The Tax Outlook for Small Business: What's on the Horizon

Testimony of:

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The Honorable Sam Graves (R-MO), Chairman
The Honorable Nydia Velazquez, (D-NY), Ranking Member

Protecting Small Business, Promoting Entrepreneurship

Chairman Graves, Ranking Member Velazquez and Members of the House Committee on Small Business, thank you for the invitation to participate in today's hearing to examine the significant impact our tax system is having, and will have, on small businesses and individuals with regard to the Affordable Care Act, the expiration of the Bush Administration tax cuts, the complexity in the tax system, and the issues affecting compliance.

My name is Leonard Steinberg. I am an Enrolled Agent, accountant, and a Certified Management Consultant. I am the principal of Steinberg Enterprises, LLC, a West Windsor, New Jersey tax and consulting practice that concentrates in the areas of tax accounting, taxpayer representation before the Internal Revenue Service, and financial and administrative operational reviews for small businesses and nonprofit organizations. We provide comprehensive tax services including preparation, planning and problem resolution services. Our organization works with all categories of small businesses (Sole proprietorships, partnerships and S-Corporations), nonprofit organizations, and individuals, regarding tax compliance, tax planning and problem resolution services. Our work includes estates, trusts, divorce issues, bankruptcy filings, and tax court preparation. Our representation services include negotiating Installment Agreements, Offers in Compromise, Collection Due Process Hearings, Appeals, and Trust Fund Recovery Penalty abatements.

I am a member of the New Jersey IRS Practitioner Liaison Committee representing over 200 Enrolled Agents in the state and our respective clients. Since 2005, I have also represented the Small Business & Entrepreneurship Council as a member of the Small Business Advisory Committee to the Financial Accounting Standards Board (the FASB). From 2001 through 2004, I was a member of the Taxpayer Advocacy Panel (TAP) and chair of the Small Business/Self Employed Payroll Tax Committee.

My testimony today is based on my practical experience in dealing with all tax issues affecting the small business community and its individual taxpayers.

The Small Business Community:

The structure of the small business community is comprised of one of the following: Sole Proprietorships, Limited Liability Companies, which can be either classified as partnerships or Sub-Chapter S-Corps, Partnerships, or Sub-Chapter S-Corporations.

Sole Proprietorships and sole owners of Limited Liability Companies are required to file Schedule C, with their personal income tax returns. Partnerships and Sub-Chapter S-Corps issue IRS Form K-1 which flow through to the individual's personal income tax return. These structures are called flow-through entities.

It is quite rare that a small business would be classified as a C-Corp since this type of organization is subject to double taxation, i.e. that the corporation pays income tax and then the person(s) who own the corporation is/are taxed on their income from the corporation.

Tax Complexity:

Each of the above small business organizational structures are affected by the number and extent of laws, rules, regulations and compliance issues in the current tax code. As ONE example, let's tax a look at the subject of Depreciation. The tax code lists 18 different methods to depreciate assets. However, the method must be matched to the class life of the asset. There are 11 different class lives of various types of assets. Unless the business owner is an accountant or has an accounting background, a tax advisor must provide the updated depreciation schedule each year. Since each asset can use a different depreciation method, the work required can be quite complex. Selling an asset before its completed useful life has its own set of rules, regulations, policies and procedures.

Business owners also can use Section 179 to expense capital investments. Section 179 has been in existence since 1981 with passage of the Economic Recovery Tax Act (ERTA); a major piece of tax legislation enacted during the first Reagan Administration. The purpose of the code section was to allow business owners that make capital investments in their business, to deduct the investment in the year that such investment is made; instead of having to deduct the cost basis over a longer period of time (e.g. useful life).

The purpose of the legislation was to encourage business owners, who were contemplating an investment in capital equipment to make that investment in the current year, which would stimulate growth in the economy.

The maximum deduction in 1981 was $10,000 and during the succeeding years it increased to $25,000. In 2003, The Jobs and Growth Tax Relief and

Reconciliation Act (JGTRRA) was passed by Congress, during the Bush Administration. This bill increased the §179 deduction limit to $125,000.

