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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

Memorandum

To:	Members, House Committee on Small Business
From:	Chairman Sam Graves
Date:	April 11, 2011
RE:	Full Committee Hearing: *How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth*

On Wednesday, April 13, 2011, in Room 2360 of the Rayburn House Office Building, the House Committee on Small Business will hold a hearing titled, *How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth.* Witnesses will include: Nina E. Olson, National Taxpayer Advocate, Monty Walker, Walker Advisory, Wichita Falls, TX; and Steve Strobel, Chief Financial Officer, BlueStar Energy Solutions, Chicago, IL.

President Obama, Members of the House Ways and Means Committee and Members of the Senate Finance Committee have all expressed support for fundamental tax reform. This hearing will provide an opportunity to learn more about the effect of tax complexity on entrepreneurs and small firms.

I. Introduction

The U.S. economy appears to be improving, but not enough to result in significant job growth. Energy prices are volatile and may be a drag on growth. Months of rising prices for food, cotton and other commodities have caused wholesale prices to rise. Companies are beginning to pass on higher cost to retailers, which may result in consumer price increases later this year.[1]

Small businesses are still not confident enough in economic growth to increase hiring. Congress' temporary extension of the 2001 and 2003 tax rates and payroll tax cuts may help business confidence, but businesses are still wary of economic uncertainty,

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[1]Ben Bernanke, *The Economic Outlook and Macroeconomic Policy*, Speech to the National Press Club, January 3, 2011, available at: http://www.federalreserve.gov/newsevents/speech/bernanke20110203a.htm.

and are not ready to commit to growth or expansion. Economists predict continued consumer caution, high unemployment and slow growth in household income through 2011.[2]

As most people know, small businesses create seven out of every ten new jobs in America. They are the economic engines that can lead our recovery. But the federal government must promote policies that will enable small businesses to flourish, not hinder them with more regulations, mandates and uncertainty. Tax complexity is a continuing burden for businesses, one that is an increasing cost and source of confusion. Simplifying the tax code could help increase compliance rates and reduce costs, and free small businesses to use their resources to expand their firms, hire workers and create a stronger economy.

The House Ways and Means Committee and Senate Finance Committee have begun a series of hearings to consider fundamental tax reform. The effect of the present tax code on small businesses, not just individuals or corporations, must be considered in this debate.

This hearing will provide an opportunity for Members of the Committee to listen to the concerns of small business owners who face the onerous burden of compliance with our complex tax code, and hear their ideas for simplification.

II. The Power to Tax

From its earliest beginnings, our nation's history has been closely connected with taxation.[3] One of the issues that led to the American Revolutionary War was Colonial leaders' belief that the taxes imposed by the British were excessive. More importantly, the colonists believed they should not be taxed when they had no representation in Parliament. Parliament passed the Quartering Act,[4] and although colonists complained, most complied because they accepted the British's right to provide for defense and regulate trade. Parliament later passed the Stamp Act,[5] the first direct tax within the colonies. Colonists strongly opposed the Stamp Act, because it was excessive and affected every colonist. They also feared Parliament would continue to impose taxes, eroding colonists' property and political rights. Tax resistance in the colonies led to consumer boycotts of British goods, and Parliament repealed the Stamp Act in 1767.[6] But Parliament further responded by simply passing legislation declaring its right to tax

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[2] "Economists Predict Slow Growth Through 2011," Journal of Commerce, available at: http://www.joc.com/logistics-economy/economists-forecast-slow-growth-through-2011.

[3] James W. Pratt and William N. Kulsrud, Federal Taxation, Cengage Learning, 2008.

[4] The Quartering Act, passed in early 1765, required colonists to provide housing and supplies for British officers.

[5] The Stamp Act, enacted in March, 1765, required colonists to pay a direct tax on all books, newspapers, contracts, land deeds, and other documents printed on paper. The British contended the tax was necessary to defray the expense of defending the colonies.

