations.

#### HOW PASS-THROUGHS WOULD BE AFFECTED BY ELIMINATION OF CORPORATE TAX PREFERENCES

Tax preferences for businesses take the forms of special tax deductions, tax credits, and acceleration of capital cost recovery allowances. Some of the largest tax preferences for corporations also reduce taxes paid by pass-through businesses. The corporate tax preferences that benefit pass-through businesses the most, measured by their projected revenue costs in fiscal years 2015-2024, are accelerated depreciation of machinery and equipment (\$112 billion), the deduction for US production activities (\$39 billion), and accelerated depreciation on rental housing (\$27 billion). Note that these estimates published in the FY 2016 budget assume that business tax benefits that expired at the end of 2014 will not be extended. Therefore, they do not include the effects of bonus depreciation for investment in machinery and equipment and the temporarily higher limits for expensing of qualified assets under Section 179 of the Internal Revenue Code for investments undertaken after January 1, 2015.

The 10-year revenue gain between fiscal years 2015 and 2024 from eliminating provisions that accelerate the timing of deductions, such as accelerated capital cost recovery provisions and expensing of certain small investments (section 179) is larger than the 10-year tax expenditure for two reasons. First, in the tax expenditure estimates, the revenue loss from accelerating new deductions is offset by a revenue gain in the budget period from past investments that have already used up their depreciation allowances. The revenue effect from a change in the law, however, would only apply to new investments. Second, this offset to the revenue loss from prior year investments is larger than it otherwise would be in the tax expenditure estimates because of temporary provisions such as bonus depreciation and the higher Section 179 expensing limits that further shifted cost recovery deductions on existing capital assets to earlier years.<sup>2</sup>

These figures do not include the effects of changes in inventory accounting rules, which are counted as tax expenditures by the Joint Committee on Taxation but not the Treasury Department. Changes in inventory accounting rules could be designed in ways that do not affect small businesses that use a cash basis of accounting. The tax expenditure estimates also do not reveal other options for raising taxes on business income through changes in provisions that are not explicitly listed as tax expenditures. Two of these options are proposals that would limit corporate interest deductions and tax certain large pass-through businesses as corporations. The first of these options would not affect pass-through businesses because current law does not favor debt over equity for pass-through entities. The second option could substantially raise taxes on large pass-throughs, including publicly-traded pass-throughs such as real estate investment trusts (REITs). That option would, however, exclude small businesses and may also exclude privately-held companies if limited to publicly-traded pass-throughs.

<sup>2</sup>For the same reason, however, the 10-year revenue gain from provisions that eliminate accelerated deductions overstates the long-run revenue gain from these provisions because the lower cost recovery deductions on investments made in the budget period will be offset by higher deductions on these investments outside the budget window. With investment growing, there is still a permanent revenue gain from delaying cost recovery deductions on new investments, but the long-run gain is less than the short-run gain.

#### WHAT OTHER MEASURES MIGHT OFFSET THE LOSS OF TAX PREFERENCES FOR SMALL BUSINESSES

The problem corporate tax reform would pose for pass-through businesses and for the subset of these businesses that are genuinely small business occurs because lowering only the corporate tax rate compensates corporations on average for base-broadening, but does not provide any direct benefit for pass-through businesses.

This problem can be mitigated if the approach to tax reform is broader, as in the Tax Reform Act of 1986, which reduced marginal tax rates for both individuals and corporations in exchange for reduction and elimination of both individual and corporate tax preferences. That approach was the announced framework of Representative Dave Camp's plan, which sought to reduce both the top corporate and individual tax rates to 25 percent while maintaining revenue neutrality and keeping the distribution of tax burdens roughly unchanged.

As finally drafted, Representative Camp's plan did achieve its stated objectives of maintaining current law revenues and the distribution of tax burdens by income group, according to scoring by the Joint Tax Committee. Difficult choices had to be made to meet these goals, however (see Nunns, Eng, and Austin 2014). The headline top individual rate of 25 percent was achieved only by adding on top of it a surtax rate of 10 percent at the highest incomes, making the top individual rate effectively 35 percent on an additional dollar of earnings or business income. The surtax applied to adjusted gross income instead of taxable income, and therefore did not allow taxpayers to claim itemized deductions for charitable contributions and mortgage interest in computing the surtax.<sup>3</sup> (The deductions for state and local income and property taxes were eliminated entirely.) So in effect the revenue and distributional targets were achieved by keeping a 35 percent top rate on individual income and scaling back or eliminating many popular deductions.

Congressman Camp and his staff deserve tremendous credit for producing a detailed reform plan that met his announced revenue and distributional targets and lowered the top individual and corporate rates. But his effort illustrated the challenges facing a broad-based tax reform plan that would maintain revenues and not shift the tax burden to lower and middle-income taxpayers. Such a plan would inevitably involve eliminating or scaling back many popular and widely-used tax benefits that members of both parties are reluctant to challenge. And even so, it still may be not be possible to reduce the effective top individual income tax rate very much.

In the absence of broader tax reform, however, there are several measures that can be taken to reduce the adverse effects of base-broadening on small businesses organized as pass-through enterprises. One measure would be to extend or possibly broaden the limits for expensing assets under Section 179 of the Internal Revenue Code. Beginning on January 1, 2015, taxpayers may expense

<sup>3</sup> President Obama's FY 2016 budget includes a similar proposal to limit the value of tax preferences of high-income taxpayers. The President would limit the tax saving from itemized deductions and some other preferences to 28 percent of the amount of the deduction or exemption.

up to \$25,000 per year of investments in qualifying property, generally tangible depreciable personal property (machinery and equipment) used in the active conduct of a trade of business. The amount qualifying investment is reduced dollar for dollar for annual qualifying investment in excess of \$200,000.

Before their expiration at the end of 2013 and their subsequent retroactive extension through the end of 2014, temporarily higher Section 179 expensing limits were in effect. For tax years 2010 through 2014, taxpayers were able to expense up to \$500,000 in qualifying investments per year, with the phase-out of expensing beginning for dollars of investment in excess of \$2 million. Restoring the higher expensing limits, or possibly raising them further, would reduce the cost of capital for small business taxpayers and substantially reduce compliance costs by eliminating the need to keep track of the cost basis of these investments. It would also protect them from the effects of any general reduction in accelerated depreciation for machinery and equipment—the largest current business tax preference for pass-throughs—because their purchases of these assets would be expensed and not affected by broader changes in depreciation rules. This tax benefit is targeted to small business taxpayers.

Another option to shield small businesses from the effect of corporate tax reform would be to accompany corporate base broadening by expanding the thresholds for the lower tax rates now available for small corporations (Kleinbard 2015). Corporations currently face lower tax rates on their first \$100,000 of income; the tax rate is 15 percent on the first \$50,000 of income, 25 percent on income between \$50,000 and \$75,000, and 34 percent on incomes between \$75,000 and \$100,000.<sup>4</sup> If the width of the 15 percent bracket were increased, small business taxpayers could benefit from tax reform by electing to be taxed as C corporations. They would still face the double taxation of corporate income, but the combination of a 15 percent rate at the corporate level and a 23.8 percent rate on dividends and capital gains (effectively a rate of slightly over 35 percent on distributed income and a 15 percent rate on retained profits) could compensate them for the loss of business tax preferences. Although conceptually flawed from a tax policy point of view because ability to pay is based on total *individual* income, not on income of corporations that individuals own, expanded the 15 percent corporate bracket would be a way of providing small businesses with targeted compensation for the effects of broadening the income tax base.

A final option that has been mentioned is to provide a special reduced tax rate for pass-through businesses. This proposal would be very problematic for several reasons. First, it would be unfair because it would provide a very large income tax rate cut to many high-income individuals who receive income from business investments, while retaining higher marginal tax rates on individuals whose income comes from labor compensation. Second, it would create many market distortions, as businesses seek ways to compensate highly paid employees by using them as independent contractors

<sup>4</sup> The benefit of the 15 and 25 percent brackets is phased out at incomes between \$100,000 and \$335,000, raising the average rate at \$335,000 to 34 percent. The 35 percent bracket begins at incomes of \$10 million or higher and the benefit of the 34 percent rate is phased out between incomes of \$15 million and \$18.33 million.

(subject to the reduced rate on business income) instead of employees and engage in other transactions to re-characterize income (Plesko and Henry 2012). At the same time, small business owners with lower marginal tax rates, who comprise most small business owners, would not benefit.

## CONCLUSIONS

Our increasingly dysfunctional corporate tax system has led to bipartisan calls for corporate tax reform. It is important, however to distinguish changes which affect only taxable *corporations* from those that affect all businesses. as it is impossible to reform the corporate income tax without also affecting owners of pass-through businesses whose business income is taxable under the individual income tax. Some, but not all of these affected taxpayers, are owners of small businesses.

The main way that tax reform could adversely affect owners of pass-through businesses is by reducing the benefits they receive from the generous capital cost recovery provisions in the federal income tax. Small businesses can be mostly protected from the effects of these proposals by targeted small business benefits, such as extending, expanding, or making permanent the tax year 2014 for limits of expensing under Section 179 of the Internal Revenue Code and by widening the 15 percent corporate rate bracket.

