

Congress of the United States

U.S. House of Representatives

Committee on Small Business

2361 Rayburn House Office Building

Washington, DC 20515-6515

Memorandum

To: Members, House Small Business Subcommittee on Economic Growth, Tax and Capital Access
From: Small Business Committee Staff
Date: October 31, 2011
Re: Hearing: "Pro-Growth Tax Policies: Why Small Businesses Need Individual Tax Reform"

The House Small Business Subcommittee on Economic Growth, Tax and Capital Access will meet at 10:00 a.m. on Thursday, November 3, 2011 in Room 2360 of the Rayburn House Office Building for the purpose of hearing testimony on the importance of individual tax reform to small businesses and for our economy. The Subcommittee will receive testimony from witnesses, including Robert J. Carroll, Principal, Qualitative Economics and Statistics Group, Ernst & Young, LLP, Washington, DC; William Smith, Chief Executive Officer, Termax Corporation, Lake Zurich, IL, testifying on behalf of the Precision Metalforming Association; and Stephen Capp, President and CEO, Laserage Technology Corporation, Waukegan, IL, testifying on behalf of the National Federation of Independent Business.

I. Background

In her 2010 Report to Congress,¹ the National Taxpayer Advocate said the most serious problem facing taxpayers is the complexity of the tax code and the need for tax reform.² According to an Office of the Taxpayer Advocate analysis of Internal Revenue Service (IRS) data, over the last decade, the Internal Revenue Code has almost tripled in size, growing from 1.4 million words in 2001 to 3.8 million words in 2010.³ There have been about 4.428 changes to the tax code over the past ten years, an average of more than one per day, and an estimated 579 changes in 2010 alone.⁴

As former IRS Commissioner Fred Goldberg has testified, the primary contributors to the erosion of the tax base, and its resulting complexity, reflect our priorities as a nation.⁵ The majority of tax code provisions, whether they are to help families (child credit), the environment (alternative fuel vehicle credit) or retirement savings (Individual Retirement Account savings credit) have a constituency that is

¹ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, 2010 Report to Congress, *available at* <http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7>.

² *Id.* at 3.

³ *Id.* at 4.

⁴ *Id.*, citing unpublished CCH data provided to the Office of the National Taxpayer Advocate (2010).

⁵ *Hearing on How Did We Get Here? Changes in the Tax Environment Since the Tax Reform Act of 1986, Hearing Before the Senate Finance Committee, 112th Congress, First Session (March 1, 2011) (Statement of Fred T. Goldberg, Jr.)*

trying to protect them. As Commissioner Goldberg said, “This is where the Code has expanded with abandon during the past 25 years.”⁶ Tax reform, he said, should make a contribution to reversing the “job-destroying distortions and complexity”⁷ that are now so much a part of our system.

The issue of taxes is so critical to the nation’s ability to create jobs and grow the economy that one *Wall Street Journal* writer recently said that taxes are “emerging as the defining issue for 2012.”⁸ Tax reform is particularly important to small firms, because they spend a disproportionate amount of time and money to comply with the tax code. In addition, the majority of businesses, and the majority of small companies, are organized as “pass-through” entities. This means they pay business taxes on their owner(s)’ individual tax return, rather than on a corporate return. These small firms are critical to our nation’s economic recovery, since they create 7 of every 10 new jobs. And their tax treatment is vital to their ability to generate new jobs. Because they pay taxes on individual returns, many have suggested that individual tax reform should be considered in tandem with corporate reform.⁹

II. The Need for Tax Reform

Taxpayers and preparers spend about 6.1 billion hours annually to comply with the complex requirements of the tax code.¹⁰ It has been estimated that U.S. taxpayers spend over \$160 billion annually complying with income tax requirements.¹¹ Today, more than 60% of taxpayers pay a preparer to complete their returns, and 22% purchase tax software to assist them.¹² This means that individuals and businesses are spending scarce resources on tax preparation that could otherwise be invested productively in their businesses.

Complexity is important because it affects tax compliance. Individuals who do not understand the law have more difficulty complying with it, and so less revenue is collected by the U.S. Treasury. Individuals who feel distant from the tax code have lower rates of voluntary tax compliance.¹³ The Taxpayer Advocate’s Report notes that the code is so complex that even the IRS has difficulty

⁶ *Id.*

⁷ *Id.*

⁸ Gerald Seib, Taxes Emerging As Defining Issue for 2012, WALL ST. J., September 19, 2011, available at <http://online.wsj.com/article/SB10001424053111903374004576580710594126704.html>.