In 2007 the deduction limit was increased to $250,000 for tax year 2008. The purpose, again, was to encourage capital investment and give a stimulus to the economy. In February of 2008 the $250,000 limit was extended through 2008 and it was again extended through 2009. It was extended through 2010 (§103 Hiring Incentives to Restore Employment Act of 2010, or HIRE Act).

For tax years 2010 and 2011, Congress passed the law that allowed the expansion of the Section 179 expense limitation to $500,000. As noted above, without further "enabling legislation", the 2003 "Bush Tax Cuts" will expire and go back to pre-2003 rates and the §179 deduction limit will fall back to $25,000. Such uncertainty makes it more difficult for small business owners to properly plan for capital investments and diminishes the impact of the incentive.

As a member of the FASB Small Business Advisory Committee, the issue of the pending US adoption of IFRS (the International Financial Reporting System) will have significant adverse effects on the small business community. Under the IFRS structure, small businesses would not be allowed to use the Last-In-First-Out (LIFO) method of inventory valuation. The only method permitted would be the First-In-First-Out (FIFO) method. This would be an immediate tax increase for all those who use the LIFO method. Under the LIFO method, business owners must track the reserves for the FIFO method and those would become taxable in the year of conversion. This would result in an immediate tax increase.

The issue of complexity continues with payroll and employee benefit plans. Even for the small employer, those with 50 or fewer employees, the rules and regulations at the federal level require the use of paid professionals to ensure proper compliance.

This complexity also affects employers on the state level. While this Committee is involved with federal issues only, many, if not most states, follow the federal rules, and regulations which all add to the costs of doing business.

Complexity of the tax laws and compliance only increases the amount of time small business employers must expend valuable resources. According to the Small Business Administration's analysis, small firms with fewer than 20 employees spend 60 percent more per employee than larger firms to comply with federal regulations. Small firms spend twice as much in dollars on tax compliance as their larger counterparts.

Many business clients have stated that the tax code is too complex, cumbersome and filled with so-called "loopholes" or special circumstances which make it inherently unfair. Business people sign the returns stating they are correct, but they do not truly know. Many have no idea what the accountants are actually doing, but pay them and the lawyers plenty of money to properly comply and find ways to reduce the tax burden. It seems that those with more money or more political influence can get more tax breaks.

As a member of the IRS Practitioner Liaison Committee in New Jersey, our panel works with IRS personnel in trying to resolve complex client issues. We use the IRS Issue Management Resolution System (IMRS) to monitor local and national tax complexity and compliance issues. Over the years, as the tax code has become more complex, the issues take longer to resolve and many outstanding issues are referred for possible Congressional action.

In 2010, Congress made 579 changes to the tax code which now numbers 3.8 million words which as recently reported is 4 times the length of Shakespeare's entire works.

Affordable Care Act:

Regardless of how the U.S. Supreme Court rules on the constitutionality of the Affordable Care Act, many small business entrepreneurs are concerned with the new taxes and regulations that the law imposes. Some employers have expressed concerns that they may not be able to afford to keep their employees. One of the alternatives some have considered is to re-classify their workers as independent contractors and thereby avoid the issue altogether. However, the reclassification of these workers poses additional risks for the employer and the former employee. A question is whether the business owners will accept the risk. If enough small business owners engage in this practice, the IRS and the states will be unable to monitor these actions. Some business owners will get caught while others will escape. This scenario is inherently unfair in its application.

The proposed tax increases in the Affordable Care Act will alter the way small businesses view each expenditure and cause them to be risk averse. Businesses will stagnate since business owners will be unsure of what additional rules and regulations will be promulgated by the U.S. Secretary of Health and Human

Services. This uncertainty takes money out of the worker's pockets, reduces job creation and will lead to a decline in the overall economy since there will be fewer dollars available for disposable income and less risk-taking overall.

Expiration of the Bush Administration Tax Cuts:

If no extensions of the tax relief enacted by the Bush Administration are signed into law, the pre-2001 higher tax rates will go back into effect. The 10% bracket would disappear and those taxpayers would move up to the 15% bracket, which would apply to all income below $34,550. This increase would have a negative impact on those at the bottom of the economic ladder. Obviously, increases up the ladder will impact small business owners at all income levels.