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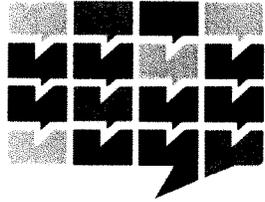


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**AEO** *Association for  
Enterprise Opportunity*  
THE VOICE OF MICROBUSINESS

Statement for the Record

House Committee on Small Business

*Tax Reform: Ensuring that Main Street Isn't Left Behind*

April 15, 2015

Association for Enterprise Opportunity

The Association for Enterprise Opportunity (AEO) is submitting testimony in support of comprehensive tax reform and to recommend improvements to certain tax policies. AEO is the voice of microbusiness in the United States. For two decades, AEO and its more than 400 member organizations have helped millions of entrepreneurs contribute to economic growth while supporting themselves, their families and their communities.

AEO commends the Committee for convening a hearing on such a critical topic. While many small business advocates have shared their views on tax policy, AEO is adding the voice of microbusiness to this important discussion. There is consensus that our tax system should be simpler.<sup>1</sup> Citing numerous reports from the Internal Revenue Service (IRS) National Tax Payer Advocate and Small Business Administration (SBA) Office of Advocacy, it is clear that small businesses face a tax code that drains them of their two most valued resources: time and money. Notably, these burdens are not uniform across company size—big business has the resources to more easily comply with, and even shape, the tax code.

Much of this is due to a tax code that is outdated. The entrepreneurial landscape no longer aligns with our anticipated tax system, last reformed more than 25 years ago. Businesses now operate everywhere, including homes and shared office spaces, and the “independent workforce” is growing at an incredible pace: the number of Americans who “primarily work on their own” is up 14% (1.3 million people) since 2001.<sup>2</sup>

These 21st century entrepreneurs struggle to navigate the deductions and credits designed to spur business creation. Of the more than 20 tax provisions supporting small businesses, almost all require increased record keeping. This requires time and money that could be put to better use. It is also these entrepreneurs who hold the key to jumpstarting our economy. As noted in AEO’s *Power of One in Three* report, if 1 in 3 microbusinesses hired just one employee, America would be at full employment.<sup>3</sup>

The majority of these microbusinesses are structured as pass-through entities, allowing business owners to calculate and pay taxes on their individual taxes. According to the U.S. Census Bureau, for example, sole proprietorships make up a full third (33.6%) of all pass-through businesses that pay taxes at individual rates. For this reason, AEO urges that any reform to the corporate tax code be accompanied by a balanced reform to the individual code. Comprehensive tax reform is the only option to ensure that a vast majority of microbusinesses do not immediately face a significant and unfair disadvantage.

Any overhaul of the tax system should also be guided by the basic principles of simplicity and fairness. In AEO’s view, tax compliance—while necessary—should not be a barrier to entrepreneurship. Microbusinesses should expect a tax system that collects rev-

<sup>1</sup> U.S. House of Representatives Committee on Small Business, *Memorandum on Tax Reform: Ensuring that Main Street Isn’t Left Behind* (2015), available at [http://smallbusiness.house.gov/uploadedfiles/4-15-2015\\_hearing\\_memo.pdf](http://smallbusiness.house.gov/uploadedfiles/4-15-2015_hearing_memo.pdf)

<sup>2</sup> Joel Kotkin, “Rise of the 1099 Economy,” *Forbes Magazine*, July 25, 2012.

<sup>3</sup> Association for Enterprise Opportunity, “Power of 1 in 3.” [http://www.aeoworks.org/pdf/one\\_in\\_three.pdf](http://www.aeoworks.org/pdf/one_in_three.pdf)

enue in a consistent manner, offering certainty from year to year. The annual sprint to extend tax credits and deductions, or “extenders,” is a prime example of how the current system gives business owners little certainty. Making tax expenditures that are proven to support small businesses permanent would eliminate annual confusion over credits and deductions.

Similarly, tax rates for businesses ought to be the same and tax liability should not depend on how a business is organized. American corporations only pay an effective tax rate of 12.6%, a far cry from the statutory 35%, while small businesses operating as S-Corps pay an effective tax rate of nearly 27%.<sup>4</sup> Conversely, tax deductions or credits should be applicable to any form of business (e.g. the self-employed cannot deduct health expenses, an option available to other businesses). Reforms should address these inequities. In our view, business is business.

In addition to ensuring that broader reforms take small businesses into consideration, AEO recommends the following policies that will benefit Main Street:

#### Expand Volunteer Income Tax Assistance Program to Assist Microbusiness

More than 1 in 4 (27%) of microbusinesses cited tax preparation as a problem for business.<sup>5</sup> This does not have to be the case. Already a program exists that could aid entrepreneurs. The Volunteer Income Tax Assistance (VITA) Program currently assists low- and moderate-income (LMI) individuals with support from IRS-certified volunteers. Congress and the IRS should expand the VITA Program’s capacity to help microbusiness owners navigate the tax system.

First, the IRS Office of Stakeholder Partnerships, Education and Communication (SPEC) Office should improve the support that the program delivers to microbusiness owners. The program’s capacity to serve microbusiness owners is limited by program rules that preclude VITA sites from preparing all but the simplest Schedule C forms. The Corporation for Enterprise Development (CFED) found that VITA sites are ready and willing to do more for microbusiness.<sup>6</sup> The IRS has the authority to lift the restrictions on Schedule C preparation at its discretion, without initiating the lengthy process of proposing a regulation for public comment.

The Entrepreneur Start-Up Growth Act (H.R. 3571), introduced in 2011 by Committee Member Judy Chu, proposed a pilot program to test the feasibility of expanding VITA support to self-employed tax filers. AEO hopes that similar legislation will be reintroduced in the 114th Congress. New provisions could consider authorizing VITA sites to implement pay-as-you-go fees for the most complex tax filings.

<sup>4</sup>U.S. Government Accountability Office, “Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate.” 2013. Available online at <http://www.gao.gov/assets/660/654957.pdf>

<sup>5</sup>Corporation for Enterprise Development, “Microbusinesses: America’s Unsung Heroes.” 2013. Available online at: [http://cfed.org/assets/pdfs/FactFile\\_May2013.pdf](http://cfed.org/assets/pdfs/FactFile_May2013.pdf)

<sup>6</sup>Corporation for Enterprise Development, “Innovations in Microbusiness.” 2014. Available online at: [http://cfed.org/assets/pdfs/Innovations\\_in\\_Microbusiness.pdf](http://cfed.org/assets/pdfs/Innovations_in_Microbusiness.pdf)

### Aiding Underserved Communities through Proven Tax Policy

The Earned Income Tax Credit (EITC) is an important tax credit for low-income workers and allows entrepreneurs to reinvest their EITC back into their business. Research has shown that the EITC promotes work, reduces poverty, and benefits microbusinesses.<sup>7</sup>

The EITC can be strengthened to continue to aid underserved communities. Interestingly, the current structure of the EITC (withholding credit in U.S. Treasury) has increased savings among low- and moderate-income individuals—a lauded goal.

### Create and Expand Credits Needed by Microbusiness

AEO believes a New Entrepreneur Tax Credit would incentivize business creation. Studies have consistently found that underserved communities and individuals benefit from self-employment and new business ventures.<sup>8</sup> AEO encourages Congress to look further at small business tax provisions already in the tax code and how they could benefit new businesses during its time of greatest challenge.

Established microbusinesses should also be supported to save for their retirement. The SBA Office of Advocacy found that microbusinesses, especially those owned by minorities, are the least likely to have retirement savings. Currently, the Saver's Credit exists to address this issue. That credit, however, is nonrefundable, needlessly complex and is defined by sharp income eligibility cliffs. These shortcomings mean that only a very small percentage of low-income tax filers qualify for the credit, and an even smaller number actually claim the credit. By simplifying how microbusiness owners claim the credit and by making it refundable, Congress can improve the Saver's Credit's ability to aid saving for retirement.

The need for action on comprehensive tax policy is clear. In our view, addressing the corporate rate alone would be unfair for the microbusiness community at the very backbone of the American economy. Reforms should be enacted, based on the ideas of a simpler and fair tax code. Finally, should a tax overhaul not be viable this Congress, there are still small, but important, tax changes for policymakers to consider to strengthen the community AEO serves.

Thank you for consideration of these views and for this Committee's efforts to support microbusiness.

<sup>7</sup> Center on Budget and Policy Priorities, "EITC and Child Tax Credits Promote Work, Reduce Poverty, and Support Children's Development." (2015). Available online at <http://www.cbpp.org/cms/?fa=view&id=3793>

<sup>8</sup> Brookings Institution, "Minority and Women Entrepreneurs: Building Capital, Networks, and Skills." (2015). Available online at [http://www.brookings.edu/media/research/files/papers/2015/03/11-hamilton-project-expanding-jobs/minority\\_women\\_entrepreneurs\\_building\\_skills\\_barr\\_final.pdf](http://www.brookings.edu/media/research/files/papers/2015/03/11-hamilton-project-expanding-jobs/minority_women_entrepreneurs_building_skills_barr_final.pdf)

**About AEO**

The Association for Enterprise Opportunity (AEO) is the voice of microbusiness in the United States. For two decades, AEO and its more than 400 member organizations have helped millions of entrepreneurs contribute to economic growth while supporting themselves, their families and their communities. AEO members and partners include a broad range of organizations that provide capital and services to assist underserved entrepreneurs in starting, stabilizing and expanding their businesses. Together, we are working to change the way that capital and services flow to underserved entrepreneurs so that they can create jobs and opportunities for all.



