

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, Committee on Small Business
From: Committee Staff
Date: April 13, 2015
Re: Hearing: "Tax Reform: Ensuring that Main Street Isn't Left Behind"

On April 15, 2015 at 11:00 am, the Committee on Small Business will meet in room 2360 of the Rayburn House Office Building for the purpose of receiving testimony on tax reform and how it could affect small businesses. The hearing will examine the need for and the potential economic benefits of comprehensive tax reform, with a particular focus on how changes to the tax code will enable small enterprises to expand.

I. Background

On April 15, Americans will once again observe Tax Day, and small business owners across the country will be filing their tax returns. For small firm owners, tax rates can drive business decisions. Higher tax rates mean small firms have less capital to reinvest in their companies or expand by hiring new employees. Tax changes can be particularly problematic for small firms, not only because of the economic impact, but also the time and expense needed to comply with the law, recordkeeping, and filing requirements, stay current with the law, the paperwork and recordkeeping. While tax policy is an important policy matter, its impact on small businesses, as the generators of most new jobs, is especially significant.

Over time, our tax code has become more complex and truly temporary, with significant tax relief being extended for one year, for months at a time or even retroactively. Taxpayers, and particularly small business owners, complain that this uncertainty, coupled with new taxes and regulations, have made it difficult to plan for growth of their companies.

The Internal Revenue Service's (IRS) National Taxpayer Advocate noted that our tax system, by virtue of its complexity, creates burden, confusion, and unfairness.¹ Entrepreneurs struggle to decipher the code, file paperwork and pay their taxes while keeping their businesses running. Such requirements may necessitate expending scarce capital on experts that otherwise could be invested in their business. A recent report published by the National Federation of

¹ IRS, NATIONAL TAXPAYER ADVOCATE, 2014 REPORT TO CONGRESS, (2015) [hereinafter 2014 NTA], *available at* <http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2014-Annual-Report/Volume-One.pdf>.

Independent Business (NFIB) states that tax issues, such as the level of federal taxation, tax complexity, and uncertainty in the tax code occupy the sixth, seventh, and eighth most pressing problems facing its members.²

For the past few years, Members of Congress and the Administration have expressed significant interest in reforming the tax code. In addition to our Committee, the Senate Finance and House Ways and Means Committees have held numerous hearings on tax reform.³

For many of the reasons cited above, small business owners have urged Congress to address tax reform. But “tax reform” can mean different things to different people. Some have asked that Congress at least establish a process to review tax policy.⁴ During Committee on Small Business hearings, small business owners have continually asked for simplification of the tax code and reduced tax rates, both for corporations and individuals.⁵

II. Tax Problems for Small Business

A. Tax Complexity and Compliance

Small businesses are disproportionately affected by tax complexity. A study by the Small Business Administration’s (SBA) Office of Advocacy disclosed that small firms pay 67% more to comply with the tax code than large firms do, with tax complexity a contributing factor.⁶ This results from the growth of the code and its interpretative glosses added by the Department of Treasury and IRS that must be interpreted by in-house employees or outside experts.⁷ Taxpayers and preparers spend about 6.1 billion hours annually to comply with the complex requirements of the law.⁸ It has also been estimated that United States taxpayers spend over \$160 billion

² NATIONAL FEDERATION OF INDEPENDENT BUSINESS, NFIB SMALL BUSINESS GROWTH AGENDA FOR THE 114TH CONGRESS 25 (2015) [hereinafter NFIB Growth Agenda], available at <http://www.nfib.com/Portals/0/PDF/AllUsers/IssuesElections/nfib-growth-agenda-congress.pdf>.

³ See, e.g., *Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform: Hearing Before the S. Comm. on Finance, 114th Cong.* (2015), available at <http://www.finance.senate.gov/hearings/hearing/?id=d121784e-5056-a032-52f3-e7560f44c675>; *The Biggest Tax Problems for Small Businesses: Hearing Before the H. Comm. on Small Business* (2014), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=373095>.

⁴ Sam Goldfarb, *Facing the Uncomfortable Realities of ‘Tax Reform,’* CONG. Q. Oct. 22, 2012, available at <http://www.cq.com/doc/weeklyreport-4167564>.

⁵ *The Tax Outlook for Small Business: What’s on the Horizon? Hearing before the House Committee on Small Business* (2012) (statement of Leonard Steinberg), available at http://smallbusiness.house.gov/uploadedfiles/steinberg_testimony.pdf.

⁶ See Nicole V. Crain and W. Mark Crain, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS 7-8 (2010) (SBA Contract No. HQ-08-M-0466), [hereinafter Crain] available at https://www.sba.gov/sites/default/files/advocacy/The%20Impact%20of%20Regulatory%20Costs%20on%20Small%20Firms%20%28Full%29_0.pdf.

⁷ Small businesses face the code’s confusing patchwork of provisions that includes equipment depreciation, net operating loss carryover, the home office deduction, employment taxes, classification of workers and the earned income tax credit.

