

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, Committee on Small Business
From: Committee Staff
Date: April 7, 2014
Re: Hearing: "The Biggest Tax Problems for Small Businesses"

On April 9, 2014 at 1:00 p.m., the Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building to receive testimony on the biggest tax problems facing small businesses.

I. Introduction

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 invest back into their companies or create jobs. Tax changes can be particularly problematic for small firms, not only because of the economic impact, but also the time needed to stay current with the law, the paperwork and recordkeeping. Because small businesses are the economy's job generators, the effect of tax policies can have critical importance to the economy.

II. Tax Problems for Small Businesses

According to the Internal Revenue Service's (IRS) National Taxpayer Advocate, tax issues are a significant set of regulatory burdens for most small businesses.¹ One National Federation of Independent Business Research Foundation study of Small Business Problems and Priorities found that four of the top ten problems small businesses identified were tax related.² Entrepreneurs struggle to decipher the code, file paperwork and pay their taxes while keeping their businesses running. Small businesses face unique challenges when dealing with the code. As new taxes are implemented, and tax rates increase, small business owners must stay current with the law, or hire a professional to do so, and ensure that their company complies.

¹*Tax Burdens Facing Small Businesses: Hearing Before the United States House of Representatives Committee on Small Business*, 109th Congress, Second Session (September 21, 2005) (testimony of Nina E. Olson), available at http://www.irs.gov/pub/irs-utl/nta_small_business_comm_testimony_v4_single.pdf.

² William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC, series. See also TAXES, TAX REFORM AND SMALL BUSINESS, NFIB, available at <http://www.nfib.com/advocacy/taxes>.

A. Tax Complexity and Compliance

Small businesses are disproportionately affected by tax complexity. A study by the Small Business Administration's 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.³ 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.

Tax 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,⁴ although it is uncertain what makes one feel "connected" to it. The Taxpayer Advocate's 2011 Report to Congress states the code is so complex that even the IRS has difficulty administering it.⁵ The IRS has found it more challenging to answer the millions of phone calls and taxpayer correspondence it receives each year.⁶ The expectations are so low that IRS set its Fiscal Year 2010 telephone customer service goal at 71.2%. That means almost three out of ten callers to the IRS were not expected to get through.⁷

Over the past few years, the Report of the National Taxpayer Advocate identified the need for tax reform as one of the top priorities in tax administration.⁸ Taxpayers and preparers spend about 6.1 billion hours annually to comply with the complex requirements of the law.⁹ It has also been estimated that U.S. taxpayers spend over \$160 billion annually just to comply with income tax requirements.¹⁰ Because of complexity, more than 60% of taxpayers pay a preparer to complete their returns, and about 22% purchase tax software to assist them in preparing their own return.¹¹ 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.

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.

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

³ See Nicole V. Crain and W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2010), available at <http://archive.sba.gov/advo/research/rs371tot.pdf>.

⁴ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, REPORT TO CONGRESS (2011) [hereinafter "Advocate's Report"], available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ Pub. L. No. 111-148, 124 Stat. 119 (2010), codified at scattered sections of the United States Code.

⁹ Advocate's Report at Summary.

¹⁰ *Id.*

¹¹ Nina E. Olson, *We Still Need a Simpler Tax Code*, WALL ST. J., April 10, 2009.

“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.¹²

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.¹³ Several of the provisions that affect small firms are listed in Section E below.

In addition, some tax filing requirements are changing. Small business owners must learn what those requirements are and obtain the new forms and instructions.¹⁴ Some forms and instructions can be lengthy; the 2013 1040 Form Instructions number 206 pages.¹⁵ The Chairmen of the House Ways and Means Committee and the Senate Finance Committee have said they will begin examining these provisions in April.

New tax provisions and tax increases complicate the tax code. They also divert scarce resources that small firms use to reinvest in their businesses and to hire workers.¹⁶ Over the past few years, numerous new tax provisions and tax increases have been passed.¹⁷ Many new taxes are or will be effective as part of the health care law.¹⁸ Several of the provisions that may affect small firms are listed in Section E below.

C. Cost of Tax Compliance for Small Firms

According to the Small Business Administration (SBA), small businesses 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.

In 2012, the National Taxpayer Advocate reported estimated that it took a total of 6.1 billion hours for taxpayers to handle all their taxes. This was down from 7.6 billion hours in 2008, probably due to the efficiencies of tax software.²⁰

¹² MOLLY F. SHERLOCK, TAX PROVISIONS EXPIRING IN 2013 2, CONGRESSIONAL RESEARCH SERVICE (Dec. 31, 2013).