American Institute of CPAs  
1455 Pennsylvania Avenue, NW  
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April 23, 2015

The Honorable Steve Chabot  
Chairman  
Committee on Small Business  
United States House of Representatives  
2361 Rayburn House Office Building  
Washington, DC 20515

The Honorable Nydia Velázquez  
Ranking Member  
Committee on Small Business  
United States House of Representatives  
2361 Rayburn House Office Building  
Washington, DC 20515

RE: April 15, 2015 Hearing on Tax Reform: Ensuring that Main Street Isn't Left Behind

Dear Chairman Chabot and Ranking Member Velázquez:

The American Institute of Certified Public Accountants (AICPA) respectfully submits the enclosed statement for the record of the hearing held on April 15, 2015 on "Tax Reform: Ensuring that Main Street Isn't Left Behind." We appreciate the efforts of the Members of the Committee for examining the need for and potential economic benefits of comprehensive tax reform.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 128 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

If you have any questions, please feel free to contact me at (801) 523-1051, or [tlewis@sisna.com](mailto:tlewis@sisna.com); or Jeffrey Porter, Chair, AICPA Tax Reform Task Force, at (304) 522-2553, or [jporter@portercpa.com](mailto:jporter@portercpa.com); or Melissa Labant, AICPA Director of Tax Advocacy, at (202) 434-9234, or [mlabant@aicpa.org](mailto:mlabant@aicpa.org).

Sincerely,

A handwritten signature in black ink that reads "Troy K. Lewis".

Troy K. Lewis, CPA  
Chair, AICPA Tax Executive Committee



American Institute of CPAs  
1455 Pennsylvania Avenue, NW  
Washington, DC 20004-1081

**WRITTEN STATEMENT  
OF  
THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS  
FOR THE RECORD OF THE  
APRIL 15, 2015  
HEARING OF  
THE UNITED STATES HOUSE OF REPRESENTATIVES  
COMMITTEE ON SMALL BUSINESS  
ON  
TAX REFORM: ENSURING THAT MAIN STREET ISN'T LEFT BEHIND**

AICPA's Written Statement for the Record  
 U.S. House of Representatives, Committee on Small Business  
 April 15, 2015 Hearing on Tax Reform: Ensuring that Main Street Isn't Left Behind  
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## **INTRODUCTION**

The American Institute of Certified Public Accountants (AICPA) commends Chairman Chabot, Ranking Member Velazquez, and Members of the House Committee on Small Business for examining the need for and potential economic benefits of comprehensive tax reform. We applaud the leadership taken by the Committee to spur tax reform discussions and recognize the tremendous effort required to analyze the current complexities in the tax law, examine policy trade-offs, and consider the various reform options.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 128 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized business, as well as America's largest businesses.

We are a long-time advocate for an efficient and effective tax system based on principles of good tax policy.<sup>1</sup> Our tax system must be administrable, stimulate economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations. We believe these features of a tax system are achievable if the ten principles of good tax policy are considered in the design of the system:

- Equity and Fairness
- Convenience of Payment
- Simplicity
- Economic Growth and Efficiency
- Minimum Tax Gap
- Certainty
- Economy in Collection
- Neutrality
- Transparency and Visibility
- Appropriate Government Revenues

We, therefore, appreciate the opportunity to provide input as you begin shaping tax reform policy in the small business income tax area.

In the interest of good tax policy and effective tax administration, specifically focusing on the simplification of small business income tax, we respectfully submit comments on the following key issues:

1. Cash Method of Accounting
2. Tangible Property Regulations – De Minimis Safe Harbor Threshold
3. Civil Tax Penalties
4. Permanence of Tax Legislation
5. Retirement Plans
6. Alternative Minimum Tax Repeal

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<sup>1</sup> AICPA, Guiding Principles for Good Tax Policy: Framework for Evaluating Tax Proposals, 2001.

AICPA's Written Statement for the Record  
 U.S. House of Representatives, Committee on Small Business  
 April 15, 2015 Hearing on Tax Reform: Ensuring that Main Street Isn't Left Behind  
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7. Tax Return Due Date Simplification
8. IRS Taxpayer Assistance

## AICPA PROPOSALS

### **1. Cash Method of Accounting**

The AICPA wholly supports the expansion of the number of taxpayers who may use the cash method of accounting. The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income. For these same reasons, we are concerned with, and oppose, any new limitations on the use of the cash method for service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as S corporations and partnerships. Requiring these businesses to switch to the accrual method upon reaching a gross receipts threshold would unnecessarily discourage growth. A required switch to the accrual method would affect many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

The AICPA believes that limiting the use of the cash method of accounting for service businesses would:

- 1) Discourage their natural business growth;
- 2) Impose an undue financial burden on their individual owners;
- 3) Impose complexities and increase their compliance burden; and
- 4) Treat similarly situated taxpayers differently (because income is taxed directly on their owners' individual returns).

As the AICPA has previously stated,<sup>2</sup> we believe that Congress should not further restrict the use of the long-standing cash method of accounting for the thousands of U.S. businesses (e.g., sole proprietors, personal service corporations, and pass-through entities) that currently utilize it. We believe that forcing more businesses to use the accrual method of

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<sup>2</sup> AICPA comment letter on the "Continued Availability of Cash Method of Accounting," August 15, 2013, [http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.08.15\\_Comments\\_on\\_Continued\\_Availability\\_of\\_Cash\\_Method\\_of\\_Accounting.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.08.15_Comments_on_Continued_Availability_of_Cash_Method_of_Accounting.pdf), AICPA written statement before the House Committee on Ways And Means, dated May 15, 2013, Small Business and Pass-through Entity Tax Reform Discussion Draft; <http://www.aicpa.org/Advocacy/Tax/Partnerships/DownloadableDocuments/AICPA-WRITTEN-STATEMENT-May-15-2013-hwmc-srsubcomte-camp-small-bus-submit.pdf>, and AICPA written statement before the House Committee on Small Business, Subcommittee on Economic Growth, Tax and Capital Access, dated July 10, 2014, Hearing on "Cash Accounting: A Simpler Method for Small Firms?"; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA%20WRITTEN%20STATEMENT%20July%2010%202014%20to%20House%20Subcte%20on%20Economic%20Growth%20Tax%20and%20Capital%20Access.pdf>.

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accounting for tax purposes would increase their administrative burden, discourage business growth in the U.S. economy, and unnecessarily impose financial hardship on cash-strapped businesses.

## **2. Tangible Property Regulations – De Minimis Safe Harbor Threshold**

The AICPA urges the Internal Revenue Service (IRS or "Service") and Treasury to increase the de *minimis* safe harbor threshold in order to offer meaningful tax compliance relief to small businesses. Final tangible property regulations (T.D. 9636) provide guidance for taxpayers to elect a minimum capitalization threshold, otherwise known as the de *minimis* safe harbor. The safe harbor allows taxpayers to set a minimum capitalization amount under which amounts are not capitalized. To reduce the unnecessary compliance burdens placed on small businesses, the AICPA recommends increasing the de *minimis* safe harbor threshold amount for taxpayers without an applicable financial statement (AFS) from \$500 to \$2,500.

Additionally, we recommend adjusting the de *minimis* safe harbor threshold amount on an annual basis for inflation.<sup>3</sup>

We understand that the intent of the \$500 de *minimis* safe harbor election is to reduce the administrative burden of applying the complex set of capitalization rules for business taxpayers without an AFS (e.g., small business taxpayers). However, we have concerns about the current low amount (\$500) of the de *minimis* safe harbor threshold for taxpayers without an AFS:<sup>4</sup>

### **a. Reduction of Administrative Burden**

Many small business owners have stated that repairs are consistently over \$500 (parts are at least \$250 and labor is at least \$250). A cell phone or printer easily cost over \$500 and are replaced quickly making it administratively impractical and costly to track. The \$500 threshold is too low to effectively achieve any reduction in administrative burden.

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<sup>3</sup> The AICPA submitted comments on increasing the safe harbor de *minimis*. See letter to IRS, "[Request for Comment on De Minimis Safe Harbor Limit](#)," dated April 21, 2015.

<sup>4</sup> An applicable financial statement (AFS) is a financial statement that is (i) a financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders); (ii) a certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for credit purposes, reporting to shareholders, partners, or similar persons, or any other substantial non-tax purpose; or (iii) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the IRS).

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**b. Relation with Section 179**

The IRS states that the safe harbor *de minimis* threshold, in conjunction with section 179<sup>5</sup> election to expense certain depreciable business assets, provide significant tax simplification to small businesses. Unfortunately, section 179 requires costly and time-consuming tracking of the item on a fixed asset depreciation schedule. Furthermore, not all property qualifies for the section 179 deduction (e.g., air conditioning and heating equipment, and real property such as land, buildings, and permanent structures).

Enhanced section 179 relief was also temporary and is, therefore, arguably unreliable. Currently, the section 179 deduction limit is only \$25,000 for tax year 2015, despite having a limit of \$500,000 for last year.

**c. Clear Reflection of Income Test**

To deduct amounts in excess of the \$500 threshold, small businesses must prove that expensing such amounts "clearly reflects income." The clear reflection of income test is based on the taxpayer's facts, circumstances, and interpretations of those facts and circumstances by the taxpayer and IRS. Large businesses (e.g., taxpayers with an AFS), however, are allowed the higher (\$5,000) threshold without the negative added compliance burdens.

**d. Current Capitalization Policies**

We also believe the \$500 threshold does not accurately reflect the current capitalization policy threshold for many small businesses. An informal survey amongst our members, shows that many of our members and/or their small business clients have a minimum capitalization threshold in excess of \$500 since few items costing \$500 or less have a useful life of greater than one year. Therefore, we think that the \$500 threshold does not provide any impactful relief for many small businesses.

