

**Testimony of
Professor David J. Kautter
Managing Director of Kogod Tax Center
American University Kogod School of Business
Washington, District of Columbia**

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**Hearing on
The Biggest Tax Problems of Small Businesses
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Chairman Graves, Ranking Member Velazquez and Members of the Committee, thank you for the opportunity to testify on The Biggest Tax Problems of Small Businesses.

My name is David Kautter and I am the Managing Director of the Kogod Tax Center. The Kogod Tax Center is an independent tax research institute located at American University's Kogod School of Business. The Kogod Tax Center promotes balanced, nonpartisan research on tax matters affecting small businesses, entrepreneurs and middle-income taxpayers, including the challenges of complying with the Internal Revenue Code. We also develop and analyze potential solutions to tax-related problems faced by these three groups of taxpayers and promote public dialogue about critical tax issues.

I have been a tax practitioner for over 40 years. Prior to joining the Kogod Tax Center, I was the Director of National Tax for Ernst & Young. Over the course of my career as a tax practitioner, I have witnessed, with much disappointment, the tax law grow increasingly complex in its structure, pervasive in its reach and incomprehensible in its nature. There is little doubt that the nearly paralyzing complexity, overwhelming length and constantly changing nature of our federal tax laws are having a profound effect on small businesses, affecting not only their decision making but impeding their ability to grow and create jobs.

The National Taxpayer Advocate has found that the single most pressing problem encountered by taxpayers, including small businesses, is the complexity of the Internal Revenue Code. The National Taxpayer Advocate estimates that each year small businesses spend approximately 2.5 billion hours complying with tax filing requirements, the equivalent of 1.25 million full-time jobs. According to the National Taxpayer Advocate, more than 70% of all unincorporated businesses (which tend to be small businesses) use paid tax return preparers

and spend more than \$16 billion for professional advice and compliance assistance from attorneys, accountants and enrolled agents. While this complexity has generated a healthy business for tax professionals, our economy suffers as a result, for it cannot prosper when small businesses are diverting disproportionate time and resources to activities that neither grow their businesses nor create jobs. The tax complexity that small businesses have to endure is an inevitable drag on the economy.

It is estimated that the Internal Revenue Code is nearly four million words in length, and the income tax regulations are in excess of another 5 million words. Overall, taxpayers – businesses and individuals – are estimated to spend more than 6.1 billion hours meeting their annual federal tax filing obligations, and it is estimated that 60% of all taxpayers retain paid tax return preparers to fulfill their federal tax filing obligations while another 30% use commercial software. I can personally attest that the effort required to comply with the tax law today is disheartening even to experienced tax professionals. The cost to comply is increasingly expensive in time and dollars. Not only is it increasingly expensive in terms of time and dollars to comply with the tax law, the tax law is increasingly distorting individual and business decision-making, especially that of small businesses. In my experience, most tax professionals would prefer to spend their time advising clients on the tax consequences of growing their businesses, not on complex compliance activities that add no value to the business.

Sources Of The Biggest Problems Facing Small Businesses

The Kogod Tax Center conducts periodic surveys of small business tax return preparers and tax advisers, most of whom are also small business owners themselves. Based in large part on surveys we have conducted over the past three years, as well as discussions we have had with small business owners and their tax advisers, and personal experience, my view is that the biggest tax problems facing small businesses come from two sources: complexity and constant change in the tax law. As a result of complexity and constant change, here are what I believe to be the seven biggest tax problems facing small businesses.

Understanding The Law And Compliance Obligations

Most small business owners simply have very little idea of what is expected of them under the tax law and have given up trying to understand either the substantive provisions of the tax law or their compliance obligations. They increasingly rely on outside tax advisers for tax planning and tax return preparation for both income taxes and employment taxes. They worry about making a mistake that will cost them time, money and their reputation because they unknowingly made a mistake, so they have "outsourced" their tax planning and tax compliance obligations.

This is most clearly seen in the number of small businesses that have their income tax return prepared by someone else. Similar to the findings of the National Taxpayer Advocate, a recent survey conducted by the

National Federation of Independent Business (NFIB) found that professional tax return preparers either completely or partially prepared tax returns for 91% of its members – 81% had them prepared exclusively by a professional, and another 10% used both a software package and a professional. Given the complexity of the tax law, that means to me that the other 9% are, most likely, completely wrong.