⁸ Crain, *supra* note 6, at 68.

annually just to comply with income tax requirements.⁹ For small businesses these costs are spread over lower output in comparison to larger firms thereby increasing their unit costs that has nothing to do with the actual production of a good or service.¹⁰

Tax complexity also is important because it relates to tax compliance. Individuals who do not understand the law have more difficulty complying with it, and the result is less revenue in the United States Treasury. The Taxpayer Advocate's 2011 Report to Congress states the code is so complex that even the IRS has difficulty administering it.¹¹ The IRS has found it more challenging to answer the millions of phone calls and taxpayer correspondence it receives each year.¹²

B. The Changing Tax Law

Most small businesses find it difficult to stay current on tax laws because so many tax provisions are temporary -- effective for only a few years or even months and regularly extended (referred to as tax "extenders"). Congress finds it difficult to pay for the cost of them, and some believe that these provisions should be addressed as part of comprehensive tax reform.¹³ At the end of 2013, over 50 temporary tax provisions that small businesses utilize expired, including the research and development tax credit, provisions allowing shorter depreciation of business equipment and incentives for the use of alternative energy.¹⁴ Many of these provisions were retroactively extended through Fiscal Year 2014 when the Tax Increase Prevention Act of 2014¹⁵ was signed into law on December 19, 2014. These extensions (and possible modifications) in the Tax increase Prevention Act of 2014 are simply the latest in a long line of tax code changes passed by Congress. For example, the Patient Protection and Affordable Care Act included 23 separate revenue provisions.¹⁶

In addition, some tax filing requirements are changing. Small business owners must learn what those requirements are and obtain the new forms and instructions.¹⁷ Some forms and instructions can be lengthy; the 2014 1040 Form Instructions number 104 pages.¹⁸

⁹ *Oversight of the Internal Revenue Service's Implementation of the Affordable Care Act: Hearing Before the Comm. on Ways and Means* (2012) (statement of Scott A. Hodge, President, Tax Foundation, available at <http://waysandmeans.house.gov/calendar/eventsingle.aspx?EventID=307388>).

¹⁰ The issue of small business compliance costs will be addressed in greater detail later in this memorandum.

¹¹ IRS, OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS, EXECUTIVE SUMMARY 2 (2011), available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

¹² *Id.*

¹³ See, e.g., NFIB GROWTH AGENDA 4 (2014); NATIONAL SMALL BUSINESS ASSOCIATION, LAME DUCK SESSION PRIORITIES 4 (2014), available at <http://www.nsba.biz/wp-content/uploads/2014/11/Lame-Duck-Survey-2014.pdf>.

¹⁴ <http://www.forbes.com/sites/ashleaebeling/2014/12/19/obama-signs-2014-tax-extenders-money-in-your-pocket/>.

¹⁵ Pub. L. No. 113-295, 128 Stat. 4010 (2014).

¹⁶ Pub. L. No. 111-148, Tit. IX, 124 Stat. 119, 847-83 (2011).

¹⁷ Email from David Kautter, Managing Director, Kogod Tax Center, American University March 16, 2014 (on file with the Committee).

¹⁸ <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

C. Cost of Tax Compliance for Small Firms

According to the Office of the Chief Counsel for Advocacy of the Small Business Administration, small firms spend more than 5.5 billion hours fulfilling their income tax obligations.¹⁹ Of course, this does not include other tax obligations, such as state and local taxes. That same report found that in general, the annual tax compliance burden of small businesses increases as the size of the business and its receipts increases.²⁰ In 2004, the average number of hours spent on tax compliance by small businesses organized as sole proprietors was 32 hours.²¹ In contrast, those businesses organized as S corporations had an average burden that was almost ten times as much.²² Small businesses organized as C corporations incurred an average compliance burden of about 451 hours while those businesses organized as partnerships incurred the highest average burden, about 550 hours, once the combined burden of all the partners was factored in.²³ Small business owners have said that the cost of tax compliance is wasted money and effort, and that making it easier to comply would lower costs for both the public and private sectors.²⁴

The number of federal income tax returns that the IRS examined has increased over the past few years, with one out of every 90 taxpayers examined in Fiscal Year 2010.²⁵ That represents an increase of 23% from Fiscal Year 2006, when about one of every 108 individual tax returns was examined.²⁶ The IRS has also strengthened its use of enforcement tools, such as liens, levies and seizures.²⁷

In recent years, the IRS has also attempted to reduce the tax gap – the difference between what the IRS collects on time and what it believes taxpayers owe. As a result, the IRS increased its audits of businesses in certain years.²⁸ Simplifying the code could help reduce audits of small business owners who are non-compliant simply because they cannot decipher the code.