**e. Expansion of the AFS Definition for \$5,000 Safe Harbor De Minimis Threshold**

The AICPA believes the requirement that a taxpayer have an AFS to use the \$5,000 *de minimis* threshold unfairly discriminates against smaller taxpayers, and recommends an alternative test to allow such taxpayers to use the *de minimis* rule. The AICPA recommends an expansion of the definition of AFS to include a financial statement that has been reviewed by a certified public accountant.

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<sup>5</sup> All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated there under, unless otherwise specified.

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### **3. Civil Tax Penalties**

Congress should carefully draft penalty provisions and the Executive Branch should sensibly administer the penalties to ensure they deter bad conduct without deterring good conduct or punishing the innocent (i.e., unintentional errors, such as those who committed the inappropriate act without intent to commit such act). Targeted, proportionate penalties that clearly articulate standards of behavior and that are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws. On the other hand, overbroad, vaguely-defined, and disproportionate penalties, particularly those administered as part of a system that automatically imposes penalties or that otherwise fails to provide basic due process safeguards, create an atmosphere of arbitrariness and unfairness that is likely to discourage voluntary compliance.

We have concerns<sup>6</sup> about the current state of civil tax penalties and would like to offer the following suggestions for improvement:

#### **a. Trend Toward Strict Liability**

The IRS discretion to waive and abate penalties where the taxpayer demonstrates reasonable cause and good faith is needed most when the tax laws are complex and the potential sanction is harsh. This reason is especially true where the taxpayer's state of mind is central to the conduct that is subject to penalty. Because it is not feasible to anticipate every possible situation to which a penalty might apply, permitting a reasonable cause defense and avoiding fixed-dollar amount penalties helps to ensure that a disproportionately large penalty is not applied to an unforeseen and/or unintended set of facts.

Over the past several decades, there has been an exponential increase in the complexity of the tax laws and a proliferation of increasingly severe civil tax penalties, with the Internal Revenue Code (IRC or "Code") currently containing eight strict liability penalty provisions.

#### **b. An Erosion of Basic Procedural Due Process**

Penalties should apply prospectively to future conduct and not retroactively to conduct that was appropriate at the time the conduct occurred. Judicial review of an IRS decision to impose a penalty or to deny waiver is an important constitutional check on Executive authority. Statutes that prohibit judicial review of agency penalty determinations undermine voluntary compliance by undercutting

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<sup>6</sup> See the "AICPA Tax Penalties Legislative Proposals," submitted to Congress in April 2013: <http://www.aicpa.org/Advocacy/Tax/TaxLegislationPolicy/DownloadableDocuments/AICPA-legislative-proposals-penalties-2013.pdf>; and the "AICPA Report on Civil Tax Penalties," submitted April 2013: <http://www.aicpa.org/Advocacy/Tax/TaxLegislationPolicy/DownloadableDocuments/AICPA-report-civil-tax-penalty-reform-2013.pdf>.

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taxpayers' faith in the system and eliminating an essential and expected avenue of potential redress.

Taxpayers should know their rights to contest penalties and have a timely and meaningful opportunity to voice their feedback before assessment of the penalty. In general, this process would include the right to an independent review by the IRS Appeals office or the IRS's FastTrack appeals process, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.

**c. Repeal Technical Termination Rule**

We recommend<sup>7</sup> the repeal of section 708(b)(1)(B) regarding the technical termination of a partnership.<sup>8</sup> Under current law, when a partnership is technically terminated, the legal entity continues, but for tax purposes, the partnership is treated as a newly formed entity. The current law requires the partnership to select new accounting methods and periods, restart depreciation lives, and make other adjustments. Furthermore, under the current law, the final tax return of the "old" partnership is due the 15th day of the fourth month after the month-end in which the partnership underwent a technical termination.<sup>9</sup>

A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Because this 12-month time frame can span a year-end, the partnership may not realize that a 30% change (a minority interest) in one year followed by a 25% change in another year, but within 12 months of the first, has caused the partnership to terminate.

In practice, this earlier required filing of the old partnership's tax return often goes unnoticed because the company is unaware of the accelerated deadline due to of the equity transfer. Penalties are often assessed upon the business as a result of the

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<sup>7</sup> AICPA submitted comments to the House Committee on Ways and Means on the Tax Reform Act of 2014, dated January 12, 2015; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf>.

<sup>8</sup> AICPA submitted letters and written statements on Option 1 and Option 2 of Chairman Camp's Small Business Tax Reform Draft: See Option 1 comments at "AICPA testimony on Small Business and Pass-through Entity Tax Reform," dated May 17, 2013; [http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.05.13\\_Testimony\\_on\\_Small\\_Business\\_and\\_Pass-Through\\_Entity\\_Tax\\_Reform\\_Discussion\\_Draft.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/2013.05.13_Testimony_on_Small_Business_and_Pass-Through_Entity_Tax_Reform_Discussion_Draft.pdf), and Option 2 comments, dated July 30, 2013; <http://www.aicpa.org/Advocacy/Tax/Partnerships/DownloadableDocuments/AICPA-Option-2%20-comments-7-30-13.pdf>.

<sup>9</sup> For example, a partnership that technically terminated on April 30 of the current year due to a transfer of 80% of the capital and profits interests in the partnership to be timely filed must file its tax return for that final tax year on or before August 15 of the current year.

missed deadline. Although ignorance is not an acceptable excuse, this technical termination area is often misunderstood and misapplied. The acceleration of the filing of the tax return, to reset depreciation lives and to select new accounting methods, serves little purpose in terms of abuse prevention and serves more as a trap for the unwary.

**d. Late Filing Penalties of Sections 6698 and 6699**

Sections 6698 and 6699 impose a penalty of \$195 per partner related to late filed partnership or S corporation return. The penalty is imposed monthly not to exceed 12 months, unless it is shown that the late filing is due to reasonable cause. 2014 amendments to sections 6698 and 6699 adjust the penalty for inflation beginning after 2014.

The AICPA proposes that a partnership, comprised of 50 or fewer partners, each of whom are natural persons (who are not nonresident aliens), an estate of a deceased partner, a trust established under a will or a trust that becomes irrevocable when the grantor dies, and domestic C corporations, will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 or 6699 if:

- The delinquency is not considered willful under section 7423;
- All partnership income, deductions and credits are allocated to each partner in accordance with such partner's capital and profits interest in the partnership, on a pro-rata basis; and
- Each partner fully reported its share of income, deductions and credits of the partnership on its timely filed federal income tax return.

**e. Failure to Disclose Reportable Transactions**

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Code. For penalties assessed after 2006, the amount of the penalty is 75% of the decrease in tax shown on the return as a result of the transaction (or the decrease that would have been the result if the transaction had been respected for federal tax purposes). If the transaction is a listed transaction (or substantially similar to a listed transaction), the maximum penalty is \$100,000 for individuals and \$200,000 for all other taxpayers. In the case of reportable transactions other than listed transactions, the maximum penalty is \$10,000 for individuals and \$50,000 for all other taxpayers. The minimum penalty is \$5,000 for individuals and \$10,000 for all other taxpayers. The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to the penalty. The Commissioner may, however, rescind all or a portion of a penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote efficient tax administration and only after the taxpayer submits a

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lengthy and burdensome application. In the case of listed transactions, the IRS has no discretion to rescind the penalty. The statute precludes judicial review where the Commission decides not to rescind the penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20% (if the transaction was disclosed) and 30% (if the transaction was not disclosed). A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not proper. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

The AICPA proposes for an amendment of section 6707A to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we propose an amendment of section 6664 to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

**f. 9100 Relief**

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list<sup>10</sup> of elections (not all-inclusive) for which section 9100 relief currently is not granted by the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities. We do not believe taxpayers are likely to abuse or exploit hindsight, as the IRS would continue to have discretion as to whether to grant relief for each specific request.

**g. Form 5471 Penalty Relief**

On January 1, 2009, the IRS began imposing an automatic penalty of \$10,000 for each Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, filed with a delinquent Form 1120 series return. When imposing the penalty on corporations in particular, the IRS does not distinguish between: a) large public multinational companies, b) small companies, and c)

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<sup>10</sup> AICPA letter on "Tax Reform Administrative Relief for Various Statutory Elections," submitted January 23, 2015: <http://www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa-letter-to-congress-on-9100-relief-1-23-15submitted.pdf>.

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companies that may only have insignificant overseas operations, or loss companies. This one-size-fits-all approach inadvertently places undue hardship on smaller corporations that do not have the same financial resources as larger corporations. The AICPA has submitted recommendations<sup>11</sup> regarding the IRS administration of the penalty provision applicable to Form 5471. Our recommendations focus on the need for relief from automatic penalties assessed upon the late filing of Form 5471 in order to promote the fair and efficient administration of the international penalty provisions of the Code.

#### **4. Permanence of Tax Legislation**

Taxpayers and tax practitioners need certainty to perform any long-term tax, cash-flow or financial planning and reporting.<sup>12</sup> The permanence of tax provisions, such as the enhanced section 179 deduction, can have impacts on the growth of small businesses. The section 179 provision allows small and mid-size business owners to immediately take a tax deduction on qualifying equipment, rather than delaying the deduction and taking it in smaller portions over an extended period of years. With the increased section 179 expense provision, business owners could deduct up to \$500,000 of qualifying assets. In 2015, the section 179 expense has reverted back to \$25,000. However, over the past several years, Congress has retroactively passed an increased section 179 limit during or even after the applicable tax year. The possibility for such a retroactive action in 2015 still exists; however, the uncertainty creates unnecessary confusion, anxiety and administrative and financial burdens.