When citizens and business owners do not understand their obligations under the law, resentment, suspicion and skepticism follow. When resources and time have to be diverted from running a business to gathering information so a tax return preparer can prepare a form that the business owner does not understand and has to sign under penalties of perjury, there is an understandable sense of fear, intimidation and frustration.

This sense of skepticism, trepidation and frustration can clearly be seen in a 2012 survey of over 3,300 sole proprietors conducted by the Taxpayer Advocate. The survey found that only 16% of the sole proprietors surveyed said they believe the tax laws are fair and only 12% said they believe taxpayers pay their fair share of taxes. The results of these surveys mirror my own personal experience in dealing with small business owners. From a public policy or business point of view, this is not a healthy state of affairs for a democracy that bases its tax compliance system on self reporting.

Constantly Changing Law And Regulations

It has been estimated that since 2001, there have been almost 5,000 changes to the Internal Revenue Code, an average of about one a day. While most small businesses have outsourced their tax planning and compliance, the tax professionals they hire have to keep up to date with all the changes in the law and accompanying regulations. This cost is passed along to small businesses in the form of higher tax consulting and return preparation fees, contributing to a further drain on the resources from small businesses.

Another major issue for many small businesses created by the constantly changing nature of the tax law grows out of the so-called “tax extenders”. Fifty five tax provisions expired in 2013 and another six are slated to expire this year. While that is a large number, only a handful directly affect small businesses. The special rules for qualified small business stock (Section 1202 stock), the rules relating to depreciation of qualified leasehold improvements and restaurant buildings and improvement, bonus depreciation, and the S corporation built-in gains tax, all matter to various members of the small business community. But, far and away, the most important “tax extender” is the ability to immediately expense depreciable property (Section 179). In fact, for many small businesses it is the **only** one they really care about. Small businesses are frustrated with their inability to know what the rules for expensing and depreciating equipment will be from one year to the next, and sometimes (like this year) what the rules will be for the current year. Small businesses often end up making decisions on whether or not to purchase equipment before the rules are settled. Not only does this have an effect on small businesses themselves, it has an effect on the overall economy. The constant changing of the expensing rules makes informed planning for capital purchases impossible and leads to decisions being made by small business owners without full knowledge of the economic consequences of their decisions. This is not the way to

encourage growth in our economy overall and especially for the sector of our economy that provides over half of all jobs and most of the new jobs in the country. These rules need to be settled.

Constantly Changing Filing Requirements

One consequence of the constantly changing law and regulations is constantly changing filing requirements. Every year, the IRS seems to expand the information required on income tax returns and the Form W-2. Although preparing tax returns (both income tax and employment tax) has largely been outsourced to tax return preparers, small businesses still have to provide the necessary information to their tax return preparers and that is a source of frustration both in terms of time and cost. Since the tax law and regulations are constantly changing, the information required to comply with the tax law is also constantly changing which means the forms are constantly changing which, in turn, means the information required from small businesses is constantly changing. For example, here are the changes made to two of the most often used tax forms for small businesses over the past three years.

Changes To Schedule C

2011

New lines “i” and “j” were added to Schedule C, which address the required filing of Form 1099.

Changes were made to “Part I – Income” for new “Merchant card and third party payments reporting requirements”. Line “1a” and “1b” were added to implement reporting of gross receipts received via merchant card and third party network payments. Line “1c” was added to report income reported on Form W-2 if “Statutory Employee” box on that form was checked.

Qualified joint ventures reporting rental real estate income that is not subject to self-employment tax had to report that income on Schedule E instead of Schedule C.

2012

The changes that had been made to Part I for separate payment card reporting in 2011 were reversed, and the gross receipts received via payment card and third party network payments are no longer reported separately on Schedule C.

2013

A “Simplified method” for business use of home deduction is added to Line 30 of Schedule C.

Changes To Form 1065

2011

- “Schedule A” (Cost of Goods Sold) was deleted from Form 1065.

- On Schedule B, line “3a”, “any foreign government” was added to the list of partners the partnership may need to disclose.
- On Schedule B, new lines “18a” and “18b” regarding Form 1099 were added.
- On Schedule B, new line “19” for Form 5471 was added.
- On Schedule L, line “7a” (Loans to partners or persons related to partners) and line “19a” (Loans from partners or persons related to partners) were added.

2012

- On Schedule B, line 20 (number of partners that are foreign governments under §892) was added.