III. The Need for Reform: The Tax Concerns of Small Business Owners

A. The Importance of Individual Reform

In the United States, the majority of small businesses operate as pass-through entities, such as S corporations, Limited Liability Company (LLCs) or partnerships.²⁹ These

¹⁹ OFFICE OF ADVOCACY, SBA, MEASURING AND MODELING THE FEDERAL INCOME TAX COMPLIANCE BURDEN OF SMALL BUSINESSES 21 (2011), AVAILABLE at <http://www.sba.gov/sites/default/files/files/rs382tot.pdf>.

²⁰ *Id.* at 23 and 25.

²¹ *Id.* at 21.

²² *Id.*

²³ *Id.*

²⁴ Email from Tim Reynolds, President, Tribute, Inc., March 26, 2014 (on file with the Committee).

²⁵ DEPARTMENT OF TREASURY INSPECTOR GENERAL FOR TAX COMPLIANCE, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2010, at 9 (2011) available at <http://www.treasury.gov/tigta/auditreports/2011reports/201130071fr.pdf>.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ Businesses organized as S corporations pay no income tax and all of the income or losses of the corporation for the year are passed through to the shareholders, who report them on their individual returns. A business defined as a

entrepreneurs report any business profit or loss on their individual income tax return. That income is “passed through” to the small business owner’s individual tax return and it is taxed at his or her individual income tax rate.³⁰

Small business organizations have urged Congress to undertake comprehensive tax reform; that is, reform of both corporate and individual rates. The Chairman of the House Committee on Ways and Means, Paul Ryan, has said he would like Congress to undertake comprehensive tax reform.³¹ If Congress acts only to reduce corporate rates, and eliminates popular deductions, it would result in small businesses that are organized as pass-throughs losing deductions with no commensurate lowering of rates – a net tax *increase*.

B. Tax Complexity, Compliance and Certainty

According to testimony by former Comptroller General David Walker,³² the design of the current system of business taxation is widely viewed as flawed. Complexity can promote the use of tax shelters and reduces the perception of fairness and public confidence that other taxpayers are paying their fair share.³³ Simplification and increased uniformity could encourage greater compliance.

Small and large businesses provide a significant portion of tax revenue to the federal government. But the numerous additions and changes to the code over the years have resulted in confusion and difficulty with compliance, especially among small business owners.

Certainty, along with simplicity and stability, is one of the cornerstones of a good tax system. In fact, certain tax experts point to certainty as the single most important aspect of a fair and simple tax system and confidence in knowing precisely what the tax code will require has become more important than how much it will cost them.³⁴

partnership is one where the business operation between two or more individuals who share management and profits and allows for the pass-through of profits to each of the partners to declare on their individual tax returns. An LLC it is essentially a hybrid entity that combines the characteristics of a corporation and a partnership or sole proprietorship. While the limited liability feature is similar to that of a corporation it can be structured with the availability of pass-through taxation to the members of the company.

³⁰ *Small Business Uncertainty: Perspectives on the Tax Cliff. Hearing by the H. Comm. on Small Business*, 112th Cong. 3 (2012) (statement of Theresa Kern, President, MA Steel Erectors, Inc.), available at http://smallbusiness.house.gov/uploadedfiles/9-13_kern_testimony.pdf; see also *Tales of Resilience: Small Business Survival in the Recession. Hearing Before the H. Comm. on Small Business*, 112th Cong. 3 (2012) (statement of Elise Mitchell, President and CEO, Mitchell Communications Group), available at http://smallbusiness.house.gov/uploadedfiles/7-25_mitchell_testimony.pdf.

³¹ http://www.jsonline.com/news/opinion/paul-ryan-were-offering-an-agenda-to-empower-americans-restore-optimism-b99437788z1-290660081.html?utm_source=&utm_medium=&utm_campaign=hs.

³² *Simplification and Increased Uniformity of Taxation Would Yield Benefits: Hearing Before the S. Comm. on Finance*, 110th Cong. (2006) (statement of David M. Walker), available at <http://www.gao.gov/new.items/d061113t.pdf>.

³³ IRS, NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 18 (2012), <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report>.

³⁴ <http://www.benefitspro.com/2012/05/29/tax-code-certainty-important-for-employers>

When small businesses do not know what their tax liability will be throughout the year, they are making decisions without full knowledge of their economic consequences.³⁵ According to a survey produced by the Kogod School of Business at American University, the single most important area of tax uncertainty for small businesses involves how much equipment can be immediately deducted, and what has to be depreciated.³⁶ Adding a level of certainty and stability gives small businesses the confidence to make capital investments as necessary, expand business operations, hire new employees and ultimately grow the economy.

IV. Conclusion

The hearing will provide an opportunity for Members to learn about why tax reform is needed, potentially discuss specific proposals for reform, and how they could affect small businesses.

³⁵ *The Biggest Tax Problems for Small Businesses: Hearing Before the H. Comm. on Small Business, 113th Cong. (2013)* (statement of David Kautter, Managing Director, Kogod Tax Center, American University) available at http://smallbusiness.house.gov/uploadedfiles/4-9-2014_kautter_testimony.pdf.

³⁶ *Id.*