Without permanency in the Code, we are concerned about the following consequences:

##### **a. Impact on a Company's Financial Accounting and Reporting**

The retroactive extension of tax deductions and credits has implications for a company's financial accounting and reporting. For financial accounting purposes, "the effect of a change in tax laws or rates shall be recognized at the date of enactment."<sup>13</sup> Accordingly, even if Congress signals that it plans to extend various

<sup>11</sup> AICPA submitted comments to the IRS, dated March 26, 2013; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-Form-5471-Penalties-3.26.13.pdf>.

<sup>12</sup> For example, see the [AICPA testimony](#) before the U.S. House of Representatives Committee on Small Business Subcommittee on Economic Growth, Tax, and Capital Access on the September 13, 2012, hearing on Adding To Uncertainty: Small Businesses' Perspectives on the Tax Cliff, and [AICPA written statement](#) for the hearing before the U.S. House of Representatives Committee on Ways and Means Subcommittee on Select Revenue on May 15, 2013, on the Small Business and Pass-Through Entity Tax Reform Discussion Draft.

<sup>13</sup> See Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, Income Taxes (<https://asc.fasb.org/> and <http://www.uic.edu/classes/actg/actg593/Cases/ASC/Standards/ASC-740-10- Income-Taxes.pdf>), 740-10-25-47, September 29, 2011, page 15.

tax credits and other tax incentives, because these tax credits and other tax incentives were not signed into law by the end of 2014, companies must calculate their 2015 tax provisions without regard to the extended tax credits and other tax incentives. Where the relevant credits and incentives are material, the failure to extend the expired provisions in a timely manner creates unnecessary and undesirable ambiguity for financial markets.

**b. Complexity and Administrative Burden for Taxpayers and the IRS**

When Congress enacts extensions of these provisions late in the year or in the beginning of the following year, after IRS has already finalized the income tax returns for the tax year, it causes confusion, complexity, and compliance burdens for taxpayers and practitioners, and the IRS. If the tax forms have already been released, the IRS may need to provide additional instructions or revised forms to clarify the new law and reporting. This instructions and forms delay causes the filing season to be even more compressed and taxpayers are not able to file and receive their tax refunds until later in the year.

If taxpayers have already filed their tax returns prior to the change in the law, they may need to file amended tax returns, reflecting the newly enacted tax rules for the prior tax year. Those taxpayers may have to pay additional costs for an amended tax return, and the IRS will have additional costs and burdens to process the amended tax returns. For example, a March 31, 2015 fiscal year corporate filer will likely have to (1) report 9/12ths of the research credit on the originally filed return and (2) amend the return when the credit is reinstated to claim the credit for the additional three months (assuming the credit is reinstated after the tax return is filed, which was the case for the provisions that expired in 2010).

**c. Adverse Impact on Small Businesses and Ultimately Jobs and Growth**

These ever-changing, often expiring, short-term changes to the tax laws make it increasingly difficult for small businesses and their owners to perform any long-term tax, cash-flow or financial planning. If businesses are not able to rely on these tax benefits for the long term, they are limited in their ability to plan, invest, grow and expand, and hire additional workers. Therefore, we urge Congress to extend these provisions sooner rather than later.

While taxpayers have come to anticipate the retroactive reinstatement of expiring provisions (e.g., the research and development credit and the enhanced section 179 expense deduction) and may act under the assumption that Congress again may extend the provisions, an incorrect assumption may prove costly. While a prudent small business owner may wait until Congress provides certainty, the delay may result in the small business owner postponing equipment acquisitions and research expenditures from 2015 to 2016. The intended impact and reason for these provisions as an incentive for small businesses to replace aged equipment and

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pursue research and development are not achieved when the tax incentives are not available all or much of the year.

**d. Effect on Economic Decisions and Tax Payments**

Uncertainty concerning whether Congress will extend certain tax provisions also adversely impacts tax planning and economic decisions made by individuals. These planning challenges are further compounded when tax laws are changed after the year has already begun but are slated to take effect that same year. When tax laws are issued late in the year or at the last minute, individuals try their best to comply, with no ability to plan for such provisions, no matter how well-intentioned. Incorrect assumptions may result in underpayments of estimated taxes and potential penalties or overpayment of taxes.

**e. Lack of Transparency and Certainty with Short-Term, Retroactive Extensions**

The AICPA continues to support long-term tax reform simplification efforts as we strongly believe the short-term, retroactive extension of tax provisions on an annual basis is counter to the AICPA's Guiding Principles of Good Tax Policy, which promote certainty, as well as transparency and visibility. We also generally urge Congress to enact future tax changes with a presumption of permanency, except in rare situations in which there is an overriding and explicit policy reason for making provisions temporary, such as short-term stimulus provisions or when a new provision requires evaluation after a trial period. Providing long-term certainty will provide simplification. Eliminating the need to constantly extend expiring provisions, such as the research and experimentation credit, will decrease the current state of confusion and, in many cases, reaffirm (rather than undermine) the policy reasons behind these incentives. Eliminating the on-again-off-again nature of these provisions, coupled with the often retroactive tax law changes, will better support long-term planning, reduce the number of amended returns, and significantly decrease the overall complexity of the tax rules.

**5. Retirement Plans**

Small businesses are especially burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Therefore, we encourage Congress to consider the following measures for simplifying the operation of retirement plans:

**a. Create a Uniform Employee Contributory Deferral Plan**

The AICPA suggests that Congress create a uniform contributory deferral plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and employers. Congress could eliminate the unnecessary complexity by reducing the number of choices of the same type of plan

while keeping the desired goal intact; affording employers the opportunity to offer a contributory deferral plan to their employees and allowing employees to use this type of retirement plan to save for their retirement.

**b. Eliminate Certain Nondiscrimination Tests on Employee Pre-tax and Roth Deferrals for 401(k) Plans, Matching Contributions**

We propose eliminating the following nondiscrimination tests since they artificially restrict the amount higher-paid employees are entitled to save for retirement on a tax preferred basis by creating limits based on the amount deferred by lower-paid employees in the same plan. The tests result in placing greater restrictions on the ability of higher-paid employees to save for retirement than those placed on lower-paid employees. Although the 403(b) plan is of a similar design, there is no comparable test on deferrals for this type of plan.

Specifically, we recommend elimination of the following nondiscrimination tests:

- The actual deferral percentage (ADP) test – The ADP test limits the amount highly compensated employees can defer pre-tax or through Roth after-tax contributions by reference to the amount deferred by non-highly compensated employees. This test applies only to a 401(k) plan.
- The actual contribution percentage (ACP) test – The ACP test similarly limits, for highly compensated employees, the amount of employer matching contributions and the amount of other employee after-tax contributions (which are based on employee contributions). This test is applicable for both 401(k) and 403(b) plans.

**c. Eliminate the Top Heavy Rules**

We propose eliminating the top heavy rules because they constrain the adoption of 401(k) and other qualified retirement plans by small employers. Since the top heavy rules were enacted in 1982, there have been a number of statutory changes which have significantly decreased their effectiveness. The sole remaining top heavy rule is a required minimum contribution or benefit. The determination of top heavy status is difficult and the required 3% minimum contribution is often made for safe harbor 401(k) plans. The effect of the top heavy rules is to deter a small business from adopting a qualified retirement plan, including a non-safe harbor 401(k) plan. Without the top heavy rules, more small businesses would adopt plans to benefit their employees.

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## **6. Alternative Minimum Tax Repeal**

The AICPA supports repeal of the alternative minimum tax (AMT).<sup>14</sup> We believe that the current system's requirement for taxpayers to compute their income for purposes of both the regular income tax and the AMT is a far-reaching complexity of the Code. Small businesses, including those businesses operating through pass-through entities, are increasingly at risk of being subject to AMT.

This tax was created to ensure that all taxpayers pay a minimum amount of tax on their economic income. However, small businesses suffer a heavy burden because they often do not know whether they are affected until they file their taxes. They must constantly maintain a reserve for possible AMT, which takes away from resources that could be allocated to business needs such as hiring, expanding, and giving raises to workers.

The AMT is a separate and distinct tax regime from the "regular" income tax. Code sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions, and credits under the AMT system. This separate calculation must be done on all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations. Small businesses must maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. Including adjustments and preferences from pass-through entities contributes to AMT complexity. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity affects the IRS's ability to meaningfully track compliance.

AICPA supports repealing the AMT for corporations and individuals altogether. As AMT complexities increase, so do the tax regime's impact on unintended taxpayers<sup>15</sup> and related compliance problems.

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<sup>14</sup> AICPA written testimony before the House Committee on Ways And Means, Subcommittee on Select Revenue Measures, dated March 03, 2011, "Hearing on Small Businesses and Tax Reform," <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/FINALTESTIMONYFORTHOMPSONMarch32011.pdf>; and AICPA submitted comments to the House Committee on Ways and Means on the Tax Reform Act of 2014, dated January 12, 2015; <http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/AICPA-Comments-on-2014-Camp-Draft-General-Comments-Final.pdf>.