¹³ *Id.*

¹⁴ Email from David Kautter, Managing Director, Kogod Tax Center, American University March 16, 2014 (on file with the recipient).

¹⁵ <http://www.irs.gov/pub/irs-pdf/i1040.pdf>.

¹⁶ *Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividend: Hearing Before the United States Senate Committee on Finance*, 112th Congress, Second Session 4 (September 14, 2010) (testimony of Bill Rys), available at <http://finance.senate.gov/imo/media/doc/Rys%20Testimony.pdf>.

¹⁷ See, e.g., Title IX of Pub. L. No. 111-148, 124 Stat. 119 (2010), available at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ148/pdf/PLAW-111publ148.pdf>.

¹⁸ JOINT COMMITTEE ON TAXATION, UNITED STATES CONGRESS, LIST OF EXPIRING FEDERAL TAX PROVISIONS, 2013-2023 (January 11, 2013), available at <https://www.jct.gov/publications.html?func=startdown&id=4499>.

¹⁹ OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, MEASURING AND MODELING THE FEDERAL INCOME TAX COMPLIANCE BURDEN OF SMALL BUSINESSES (Sept. 2011) [hereinafter “SBA report”], available at <http://www.sba.gov/sites/default/files/files/rs382tot.pdf>.

²⁰ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, UNITED STATES INTERNAL REVENUE SERVICE, REPORT TO CONGRESS (2011), available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

A Small Business Administration report found that in general, the annual tax compliance burden of small businesses increases as the size of the business and its receipts increases.²¹ In 2004, the average number of hours spent on tax compliance by sole proprietors was 32 hours, by partnerships 55 hours and S corporations 314 hours.²² 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.²³

The number of federal income tax returns that the IRS examined increased over the past few years, with one out of every 90 taxpayers examined in Fiscal Year 2010.²⁴ That represents an increase of 23% from Fiscal Year 2006, when about one of every 108 individual tax returns was examined.²⁵ The IRS has also strengthened its use of enforcement tools, such as liens, levies and seizures.²⁶

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 taxpayers owe. As a result, the IRS increased its audits of businesses.²⁷ Simplifying the code could help reduce audits of small business owners who are non-compliant simply because they cannot decipher the code.

D. Dealing with the IRS

Anecdotally, surveys of small businesses and their tax advisors have said it now takes longer to get tax questions answered from the IRS. Several reasons have been cited for this problem. First, they cited a decline in the knowledge of the IRS customer service personnel.²⁸ According to the 2013 report of the IRS Taxpayer Advocate, in 2013, IRS personnel could answer only 61% of calls from taxpayers seeking to speak with a customer service representative, and those who got through had to wait nearly 18 minutes on hold.²⁹ Second, survey responses cited the inability of IRS personnel to resolve small business matters on their own, without escalating the issue to a supervisor.³⁰ When ranking IRS customer service performance in surveys, small business owners and tax advisors said IRS customer service has declined in several ways. The biggest declines were in the ability of IRS personnel to resolve controversies in a timely manner, timeliness of IRS responses to inquiries, performance of IRS personnel, knowledge of IRS personnel, ability to resolve controversies without escalation to a supervisor and clarity of IRS correspondence.³¹

²¹OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, MEASURING AND MODELING THE FEDERAL INCOME TAX COMPLIANCE BURDEN OF SMALL BUSINESSES, (Sept. 2011), *available at* <http://www.sba.gov/sites/default/files/files/rs382tot.pdf>.

²² *Id.*

²³ Email from Tim Reynolds, President, Tribute, Inc., March 26, 2014 (on file with the recipient).

²⁴ TREASURY INSPECTOR GENERAL FOR TAX COMPLIANCE, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2010 9, July 18, 2011, *available at* <http://www.treasury.gov/tigta/auditreports/2011reports/201130071fr.pdf>.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ Email from David Kautter, Managing Director, Kogod Tax Center, American University, March 16, 2014 [hereinafter “Kautter email”] (on file with the recipient).

²⁹ REPORT OF THE UNITED STATES INTERNAL REVENUE SERVICE TAXPAYER ADVOCATE (2013), *available at* <http://www.taxpayeradvocate.irs.gov/2013-Annual-Report>.

³⁰ *Id.*

³¹ Kautter email.

E. New and Higher Taxes

Many small business owners and their tax advisors are concerned about how the health care law will affect them.³² Some of the health care law provisions and expired temporary tax “extender” provisions that affect small firms are listed below.