[6] Emma J. Lapansky-Werner, Peter B. Levy, Randy Roberts and Alan Taylor, United States History to 1914, Custom Publishing, 2008, p. 102.

colonists. Other British taxes followed, such as the Townshend Acts,[7] but colonists were adamant that they would pay no taxes of any kind. Again, Parliament backed down, but Parliament retained the tax on tea, leading to the Boston Tea Party.

After the colonies gained independence, tariffs[8] became the government's primary source of revenue. When the Constitution was adopted in 1789, Article I, Section 8, Clause 1 gave Congress the power to tax and spend. Congress passed as its first act, the Tariff Act of 1789, which imposed excise taxes on imports.[9] As the scope of power of the government increased over time, political leaders believed a new source of revenue was needed. The first federal income tax, the Revenue Act of 1861, was enacted to finance the Civil War. The tax on personal income was groundbreaking, since previously taxes had been excise taxes or customs duties.[10] The Act passed despite the Constitution's requirement that any direct tax imposed by Congress be apportioned among the states on the basis of relative populations.[11] Later, Congress proposed a Constitutional Amendment permitting it to levy taxes on all incomes without apportionment. The result was the Sixteenth Amendment to the Constitution, ratified on February 25, 1913:

> The Congress shall have the power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.[12]

On October 3, 1913, Congress passed the Revenue Act of 1913, and made it retroactive to March 1, 1913. The Supreme Court later upheld the validity of the income tax.[13]

The tea party movement revived interest in individual resistance to higher levels of taxation and government spending. Like the other frustrations that small business owners endure, taxes seem to affect them disproportionately.

III. The Tax Code and Complexity

Douglas Shulman, Commissioner of Internal Revenue, is fond of saying that complexity is nothing new: the tax code is four times as long as *War and Peace*, and

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[7] The Townshend Acts, enacted in 1767, levied import duties on basic items such as glass, lead, paint, paper, copper and tea. The proceeds were to be used to pay the salaries of colonial governors and judges, rendering them independent of colonial assemblies. This concerned the colonists, who valued financial control of their governors.
[8] Tariffs are duties imposed on importers.
[9] James W. Pratt and William N. Kulsrud, Federal Taxation, Cengage Learning, 2009, pp]. 1-3.
[10] According to the Department of the Treasury, in 1861, the income tax rate was 3% on all incomes higher than $800 annually.
[11] In *Springer v. U.S.*, 102 U.S. 586 (1881), the Supreme Court ruled that only head taxes and real estate taxes are direct taxes, and upheld the unapportioned income tax.
[12] Constitution of the United States, Amendment XVI.
[13] *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916).

grows every year.[14] There has been no major tax reform in over 26 years. But according to a respected publisher of tax information, there have been 4,428 changes to the tax code in the past ten years, an average of more than one per day.[15] There were an estimated 579 changes to the code just in 2010.[16] One count showed the number of words in the tax code at 3.8 million,[17] and another report claims the number of tax code pages is now over 70,000 pages.[18] Some have said that tax complexity is the result of the trade-offs between simplicity and other goals.[19]

In her 2009 report to Congress, the National Taxpayer Advocate, Nina E. Olson, identified the need for tax reform as the number one priority in tax administration.[20] Taxpayers and preparers spend about 6.1 billion hours annually to comply with the complex requirements of the law.[21] It has also been estimated that U.S. taxpayers spend over $160 billion annually just to comply with income tax requirements.[22] Because of complexity, more than 60% of taxpayers pay a preparer to complete their returns, and 22% purchase tax software to assist them in preparing their own return.[23] This means that individuals and businesses are spending resources on tax preparation that could otherwise be invested back into their own business and job creation.