<sup>15</sup> Although most sophisticated taxpayers are aware of the AMT and that they may be subject to its provisions, the majority of middle-class taxpayers has never heard of the AMT and is unaware that the tax may apply to them. Unfortunately, the number of taxpayers facing potential AMT liability is expanding exponentially due

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### **7. Tax Return Due Date Simplification**

Taxpayers and preparers have long struggled with problems created by the inefficient timeline and flow of information. Federal Schedules K-1s are often delivered late, sometimes within days of the due date of taxpayers' personal returns and up to a month after the due date of their business returns. Late schedules make it difficult, if not impossible, to file a timely, accurate return. The current inefficient timeline of tax return due dates is a problem for taxpayers as well as their tax practitioners.

The AICPA recommendation would alleviate the problems mentioned above by establishing a logical set of due dates, focused on promoting a chronologically-correct flow of information between pass-through entities and their owners. Our proposal includes the changes as follows:

**Current Tax Due Dates:**

- March 15: S corporation and C corporation Forms 1120S and 1120; and
- April 15: Individual, Trust and Estate, and Partnership Forms 1040, 1041, and 1065

**Proposed Tax Due Dates:**

- March 15: Partnership Form 1065;
- March 31: S corporation Form 1120S; and
- April 15: Individual, Trust and Estate, and C Corporation Forms 1040, 1041, and 1120

We recommend the extended due dates to be six months after the original filing due dates for all these forms, except the trust and estate Form 1041, which we recommend be extended five and half months.

The AICPA supports<sup>16</sup> the proposal to change due dates for tax returns of partnerships, S corporations and C corporations because it would:

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to: (1) "bracket creep;" (2) classifying as "tax preferences" the commonly used personal and dependency exemptions, standard deductions, and itemized deductions for taxes paid, some medical costs, and miscellaneous expenses; and (3) the inability to use many tax credits to offset AMT.

<sup>16</sup> We are pleased that this due dates proposal has wide bipartisan support and has been included in proposed legislation introduced by Sen. Enzi and Rep. Jenkins, including in 2013 (S. 420 and H.R. 901) and in 2011 (S. 845 and H.R. 2382). It was also included in the Senate Finance Committee Tax Reform options paper on Simplifying the Tax System for Families and Businesses dated March 21, 2013; the Senate Finance Committee staff discussion draft on tax reform of tax administration provisions dated November 20, 2013; and the House Ways and Means Committee Chairman comprehensive tax reform discussion draft "Tax Reform Act of 2014" dated February 26, 2014. See AICPA webpage for recommendations on Change to Return Due Dates:

<http://www.aicpa.org/interestareas/tax/resources/taxlegislationpolicy/pages/duedatesproposal2010.aspx>.

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- Improve the accuracy of tax and information returns by allowing corporations and individuals to file using current data from flow-through returns that have already been filed rather than relying on estimates;
- Better facilitate the flow of information between taxpayers (i.e., corporations, partnerships, and individuals);
- Reduce the need for extended and amended tax returns; and
- Simplify tax administration for the government, taxpayers, and practitioners.

#### **8. IRS Taxpayer Assistance**

To further reduce the burdens of income tax compliance, Congress should address the "taxpayer service" issues at the IRS. We recognize that the IRS budget is oftentimes the subject of debate, and may be even more so now given the various events that have occurred over the last few years. However, the need to provide assistance to taxpayers and tax practitioners remain important responsibilities.

In order for small businesses (and their tax practitioners) to receive the assistance they need on tax issues, it is essential for the IRS to respond to them in a timely manner. At a minimum, for example, the IRS should improve (1) wait times for incoming telephone calls and (2) the time required for them to respond (in a substantive manner) to taxpayers' written correspondence on tax notices. The current levels of service for these two areas are simply unacceptable.

We are concerned that the IRS is spending a significantly lower percentage of its limited budget on taxpayer services (e.g., Individual Income Tax Line, Refund Hotline, Practitioner Priority Hotline, etc.) than in prior years. We understand that the IRS has new initiatives and vital responsibilities (such as addressing identity theft), but taxpayer service must remain a priority in a voluntary compliance system, such as the U.S. income tax system, which relies on individuals and businesses to properly report their income.

The AICPA believes the current situation of unacceptably low levels of taxpayer assistance warrants a Congressional discussion, including stakeholders, of what the agency should look like in the 21st Century.

#### **CONCLUDING REMARKS**

The AICPA understands the challenges that Congress faces as it tackles the complex issues inherent in drafting tax legislation, and note that both taxpayers and tax practitioners are interested in, and need, tax simplification. Compliance burdens for small business taxpayers are too heavy, both in terms of time required and out-of-pocket cost. Likewise,

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complexity increases the "Tax Gap" and may impair the efficiency of tax administration.<sup>17</sup> While there are costs associated with simplification reforms, it is also important to recognize the elimination of significant compliance burdens by such reforms.

The proliferation of new income tax provisions since the 1986 tax reform effort has led to compliance hurdles for taxpayers, administrative complexity, and enforcement challenges for the IRS. We encourage you to examine all aspects of the tax code to improve the current rules. The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will significantly reduce taxpayers' compliance costs and encourage voluntary compliance through an understanding of the rules. We look forward to working with the 114<sup>th</sup> Congress and the tax-writing committees as you address tax reform.

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<sup>17</sup> AICPA testimony on the House Committee on Ways And Means hearing on "How the Tax Code's Burdens on Individuals and Families demonstrate the need for Comprehensive Tax Reform," dated April 13, 2011; [http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/FINAL\\_TESTIMONY\\_FOR\\_NELLEN\\_April\\_13\\_2011.pdf](http://www.aicpa.org/Advocacy/Tax/DownloadableDocuments/FINAL_TESTIMONY_FOR_NELLEN_April_13_2011.pdf).

 **COALITION FOR FAIR  
EFFECTIVE TAX RATES**  
1325 G Street, N.W., Suite 1000, Washington, D.C. 20005  
TEL: 202-872-0885 FAX: 202-296-5940

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April 15, 2015

The Honorable Orrin Hatch  
Chairman, Committee on Finance  
United States Senate  
Washington, DC 20510

The Honorable Paul Ryan  
Chairman, Committee on Ways & Means  
U.S. House of Representatives  
Washington, DC 20515

Dear Chairman Hatch and Chairman Ryan:

We were disappointed and very surprised to learn from press reports on Monday about a letter received later in the day by individual members of the Coalition for Fair Effective Tax Rates (CFETR) seeking their input on tax reform as it relates to pass-through entities.

Effective tax rate parity between C Corporations and pass-through entities defines true tax reform in our view. Effective tax rate parity cannot be achieved if the tax rate on C Corporations is reduced by nearly 30 percent giving them a 15 point advantage over pass-through entities.

Rewriting our tax code so that all businesses receive a fair shake is what led to the formation of the Coalition for Fair Effective Tax Rates. The only way to accomplish this is through a comprehensive approach to tax reform. We believe that we have clearly and consistently communicated this position to you and your staffs and we reiterate it here. As a practical reality no combination of credits, deductions, or exclusions will bring about tax rate parity and produce a fair, simple, transparent and pro-growth tax code.

The President's approach to tax reform, seemingly endorsed by your letter, is contrary to the aim of true tax reform and contrary to the mission of this coalition. Real tax reform means a tax code that no longer picks winners and losers depending on how a business is legally structured or its particular industry.

As discussed in our past meetings, we simply cannot support an approach to tax reform that does not help pass-through entities as well as C Corporations.

Congress should not consider an approach that would disadvantage businesses that employ two thirds of American workers, create more jobs, and pay more in taxes.

(continued)

*April 15, 2015*  
*Page 2*

We look forward to a continued dialogue.

Respectfully yours,

***THE COALITION FOR FAIR EFFECTIVE TAX RATES MANAGEMENT COMMITTEE:***

Associated Builders and Contractors  
Associated General Contractors  
International Foodservice Distributors Association  
International Franchise Association  
National Association of Wholesaler-Distributors  
National Federation of Independent Business  
Retail Industry Leaders Association  
Small Business & Entrepreneurship Council

*Attachment:*  
*CFETR Membership List*

## COALITION FOR FAIR EFFECTIVE TAX RATES

Alabama Retail Association  
American Apparel & Footwear Association  
American Council of Engineering Companies  
American Lighting Association  
American Rental Association  
American Subcontractors Association, Inc.  
American Supply Association  
American Trucking Associations  
American Veterinary Distributors Association  
American Wholesale Marketers Association  
Arizona Builder's Alliance  
Arizona Retailers Association  
Asian American Hotel Owners Association  
Associated Builders & Contractors  
Associated Builders & Contractors of Alabama  
Associated Builders & Contractors of Arkansas  
Associated Builders & Contractors of Central Texas  
Associated Builders & Contractors of Connecticut  
Associated Builders & Contractors of Delaware  
Associated Builders & Contractors of Greater Michigan  
Associated Builders & Contractors of Hawaii  
Associated Builders & Contractors of Metro Washington  
Associated Builders & Contractors of Michigan  
Associated Builders & Contractors of Minnesota & North Dakota  
Associated Builders & Contractors of Mississippi  
Associated Builders & Contractors of North Alabama  
Associated Builders & Contractors of Southeast Texas  
Associated Builders & Contractors of Virginia  
Associated Builders & Contractors-Carolinas Chapter  
Associated Builders & Contractors-Central Florida Chapter  
Associated Builders & Contractors-Central Ohio Chapter  
Associated Builders & Contractors-Central Pennsylvania Chapter  
Associated Builders & Contractors-Eastern Pennsylvania Chapter  
Associated Builders & Contractors-Empire State Chapter  
Associated Builders & Contractors-Florida East Coast Chapter  
Associated Builders & Contractors-Georgia Chapter  
Associated Builders & Contractors-Greater Houston Chapter  
Associated Builders & Contractors-Illinois Chapter  
Associated Builders & Contractors-Inland Pacific Chapter  
Associated Builders & Contractors-Iowa Chapter  
Associated Builders & Contractors-Keystone Chapter  
Associated Builders & Contractors-New Jersey Chapter  
Associated Builders & Contractors-New Mexico Chapter  
Associated Builders & Contractors-New Orleans/Bayou Chapter  
Associated Builders & Contractors-Northern California Chapter  
Associated Builders & Contractors-Northern Ohio Chapter  
Associated Builders & Contractors-Pelican Chapter  
Associated Builders & Contractors-Rhode Island Chapter  
Associated Builders & Contractors-Rocky Mountain Chapter  
Associated Builders & Contractors-San Diego Chapter  
Associated Builders & Contractors-Southeastern Michigan Chapter