Provisions in the Health Care Law

1. Unearned Income Medicare Contribution (Surtax on Investment Income)
Effective January 1, 2013, the Health Care and Education Reconciliation Act³³ imposes a 3.8% surtax on net investment income³⁴ for single individuals with adjusted gross incomes over \$200,000 and families with adjusted gross incomes over \$250,000.³⁵ The surtax applies to dividends, interest, annuities, rent and royalties income, minus the expenses associated with earning the income. Small business owners and investors in small businesses (passive investors in S corporations and partnerships, for example) may face these increases, which could make it even more difficult for these businesses to raise capital.
2. Increase in Medicare Payroll Tax
On January 1, 2013, the employee share of the Medicare payroll tax increased from 1.45% to 2.35% for individuals earning \$200,000 and families earning \$250,000.³⁶ Married taxpayers filing separately are subject to a \$125,000 threshold. Any income over those thresholds is subject to the .09% surtax. The threshold is not indexed for inflation.
3. Pre-Tax Flexible Spending Account (FSA) Cap
Effective January 1, 2013, the law imposed an annual cap of \$2,500³⁷ on FSA contributions.³⁸ The cap is indexed to inflation. Some small businesses, particularly those that do not offer health insurance, offer FSAs so employees may pay for health care expenses with pre-tax dollars.
4. Health Savings Account (HSA) Withdrawal Penalty Increase
In effect since January 2011, this provision increases the withdrawal penalty for non-medical HSA withdrawals from 10% to 20%.³⁹
5. Tax on Medical Device Manufacturers
Effective January 1, 2013, the law⁴⁰ added a new 2.3% tax on the revenues of medical device manufacturers, producers and importers.⁴¹ Eyeglasses, contact lenses, hearing aids and other products purchased by the public for individual use are excluded. The medical device industry says it will pay for the tax by reducing jobs.⁴²

³² Email from Roger Harris, President and Chief Operating Officer, Padgett Business Services, March 17, 2013 (on file with the recipient).

³³ 124 Stat. 1029.

³⁴ 124 Stat. 119.

³⁵ Technical Explanation at 134.

³⁶ *Id.* at 103.

³⁷ Prior to the health care law, there was no statutory limit on FSA contributions.

³⁸ Technical Explanation at 74.

³⁹ *Id.* at 71. The IRA withdrawal penalty is currently 10%.

⁴⁰ Pub. L. No. 111-152, 124 Stat. 1029 (2010).

⁴¹ Technical Explanation at 137.

⁴² *Id.* See also Ramesh Ponnuru, *Tongue-Depressor Tax Will Harm Jobs, Innovation*, BLOOMBERG, January 2, 2012, available at <http://www.bloomberg.com/news/2012-01-03/tongue-depressor-tax-will-harm-jobs-innovation-ramesh-ponnuru.html>.

6. New Itemized Medical Deduction Threshold from 7.5% to 10%
Beginning on January 1, 2013, itemized out-of-pocket medical expenses may be deducted if they exceed 10% of the taxpayer's Adjusted Gross Income (AGI) may be deducted.⁴³ Previously, the ceiling was 7.5%. The increase will be waived for those ages 65 and older for tax years 2013-2016.⁴⁴

Expired Temporary Tax "Extenders" that expired on December 31, 2013

1. Tax credit for research and experimentation
2. Credit for construction of new energy-efficient homes
3. Fifteen-year straight line recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements
4. Additional first-year depreciation for 50% of basis of qualified property (expires December 31, 2014 for certain longer-lived and transportation property)
5. Deduction for state and local general sales taxes
6. Increase in expensing to \$500,000/\$2,000,000 and expansion of definition of section 179 property
7. One hundred percent exclusion for qualified small business stock
8. Reduction in S corporation recognition period for built-in gains tax
9. Incentives for biodiesel and renewable diesel

IV. Conclusion

Small businesses created 63% of the net new jobs between 1993 and 2003.⁴⁵ Small firms are our nation's best job creators. However, if they are left with little time and capital to develop their companies due to additional and higher taxes and tax compliance costs, they are less able to hire workers, purchase equipment or expand the business.

The hearing will provide an opportunity for Members to learn about the tax problems of small businesses and some possible solutions.

⁴³ Technical Explanation at 96.

⁴⁴ *Id.*

⁴⁵ OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, FREQUENTLY ASKED QUESTIONS (Mar. 2014), available at <http://www.sba.gov/advocacy/7495/8420>.