Complexity is also important because it affects tax compliance. Individuals who do not understand the law have more difficulty complying with it, and the result is less revenue in the U.S. Treasury. Individuals who "feel distant" from the code have lower rates of voluntary tax compliance,[24] although it is uncertain what makes one feel "connected" to it. The Taxpayer Advocate's Report states the code is so complex that even the IRS has difficulty administering it.[25] The IRS has found it more challenging to answer the millions of phone calls and taxpayer correspondence it receives each year.[26] The expectations are so low that IRS set its Fiscal Year 2010 telephone customer service

[14] Douglas H. Shulman, Speech before the New York State Bar Association, January 26, 2010, available at: http://www.irs.gov/newsroom/article/0,,id=218705,00.html.
[15] Testimony of Nina E. Olson before the House Ways and Means Committee, January 20, 2011,available at: http://waysandmeans.house.gov/UploadedFiles/Olson-Testimony-written-WM-Tax_Reform-1-20-2011.pdf, citing CCH data.
[16] Ibid.
[17] Report of the National Taxpayer Advocate, January 5, 2010, available at: http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7.
[18] "The Joy of Tax," *The Economist*, April 10, 2010, available at: http://www.economist.com/node/15867984.
[19] Testimony of William G. Gale before the House Committee on Ways and Means, July 17, 2001, available at: http://www.brookings.edu/testimony/2001/0717useconomics_gale.aspx.
[20] Report of the National Taxpayer Advocate, January 5, 2010, available at: http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7.
[21] Ibid.
[22] Report of the National Taxpayer Advocate, January 5, 2010, available at: http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7.
[23] Nina E. Olson, "We Still Need a Simpler Tax Code," Wall Street Journal, April 10, 2009, available at: http://online.wsj.com/article/SB123933106888707793.html.
[24] Report of the National Taxpayer Advocate, January 5, 2010, available at: http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7.
[25] Ibid.
[26] Ibid.

goal at 71.2%. That means almost three out of ten callers to the IRS are not expected to get through.[27]

Albert Einstein once said, "The hardest thing in the world to understand is the income tax." When Einstein spoke those words many years ago, the tax code was nowhere near as complex as it is today. Since the 1984 reform, there have been 29 tax bills with changes to over 2,000 code provisions. That level of complexity falls on all taxpayers, but it falls very heavily on small businesses, which often lack the resources to hire expensive accountants or legal representation.

Since Congress instituted the income tax in 1913, it has passed numerous pieces of legislation that increased the length and complexity of tax laws. In 1939, Congress segregated tax law into the Internal Revenue Code, a permanent codification of federal tax statutes that is now Title 26 of the United States Code. The 1939 Code had major revisions in 1954 and 1986. There are reportedly over 1,638 different tax forms, and the Internal Revenue Service estimates that it takes over 37 hours to complete the basic 1040 short form.

The additions and changes to the code over the years result in confusion and difficulty with compliance, especially among small business owners. With the continued increases in federal spending, businesses are concerned about the possibility of higher taxes. A 2009 Tax Foundation survey revealed that a majority of adults believe that taxes are too high, and four in every five adults say the code is too complex.[28] Eighty-five percent say that the tax system needs to be completely overhauled.[29] Complexity harms taxpayers and the United States Treasury, since taxpayers who are unable to discern the code often underpay taxes, which reduces revenue. In addition, the IRS must expend time investigating and auditing taxpayers it believes may be non-compliant.

IV. Complexity's Impact on Small Businesses

According to the National Taxpayer Advocate, tax issues are the single most significant set of regulatory burdens for most small businesses.[30] A recent NFIB Research Foundation study of Small Business Problems and Priorities found that four of the top ten problems small businesses identified were tax related.[31] Entrepreneurs struggle to decipher the code, file paperwork and pay their taxes, all while keeping their businesses running. Small businesses face unique challenges when dealing with the code.

[27] Ibid.
[28] Tax Foundation Survey, April 2009, available at: http://www.taxfoundation.org/news/show/24600.html.
[29] Ibid.
[30] Testimony of Nina E. Olson, National Taxpayer Advocate, before the House Committee on Small Business, September 21, 2005.
[31] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC, series.