Associated Builders & Contractors-Southern California Chapter  
 Associated Builders & Contractors-Texas Gulf Coast Chapter  
 Associated Builders & Contractors-Western Michigan Chapter  
 Associated Builders & Contractors-Western Washington Chapter  
 Associated Equipment Distributors  
 Associated General Contractors  
 Associated General Contractors of America-Florida East Coast Chapter  
 Associated General Contractors of Michigan  
 Associated General Contractors of Ohio  
 Associated General Contractors of Tennessee  
 Associated General Contractors of Washington  
 Associated General Contractors-Central Texas Chapter  
 Association for Hose & Accessories Distribution (The)  
 Association of Pool & Spa Professionals  
 Auto Care Association  
 Business Solutions Association  
 California Business Properties Association  
 California Retailers Association  
 Colorado Retail Council  
 Connecticut Associated Builders & Contractors  
 Construction Financial Management Association  
 Education Market Association  
 Equipment Marketing & Distribution Association  
 Far West Equipment Dealers Association  
 Food Industry Suppliers Association  
 Food Marketing Institute  
 Foodservice Equipment Distributors Association  
 FPDA Motion & Control Network  
 Gases and Welding Distributors Association  
 Health Industry Distributors Association  
 Healthcare Distribution Management Association  
 Heating, Airconditioning & Refrigeration Distributors International  
 Independent Electrical Contractors  
 Independent Insurance Agents & Brokers of America  
 Independent Office Products & Furniture Dealers Association  
 Industrial Supply Association  
 International Association of Plastics Distribution  
 International Foodservice Distributors Association  
 International Franchise Association  
 International Pizza Hut Franchisee Association  
 Irrigation Association  
 ISSA-The Worldwide Cleaning Industry Association  
 Kentucky Retail Federation  
 Kentucky-Indiana Aftermarket Wholesalers Association  
 Louisiana Retailers Association  
 Material Handling Equipment Distributors Association  
 Metals Service Center Institute  
 Mid-America Equipment Retailers Association  
 Motorcycle Industry Council  
 National Association of Chemical Distributors  
 National Association of Electrical Distributors  
 National Association of Wholesaler-Distributors  
 National Beer Wholesalers Association  
 National Community Pharmacists Association  
 National Confectioners Association  
 National Electrical Contractors Association  
 National Federation of Independent Business

National Funeral Directors Association  
National Grocers Association  
National Insulation Association  
National Marine Distributors Association  
National Restaurant Association  
National Roofing Contractors Association  
Nebraska Retail Federation  
New Jersey Retail Merchants Association  
NFIB - Alabama  
NFIB - Alaska  
NFIB - Arizona  
NFIB - Arkansas  
NFIB - California  
NFIB - Colorado  
NFIB - Connecticut  
NFIB - Delaware  
NFIB - Florida  
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NFIB - Rhode Island  
NFIB - South Carolina  
NFIB - South Dakota  
NFIB - Tennessee  
NFIB - Texas  
NFIB - Utah  
NFIB - Vermont  
NFIB - Virginia  
NFIB - Washington  
NFIB - West Virginia  
NFIB - Wisconsin

NFIB - Wyoming  
North American Equipment Dealers Association  
North Carolina Retail Merchants Association  
North Dakota Retail Association  
NPES-The Association for Suppliers of Printing, Publishing and Converting Technologies  
Ohio Equipment Distributors Association  
Ohio-Michigan Equipment Dealers Association  
Outdoor Power Equipment & Engine Service Association  
Pennsylvania Retailers Association  
Pet Industry Distributors Association  
Petroleum Equipment Institute  
Power Transmission Distributors Association  
Printing Industries of America  
Retail Association of Maine  
Retail Industry Leaders Association  
Retailers Association of Massachusetts  
S Corporation Association  
Secondary Materials and Recycled Textiles Association  
Security Hardware Distributors Association  
Small Business and Entrepreneurship Council  
South Carolina Retail Association  
South Dakota Retailers Association  
Taco Bell Franchise Management Advisory Council  
Tennessee Retail Association  
Texas Retailers Association  
TEXO-The Construction Association  
Textile Care Allied Trades Association  
Truck Renting and Leasing Association  
Virginia Retail Merchants Association  
Water & Sewer Distributors of America  
West Virginia Retailers Association  
Wholesale Florist & Florist Supplier Association  
Woodworking Machinery Industry Association  
World Millwork Alliance



April 14, 2015

The Honorable Steve Chabot  
 Chairman, Committee on Small Business  
 U.S. House of Representatives  
 2361 Rayburn House Office Building  
 Washington, D.C. 20515

Dear Chairman Chabot,

On behalf of the International Franchise Association, I applaud you for holding a hearing focusing on the need for comprehensive tax reform. Your hearing entitled, "Tax Reform: Ensuring that Main Street Isn't Left Behind," rightfully focuses on the importance of reform for individuals and small businesses to our economy.

The IFA is the world's oldest and largest organization representing franchising worldwide. IFA members include large and small franchise companies in over 300 different business format categories, individual franchisees, and companies that support the industry in marketing, law, technology, and business development. Modernizing and simplifying our outdated tax code in a comprehensive manner is crucial to these businesses and a necessary catalyst for more robust business investment, a stronger economy, and a growing job market.

While much of the discussion on tax reform has been focused on corporate tax rates, the vast majority of businesses (nearly five times as many) file their tax returns as either S Corps or Partnerships and are subject to individual tax rates. As a result, most small businesses are subject to income tax at the highest marginal individual rate, which increased in January 2013. This tax burden reduces the cash available to expand and grow their businesses and stifles job growth. Two-thirds of net new jobs in America are created by small businesses.

In fact, of IFA members, fifty-eight percent of franchisees and thirty-nine percent of franchisors file as pass-through entities. In all, nearly eighty percent of franchise owners file their business income on their individual tax returns because they are not organized as corporations. Across the business community, the number of individuals filing as S Corps and pass-through entities has increased over the last fifteen years while C Corp filings have fallen reinforcing the need for comprehensive tax reform. If tax reform only addresses corporate tax rates, small businesses – many of them franchised – would be at a severe disadvantage.

A healthy U.S. economy depends on the strength of all businesses, but especially small businesses. Our current outdated tax code impedes the ability of American businesses to grow, compete, and create jobs. Our members firmly support comprehensive reform, and we are encouraged by the focus of this hearing. We are encouraging policy leaders to come together to create simpler, more-up-to-date, and more competitive tax rules for individuals and businesses.



Enacting comprehensive tax reform will result in a healthier economy and more jobs for American workers.

Sincerely,

A handwritten signature in black ink that reads 'Robert C. Cresanti'.

Robert Cresanti  
Executive Vice President of Government Relations & Public Policy

**Congress of the United States**  
**Washington, DC 20515**

April 13, 2015

Dear :

As the chairmen of Congress's two tax-writing committees, we are united in pursuing comprehensive, revenue-neutral tax reform that fixes our broken tax code for families, pass-through businesses, and corporations; significantly reduces tax rates for both individuals and businesses to lower levels; and moves away from an outdated concept of double taxation of business income, savings, and investment. Whichever specific path we might take to reach these goals, whether in one bill or multiple pieces of legislation, we intend to work tirelessly, together, to get there.

Unfortunately, the current administration does not share our vision for tax reform. With President Obama unwilling to reduce individual statutory tax rates, it is likely that some aspects of tax reform will not be completed until the next administration takes office.

That does not mean, however, that we cannot make significant progress toward our goal. The president has indicated an openness to moving part of the way down the road: scaling back tax breaks that corporations use to reduce their tax bills and using the revenue raised to lower the U.S. corporate tax rate. The United States has the highest corporate tax rate in the developed world, which drains our economy and our competitiveness. We cannot afford to wait until 2017 to act. If President Obama is willing to help us achieve a first phase of tax reform focused in part on business income, we owe it to American workers and their families to see if we can find common ground.

Still, significant policy challenges exist in pursuing this approach. Particularly, we have made clear to President Obama and his advisors that we will not leave behind family and closely held businesses organized as pass-through entities. As you know, pass-through businesses account for roughly one-half of all business income in the United States and, more importantly, over one-half of private sector employment.

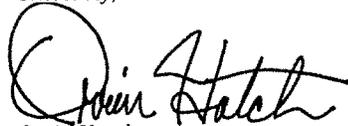
If business tax reform is pursued in 2015, it must include pass-through entities and other small businesses, to make them more competitive.