⁹ See *Hearing on How Business Tax Reform Can Encourage Job Creation: Hearing before the House Comm. on Ways and Means*, 112th Congress, First Session (June 2, 2011) (Statement of Rep. Dave Camp, Chairman, House Comm. on Ways and Means), available at <http://waysandmeans.house.gov/Calendar/EventSingle.aspx?EventID=242050>, and *First in a Series of Hearings on fundamental Tax Reform*, 112th Congress, First Session, (January 20, 2011) (Statements of Warren Hudak and Kevin Hassett), available at <http://waysandmeans.house.gov/Calendar/EventSingle.aspx?EventID=219701>.

¹⁰ *Id.* at 6.

¹¹ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, 2010 Report to Congress 7, available at <http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7>.

¹² Nina E. Olson, Editorial, *We Still Need a Simpler Tax Code*, WALL ST. J., April 10, 2009, available at <http://online.wsj.com/article/SB123933106888707793.html>.

¹³ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, 2010 Report to Congress 7, available at <http://www.irs.gov/newsroom/article/0,,id=233959,00.html?portlet=7>.

administering it.¹⁴ As a result, the IRS has difficulty answering the millions of phone calls and millions of pieces of taxpayer correspondence it receives each year.¹⁵

Small businesses are disproportionately affected by tax complexity. Studies have shown that the cost of compliance with the tax code is more than 200% higher for small firms than larger ones.¹⁶ The growing number of code provisions, along with the fact that small firms usually do not have in-house tax experts, mean that small business owners must hire outside counselors or planners or add those duties to another employee's workload.

According to a survey by the National Small Business Association,¹⁷ almost nine out of ten small businesses hire a tax preparer to complete their tax returns.¹⁸ In addition, more than half of the small businesses surveyed spent more than \$5,000 annually on tax preparation (excluding the tax owed), and 16% spent in excess of \$20,000 annually.¹⁹ Some small business owners spend even more.

At the beginning of the 112th Congress, House Ways and Means Committee Chairman Dave Camp (R-MI) and President Obama both pledged support for fundamental tax reform. Chairman Camp is holding a series of hearings to begin a constructive discussion and lay the foundation for legislative action. At one of those hearings, Chairman Camp noted that the United States has one of the highest corporate tax rates in the world – a combined federal and state rate of 39.1%, the highest rate among our trading partners.²⁰ In addition, our small businesses face increasing uncertainty over numerous new regulations and concern about individual tax rates. Along with tax complexity, uncertainty acts as a barrier to job creation, competition and economic growth.²¹

III. Business Organizational Structures

When a business forms, its owner selects an organizational structure. The owner can choose to operate as a "C" corporation,²² or some kind of "pass-through" entity. The most common types of pass-throughs are S corporations and partnerships. The decision about the type of organizational structure selected is based on a number of factors, including tax rates, the desired number of shareholders, level of liability and the types of stock it plans to issue, if any.²³

¹⁴ *Id.* at 8.

¹⁵ *Id.*

¹⁶ OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, *The Impact of Regulatory Costs on Small Firms*, September 2010, available at <http://www.sba.gov/advo/research/rs371tot.pdf>.

¹⁷ NATIONAL SMALL BUSINESS ASSOCIATION, *2011 Small Business Taxation Survey*, available at http://www.nsba.biz/docs/2011_small_business_taxation_survey.pdf.

¹⁸ *Id.* at 4.

¹⁹ *Id.*

²⁰ *Hearing on How Business Tax Reform Can Encourage Job Creation: Hearing before the House Comm. on Ways and Means, 112th Congress, First Session (June 2, 2011) (Statement of Rep. Dave Camp, Chairman, House Comm. on Ways and Means)*, available at <http://waysandmeans.house.gov/Calendar/EventSingle.aspx?EventID=242050>.

²¹ *Id.* <http://waysandmeans.house.gov/News/DocumentSingle.aspx?DocumentID=249309>.

²² "C" corporation refers to subchapter C of the section of the Internal Revenue Code, which provides the rules that govern the tax treatment of corporate entities.

²³ Ephraim P. Smith, Philip J. Harmelink & James R. Hasselback, *CCH FEDERAL TAXATION* ¶14,001 (2009).

The earnings of a C corporation are taxed twice; first at the corporate level, and again at the individual level when earnings are distributed.²⁴ One of the advantages of a pass through entity is that its earnings are taxed only once. A pass-through's income, gains and losses all pass through to the business' individual owner(s). The pass-through's capital losses can be used to offset capital gains on the owner's individual tax return.²⁵ The C corporation does not provide this benefit to the individual.

The corporate form chosen by the owners does not necessarily correspond to the size of the corporation, either the number of its employees or shareholders. S corporation rules restrict the number and type of shareholders, but the company may have thousands of employees.²⁶

IV. Current Tax Laws and Small Businesses

As Congress and the Joint Congressional Committee on Deficit Reduction consider tax reform options and reducing the budget deficit, small businesses should be part of the debate.