According to the National Federation of Independent Business, the majority of small firms -- nearly 75% -- are organized as "pass through" entities,[32] not C corporations. These types of businesses include sole proprietorships, partnerships, LLCs and S corporations. More than half of the individual income is earned by pass through entities, most of which are small businesses,[33] and these small business owners typically pay business taxes at the individual rate.

Small businesses are disproportionately affected by tax complexity. A study by the Small Business Administration's (SBA) Office of Advocacy [34] disclosed that small firms pay 67% more to comply with the tax code than large firms do, with tax complexity a contributing factor. The growing number of code provisions, along with the fact that small firms frequently do not have an in-house accountant or tax attorney, means that small business owners must hire outside experts or add those duties to another employee's workload.

Small businesses face the code's confusing patchwork of provisions that includes equipment depreciation, net operating loss carryover, home office deduction, employment taxes, classification of workers and the earned income tax credit. For small businesses, compliance is tedious and expensive.

In recent years, the IRS has attempted to reduce the tax gap – the difference between what the IRS collects on time and what it believes it believes taxpayers owe. As a result, the IRS increased its audits of businesses, and particularly small businesses. Simplifying the code could help reduce audits of small business owners who are non-compliant simply because they cannot decipher the code.

Small and large businesses provide a large portion of tax revenue to the federal government. According to testimony by former Comptroller General David Walker,[35] the design of the current system of business taxation is widely viewed as flawed. Complexity promotes tax shelters and reduces the perception of fairness and public confidence that other taxpayers are paying their fair share. Simplification and increased uniformity could encourage greater compliance.

Termination of the present tax code is possible but seems unlikely, and fundamental tax reform has not been considered by Congress for many years. As a result, each year Congress has renewed dozens of "temporary" provisions which would otherwise expire. Some of these temporary provisions, such as the research and

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[32] Testimony of Warren S. Hudak, House Committee on Ways and Means, January 20, 2011, available at: http://waysandmeans.house.gov/UploadedFiles/hudak_1_20_11.pdf.

[33] Press release, Subcommittee on Select Revenue Measures, House Committee on Ways and Means, February 24, 2011, available at: http://waysandmeans.house.gov/UploadedFiles/HEARING_ADVISORY_02_24_11.pdfn.

[34] See W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2005), available at http://www.sba.gov/advo/research/rs264tot.pdf.

[35] Testimony of David M. Walker, U.S. Senate Committee on Finance, September 30, 2006, highlights page.

development tax credit, Section 179 expensing, are vital to small businesses. In a time of economic uncertainty, any tax increase would place an untenable burden on small firms.

V. Simplification

In August, 2010, President Obama's Economic Recovery Advisory Board issued a report to Congress outlining three tax reform options. The panel of outside experts, headed by former Federal Reserve Chairman Paul Volcker, made no recommendations, but explained several simplification options, including simplifying family tax benefits; education incentives; and savings and retirement incentives, for example. The report of President Bush's 2005 tax reform commission, which suggested alternative tax structures, was never acted upon by Congress.

Many ideas for tax simplification have been proposed. Although there seems to be broad agreement that simplifying the tax code is desirable, each year it inevitably becomes more complex. Simplification has many benefits, but there can also be costs. Simplification reduces or eliminates the ability of tax policy to influence behavior, such as encouraging economic expansion or meeting social goals.[36] One of the challenges of selecting an alternative to the current code is the related issue of the current code's exemptions. These exemptions were shepherded into law by the many interests that benefit from them. Adopting a simpler tax code would likely eliminate, or at least limit, most exemptions.

VI. Alternatives to the Present Tax Code

Discussions have centered around two alternatives for reforming the present tax code, broadening the tax base, or implementing a new consumption tax.

Broadening the Base and Lowering Marginal Rates

Some have expressed concern about the number of high cost deductions, such as the mortgage interest deduction and state and local income tax deduction, in our present code. If higher cost deductions were reduced or eliminated, then marginal rates could be lowered. Some economists believe lower marginal rates spur investment and provide greater economic efficiency.