And that is where you come in. We are writing you to ask for your ideas. As a member of the *Coalition for Fair Effective Tax Rates*, you understand that, at the end of the day, the statutory tax rate is not the only tax rate that determines how competitive a business is. As the name of your coalition implies, for family businesses that do not have access to the public equity markets to raise capital, the *effective tax rate* is usually even more important. Thus, while the reality is that the statutory tax rates for pass-through businesses will have to wait until the next president, there are reforms we can enact now that will lower the *effective* tax rate on pass-through businesses.

We are looking for ideas on how to reduce the effective tax rate without reducing the statutory tax rates in a manner that will make small businesses more competitive and better able to invest, grow, hire, and increase wages for their employees. We are also seeking input on how to simplify tax filing and tax compliance for small and closely held businesses. In the coming weeks, as the Ways and Means Committee continues to build on its work on comprehensive tax reform from the last Congress, and as the Senate Finance Committee wraps up the work of its bipartisan working groups, we ask that you please supply us with your ideas for how to reduce effective tax rates and make the tax code simpler for your members. We would love to hear from you by May 31, 2015. Groups representing American small businesses have an important voice, and we'd like to work closely with those that want to play a constructive role in achieving this phase of tax reform.

We have an opportunity this year to make significant progress on tax reform, and we want to make sure that your ideas on how to make the federal tax system work better for your member businesses are reflected in the legislation we ultimately enact. Time is short, and so we look forward to hearing from you soon.

Sincerely,



Orrin Hatch  
Chairman  
Committee on Finance  
United States Senate



Paul Ryan  
Chairman  
Committee on Ways and Means  
U.S. House of Representatives



Statement for the Record

House Committee on Small Business

*Tax Reform: Ensuring that Main Street Isn't Left Behind*

April 15, 2015

Barbara Kasoff  
President  
Women Impacting Public Policy

On behalf of women entrepreneurs nationwide and our diverse group of Coalition Partners, Women Impacting Public Policy (WIPP) submits the following statement identifying the need for tax reforms to benefit women business owners.

As the advocate for the women's business community, WIPP has always supported a simpler and fairer tax code. Nearly 90% of women-owned firms are small businesses that, as this Committee has noted, face increased burdens and costs from an outdated tax system.<sup>1</sup> Most important to women business owners, though, is the need for comprehensive reform.

In the current environment of tax reform proposals, agreement is building on the need to lower the corporate tax rate to be globally competitive. Doing so without consideration for the millions of pass-through entities paying business taxes as individuals would be unfair. Tax reform must be done comprehensively. Raising or lowering the corporate or individual rate independent of the other would shift the balance between business types more than three decades in the making.

Change, however, is needed. Not only has the business environment noticeably evolved since the last tax overhaul in 1986, but also the American economy. Simply put, now is the time for reform.

WIPP believes that two overarching themes should guide a rewrite of the tax code: simplicity and fairness. The current system is too complex, creating confusion and frustration for women-owned businesses. The system is also unfair to the vast majority of women-owned firms that are small businesses, because they do not have the same capabilities and resources as larger corporations that take advantage of the code's complexity.

#### Bringing Simplicity to the Tax Code

Part of making tax reform simple is making tax reform permanent. Tax laws changed the Internal Revenue Service's (IRS) tax code on two different occasions in 2013, and the IRS National Taxpayer Advocate stated that these changes often generate taxpayer confusion.<sup>2</sup> In addition, Congressional action on business deductions on a piecemeal basis makes planning difficult. Permanent tax reform will lead to more certainty, and as a result, better-informed business decisions.

Complexity has costs for the government as well. It increases the ability of firms and individuals to hide revenues. A simpler code and filing system would make perpetrators of tax evasion more obvious to an IRS struggling with diminished resources. The annual tax gap—the significant amount of revenue owed but not collected—is partially caused by the code's complexity. In 2001, the most recent year analyzed by the IRS, the tax gap was \$345 billion.

<sup>1</sup> U.S. House of Representatives Committee on Small Business, *Memorandum on Tax Reform: Ensuring that Main Street Isn't Left Behind*. 2015. Available online at [http://smallbusiness.house.gov/uploadedfiles/4-15-2015\\_hearing\\_memo.pdf](http://smallbusiness.house.gov/uploadedfiles/4-15-2015_hearing_memo.pdf)

<sup>2</sup> Internal Revenue Service, *National Taxpayer Advocate: 2014 Report to Congress*. 2015. Available online at <http://www.taxpayeradvocate.irs.gov/media/default/documents/2014-annual-report/volume-one.pdf>

The view of the tax code with regard to complexity is best summarized by the National Taxpayer Advocate in its most recent report to Congress: “We have to face up to the fact that we have an incredibly complex tax system that, by virtue of its complexity, creates burden, confusion, and unfairness.”<sup>3</sup> WIPP agrees, and urges Congress to address these challenges.

#### Ensuring the Tax Code is Fair

American women-owned businesses come in all shapes and sizes, including partnerships, S-corps, C-corps, LLCs, and sole-proprietorships. Having different rules for different businesses only increases complexity (see above). Such a tax system hinders growth and discourages businesses to grow in a way that is best suited for their efforts and development.

Whether caused by different compliance costs, business structures, or accounting methods, the reality is, entrepreneurs are paying more than big business. American corporations only pay an effective tax rate of 12.6%, which is nowhere near the statutory 35%, while small businesses operating as S-Corps pay an effective tax rate of nearly 27%.<sup>4</sup> All the while, small firms are paying 67% more in tax compliance.<sup>5</sup> Resolving this inequity should be a goal of the next revision of the tax code.

While WIPP is optimistic that the 114th Congress can lead on tax reform, smaller tax policies can aid women entrepreneurs without a broader overhaul. In the absence of comprehensive reform, there are steps Congress can take to further support women entrepreneurs.

#### Incentivize New Businesses

Both chambers of Congress search, almost annually, for ways the tax code can support start-up companies and newly found businesses. WIPP recommends making many of the tax credits and deductions already proven to support small businesses available to newly formed businesses in their first three years. In the event of an overhaul that removes “tax extenders,” they could still be offered to the newest small businesses.

#### Employee-owned Businesses

Businesses with employees who are financially invested in the company’s success often produce impressive results. That is why WIPP recommends that any tax reform avoid modifying the provisions that support Employee Stock Ownership Plan (ESOPs). ESOPs have been a valuable option for employees to be rewarded for hard work and to move on after the departure of an owner.

<sup>3</sup> Internal Revenue Service, *National Taxpayer Advocate: 2014 Report to Congress Executive Summary* (2015), available online at <http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2014-Annual-Report-to-Congress-Executive-Summary.pdf>

<sup>4</sup> U.S. Government Accountability Office, “Corporate Income Tax: Effective Tax Rates Can Differ Significantly from the Statutory Rate.” 2013. Available online at <http://www.gao.gov/assets/660/654957.pdf>

<sup>5</sup> Small Business Administration, “The Impact of Regulatory Costs on Small Firms 7-8.” 2010. Available online: <https://www.sba.gov/sites/default/files/The%20Impact%20of%20Regulatory%20Costs%20on%20Small%20Firms%20%28Full%29.pdf>

Even more important, they represent another way for small businesses to access capital at low cost. These plans should carry protections to prevent undue risk to employees, but have also demonstrated an increase in production and profitability of many small businesses.

#### Simplify and Expand Cash Accounting Method

Most small businesses operate in a pretty simplistic manner: income and expenses run through the same bank account—similar to a personal checking account that most Americans use. Currently, the tax code does not reflect this practice—instead holding many small businesses to the same accounting standards as global corporations and publicly traded companies.

This does not have to be the case. Expanding the cash accounting method to a larger threshold would give more women entrepreneurs a simpler income reporting mechanism, allowing them to run their businesses and focus on growth.

Moreover, as the Kogod Tax Center has noted, the cash accounting method should be simplified as well. There is no benefit to the IRS, and certainly a detriment to small businesses, by keeping unnecessary complications in this accounting method.<sup>6</sup>

#### Expand the Small Business Health Care Tax Credit

The Affordable Care Act included a tax credit for small businesses that provided health insurance to their employees. Currently, the tax credit is only available to businesses with fewer than 25 employees and average wages of less than \$50,000. Moreover, to receive the full tax credit, which covers up to 50% of employer-paid premiums, businesses must have 10 or fewer employees and average wages of up to \$25,000. Women business owners have shared with WIPP that the credit is too restrictive to be valuable.

WIPP recommends expanding eligibility for the tax credit. Under legislation in this Congress, the Small Business Tax Credit Accessibility Act (S. 379), these restrictions would be relaxed to make businesses with up to 50 employees and average wages of up to \$80,025 eligible for the tax credit. Additionally, it would extend the number of consecutive years a small business can claim the tax credit from two (current law) to three years. It also removes the requirement that employers claiming the credit must contribute the same percentage of the cost for each employee's health insurance. Women business owners want to provide coverage to their employees. Accessing that help should be easy, and not limited to a few businesses.

Thank you for the consideration of these views. WIPP has long appreciated the role of the House Small Business Committee as an advocate for the diverse business community, including women entrepreneurs.



<sup>6</sup>Testimony of Donald Williamson to the House Small Business Subcommittee on Economic Growth, Tax and Capital Access, "Cash Accounting: A Simpler Method for Firms?" (2014), available online at: [http://smallbusiness.house.gov/uploadedfiles/7-10-2014\\_williamson\\_testimony.pdf](http://smallbusiness.house.gov/uploadedfiles/7-10-2014_williamson_testimony.pdf).