The tax paid by small businesses under current law varies with the company's form of legal organization and its particular tax situation. Because the pass-through's income and liabilities are reflected on the owner's individual tax return, individual tax rates are the rates that affect the owner's business decisions. These tax rates are often a critical factor in determining whether a business will hire additional workers, purchase equipment, or otherwise invest in the business.²⁷

According to a study commissioned by the Small Business Administration's Office of Advocacy,²⁸ average rates of effective federal income tax rate paid by small firms range from 13.3% for sole proprietorships to 26.9% for S corporations.²⁹ The effective income tax rate is the rate that is actually paid after computing deductions, exclusions and credits.³⁰

V. Why Individual Tax Reform is Important

Recent interest in tax reform has been generated at least in part to help stimulate economic growth and competitiveness in world markets for U.S. companies.

About 95% of businesses, and over 80% of small businesses, are organized as pass-through entities.³¹ Taken together, pass-throughs account for 54% of all business net income, and they employ

²⁴ *Id.* at ¶ 14,015.

²⁵ *Id.*

²⁶ JOINT COMMITTEE ON TAXATION, *Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity 2-3* (JCX-48-08), June 4, 2008.

²⁷ Robert Carroll & Gerald Prante, Ernst & Young, *The Flow-Through Business Sector and Tax Reform i* (April 2011) available at <http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf>.

²⁸ QUANTRIA STRATEGIES, LLC, UNDER CONTRACT WITH THE OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, *EFFECTIVE FEDERAL INCOME TAX RATES FACED BY SMALL BUSINESSES IN THE UNITED STATES (2009)*, available at <http://www.sba.gov/sites/default/files/rs343tot.pdf>.

²⁹ *Id.* at 47.

³⁰ *Id.* at 1.

³¹ Carroll & Prante *supra* note 27.

54% of the private sector workforce.³² Pass-through businesses are becoming more prevalent; between 1986 and 2005, their number more than doubled, while the number of C corporations declined.³³ Because the majority of new jobs are created by small businesses, the majority of which are pass-throughs, keeping their taxes low helps them to create jobs and invest.

Not all of the companies which file business taxes on an individual return are small businesses.³⁴ But most are, and according to a report by the Joint Committee on Taxation, raising the marginal tax rates for individuals making \$200,000 and families making \$250,000 would affect about 750,000 taxpayers, and account for 50% of the estimated \$1 trillion in business income reported in 2011.³⁵ A study prepared by Ernst & Young³⁶ found that pass-through owners would pay roughly \$27 billion more per year if Congress passes only corporate tax reform.³⁷

These small businesses do not benefit if Congress tackles only corporate reform. Many have expressed support for individual and corporate reform to be considered in tandem. So far, only Congressional hearings have been held, and no further action is scheduled. In March, Chairman Camp said that he would like to reduce the top individual and corporate rate to 25% to help promote job creation.³⁸ At the direction of Chairman Camp and Senate Finance Committee Chairman Max Baucus (D-MT), the Joint Committee on Taxation has been researching legislative methods of lowering tax rates and broadening the tax base. Several members of the Congressional Joint Select Committee on Deficit Reduction, which is charged with reducing the federal deficit, have said that comprehensive tax reform could be a way to bring down the deficit and spur economic growth.

VI. Conclusion

As Congress turns its attention to tax reform, this hearing will give Members an opportunity to learn more about individual tax reform and its importance to pass-through entities. Small business owners will discuss relationship of tax reform to pass-through entities and their ability to create jobs and economic growth.

³² Karen Hube, *Corporate Taxes: Wake up, Small Business!* THE FISCAL TIMES, August 5, 2011, available at <http://www.thefiscaltimes.com/Articles/2011/08/05/Corporate-Taxes-Wake-up-Small-Business.aspx#page1>.

³³ JOINT COMMITTEE ON TAXATION AT 3-4, citing Internal Revenue Service data.

³⁴ Glenn Kessler, *Is Obama Aiming to Hike Taxes on 'Small Businesses'?* WASH. POST, April 15, 2011, available at http://www.washingtonpost.com/blogs/fact-checker/post/is-obama-aiming-to-hike-taxes-on-small-business/2011/04/14/AFqvmPfd_blog.html.

³⁵ STAFF OF THE JOINT COMMITTEE ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY, JCX-48-08, June 4, 2008, available at <http://www.jct.gov/publications.html?func=startdown&id=1291>.

³⁶ CARROLL & PRANTE, *supra* note 27 at i.

³⁷ *Id.* at ii.

³⁸ Editorial, *Camp: Tax Plan Aims for 25% Cap*, WALL ST. J., March 11, 2011.