Consumption Taxes

Flat Tax

First proposed over twenty five years ago, the flat tax is often associated with ideas formulated by economists Robert E. Hall and Alvin Rabushka of the Hoover

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[36] Testimony of William G. Gale before the House Committee on Ways and Means, July 17, 2001.

Institution for a low, simple, flat rate tax with limited or no deductions.[37] Their proposal is a modified value-added tax (VAT) with two components: a wage tax (levied on wages, salaries and pension income, with part or all income tax free, depending on marital status and number of dependents); and a cash flow tax on businesses (usually levied on gross receipts minus wages, salaries and pension contributions). Hall and Rabushka said their proposal was so simple that an individual or business owner could complete an income tax return on a form the size of a postcard.[38] They helped to develop flat taxes for several Eastern European countries.

Fair Tax

The Fair Tax would repeal all federal taxes on corporate and personal income with a use or consumption tax on the retail sale of all new goods and services. The sales tax rate, as defined in H.R. 25 introduced in this Congress, would be set at 23% in 2013, the first year, with possible adjustments to the rate in subsequent years. Exemptions would be permitted for property or services purchased for business, export or investment purposes, and for state government functions.[39] All U.S. residents with valid Social Security cards would receive a monthly "prebate" from the federal government equivalent to the Fair Tax on essential goods and services. The prebate would be determined by the Department of Health and Human Services poverty level index multiplied by the tax rate.

Retail Sales Tax

A retail tax is a consumption tax assessed at a single stage of production, the retail stage.[40] The retailer would collect a percentage of markup in the retail price of a good or service, and then remit it to the taxing authority. Some have criticized this option as unfair to low income families, and that once established, it could be extremely easy to raise the rate.

Value Added Tax (VAT)

A value added tax (VAT) is a consumption tax levied at every stage of production, based on each firms' value added.[41] This tax is collected by each firm in the production process and remitted to the government.

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[37]James M. Bickley, *Flat Tax: An Overview of the Hall-Rabushka Proposal,* Congressional Research Service, Product 98-529, January 28, 2011. *See also* Robert E. Hall and Alvin Rabushka, *The Flat Tax*, the Hoover Institution, 2007, available at: . http://www.hoover.org/publications/books/8329.
[38] Robert E. Hall and Alvin Rabushka, *The Flat Tax*, the Hoover Institution, 2007, available at: http://www.hoover.org/publications/books/8329.
[39] H.R. 25, introduced by Rep. Robert Woodall in the 112th Congress.
[40] James M. Bickley, *Tax Reform: An Overview of Proposals in the 111th Congress*, Congressional Research Service, Product R40414, March 5, 2009.
[41]Ibid.

There are different policy implications to consider under each option. For each alternative to the present tax code, the effect on large and small business income, investment and job creation, should be considered. Because they are such an integral part of our economic recovery, entrepreneurs must be part of the dialogue on tax reform. The Committee will be actively involved in making sure the voice of small firms is heard.

VIII. Legislative Proposals

In March, House Ways and Means Committee Chairman Dave Camp (R-MI) said he supports lowering the top tax rate for individuals and corporations to 25% and reducing or eliminating many current deductions.[42] Presently, top tax rates for corporations and individuals are 35%, but the effective tax rates are lower.

Although Chairman Camp did not specify which deductions he favors targeting, the largest deductions include those for home mortgage interest, excluding employee health care, and state and local taxes. The biggest corporate deductions include accelerated depreciation credits. It is uncertain at this time how the Ways and Means Committee plans to proceed on tax reform.

IX. Conclusion

This hearing will offer Members the opportunity to examine the complexity of the current code, its effect on small companies, and some alternatives to the code. Members will hear firsthand from the National Taxpayer Advocate and small business owners about the burden of the code's complexity and the need for simplification.

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[42] "Tax Plan Aims for 25% Cap," John D. McKinnon, *Wall Street Journal*, March 17, 2011.