The Child Tax Credit would revert back to $500 per child from the current $1,000 per child. Again this tax increase would disproportionately affect those in the middle class who struggle to make ends meet during this prolonged recession.

The capital gains tax and the qualified dividends tax were both reduced to the 15% rate and were at a zero rate for lower income filers. Capital gains would revert back to 20% and qualified dividends would revert back to the higher tax rate of the filer up to the maximum rate of 39.6%. Itemized deductions would also revert back to the pre-2001 higher tax rates. This provision will have a chilling effect on future investments, especially for those with lower incomes who try to supplement their incomes and to provide for a larger retirement fund. In addition, current retirees who rely on their IRA, SEP, or 401(k) distributions will be adversely affected by having their income reduced because of higher taxes on the Required Minimum Distributions.

The marriage penalty used to equalize the standard deduction to twice that of a single filer would also revert back. Personal exemptions and phase outs of itemized deductions would also revert back to the pre-2001 rates.

Let us also include the impact of the Alternative Minimum Tax (AMT). This additional tax has never been indexed for inflation.

Small business owners, who have flow-through entities, are impacted twice should the tax cuts expire. They are impacted at the company level when net operating revenue is decreased and also on the personal level when their individual taxes are raised. Unlike employees, many small business owners are involved with their respective businesses 7 days a week. Their comparable hourly rates of pay will be reduced as they struggle to allocate fewer resource dollars thereby putting a significant strain on their ability to continue to prosper and grow.

Every small business strives to emulate the successes of other small business entrepreneurs as Will Hewlett and Dave Packard, Michael Dell, Steve Jobs, Sam Walton, and numerous others.

Conclusion:

In 1980, the year the Paperwork Reduction Act was passed into law, the number of instruction booklet pages for the individual form 1040 was approximately 45 pages and the form itself contained 68 lines. In 2004, the number of instruction booklet pages for the individual form 1040 was 128 pages and the form itself contained 75 lines. As of the 2011 filing year, the number of instruction booklet pages for the individual form 1040 was 189 pages and the form itself contained 77 lines. Burden and complexity have significantly increased in the last 25 years. This is just for regular 1040 filers.

Business returns have also grown more complex. In the year 2000, the IRS instruction booklet for Partnerships, IRS Form 1065 consisted of 35 pages; for tax year 2011, for the same return, the booklet now consists of 45 pages. In the year 200, the IRS instruction booklet for S-Corps, IRS Form 1120S consisted of 32 pages; for tax year 2001, for the same return, the booklet now consists of 42 pages.

The constant uncertainty in the tax code from year to year causes business owners to be reluctant to take actions which would enhance their respective firms. Business owners cannot effectively plan for the future. When Congress passes tax credits, these only take effect when the tax return is filed, which is at least 12 to 18 months later. The tax credits do not put money directly into the workers' pockets. At best, tax credits have a delayed effect and usually provide little substance to the business owners.

Whenever money is taken out of the economy from the small business community, the consequences have multiple effects. Business owners cannot afford to give their employees timely raises, profit sharing and other fringe benefits are cut or withdrawn, business owners defer capital expenditures affecting their suppliers and the supplier workers, worker disposable income is reduced affecting vacations, restaurants, entertainment, and other activities. The workers who work in these industries also suffer due to the cutback. The Las Vegas economy is a prime example.

Tax increases also disproportionately affect minority populations and their communities since small businesses usually operate in their own neighborhoods.

Let the example of the Reagan era tax overhaul be a guide for future discussions. When the tax code was simplified in 1986, the result was the longest continuous period of economic boom in this county's history. More jobs were created than at any other time.

The issue of tax complexity, compliance, lack of tax certainty, and burden on small businesses falls squarely within the domain of the Congress. The IRS can only implement the will of the Congress. The members of this important Committee have the influence in their respective congressional districts, their state delegations, and with the fellow congressional members to significantly impact and re-ignite the most successful economic engine in the free world, that is the U.S. small business community. I respectfully request that you make the necessary changes for the future economic growth of our great nation and as part of your public service legacy.

I sincerely thank you for the opportunity to address this Committee. Chairman Graves and members of the Committee, I look forward to our dialog and your questions on these issues.

Thank you.

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