While none of these changes by themselves are a major re-working of the forms, each takes time for small business owners and their advisers to understand and implement. Having to dig through their books and records to assemble new information takes time away from running a business. It is not only the business owners who are frustrated. In the Kogod Tax Center’s most recent survey, the factor cited more than any other as contributing most to decreased efficiency (and increased cost) was new IRS and state regulations and other filing requirements. This factor was cited by 46% of our tax return preparer respondents. In the same survey, 81% percent of the tax return preparers cited the time and complexity of gathering data to complete returns as the most frequent complaint heard from their clients during the 2013 filing season. This was up substantially from our 2012 survey on this same issue where just over half (56%) of the tax return preparer respondents said the biggest concern for their clients was the time and complexity required to compile data for return preparation. Significantly, this factor contributes to the inability to complete tax returns by the original return due date, thereby necessitating extensions and turning the tax compliance process into a year-long, never ending cycle for small businesses.

Steadily Increasing Federal Complexity

It would be one thing if the effect of the constantly changing law and filing requirements was to make things simpler, but for most small businesses it is the opposite. Complying with the tax law is becoming more and more complicated and burdensome. Recordkeeping, compliance and reporting are diverting more and more time and money away from operating and growing their business.

By any measure, tax returns for small businesses are becoming more complex, difficult as that may be to fathom. This is undoubtedly the result of the increasing complexity of the tax law and regulations. As the tax code has been amended and “patched” since the 1986 tax reform proposal, it is becoming increasingly unwieldy even for the most experienced tax professional, let alone small business owners themselves.

More than 50% of tax return preparers who responded to Kogod Tax Center's most recent survey said that Form 1065, "U.S. Return of Partnership Income," is the most complex return to complete. Some of this is presumably due to the rising complexity of how partnerships are structured for both business and tax reasons, but undoubtedly a large part of it is the underlying complexity of the law and regulations. Form 1040, "U.S. Individual Income Tax Return," was cited by about 20% of tax return preparers as the most difficult to prepare, and 16% cited the Form 1120, "U.S. Corporation Income Tax Return," for C corporations. The good news is that only 14% cited the Form 1120S, "U.S. Corporation Income Tax Return" for S corporations as the most difficult. It is time to simplify the law and the filing requirements. It is a sad commentary when tax return preparers view the returns they have to file for small businesses conducting business as partnerships (Form 1065) and sole proprietors (Form 1040 Schedule C) as more complicated than those they have to file for their much larger corporate clients (Form 1120).

Controlling The Internal And External Cost Of Compliance

With increasing complexity of the law and compliance obligations, small businesses are increasingly worried about scarce resources being diverted from their business. Increased complexity translates into higher fees for outside tax advisers and more internal time devoted to non-revenue generating tax compliance activities by small businesses, themselves.

As I mentioned earlier, in a Kogod Tax Center survey conducted last year after the close of the tax filing season, in a virtual chorus of unanimity, 81% of tax return preparers cited the time and complexity of gathering data to complete returns as the most frequent complaint heard from their clients. This was up substantially from the 56% that cited that as the main complaint from clients the year before. In the same survey, 40% of the tax return preparer respondents said they spent either moderately more or significantly more time preparing returns than they did the year before. Some of the reasons cited were the increased complexity of the returns themselves and complexity related to information reporting, partnership allocations and basis reporting. Not surprisingly, more than 70% of tax return preparers said their fees had increased from 2012. While this is good news for tax preparers, it is not such good news for small businesses.

In a recent NFIB survey, small business owners were asked what part of the Code is the most complex or complicated for them and their business. The majority (52%) reported that they let their tax professional worry about complexity, and they will pay for the help they need. They feel as though they have no choice. Relying on tax advisers and return preparers to this extent is the wise thing for most small business owners to do given the complexity of the tax law, the time involved and the penalties imposed when a mistake is made. However, it also makes it hard to control both the cost of tax planning and, especially, the cost of tax compliance. This is not a healthy state of affairs.

Dealing With The IRS Takes More Time

The increasingly complex and constantly changing tax law is also affecting the ability of the IRS to respond to small business inquiries and settle disputes. Many small businesses and their tax advisers complain that their ability to get questions answered by the IRS and solve problems is taking more and more time. They cite several reasons ranging from a decline in the knowledge of IRS personnel with respect to particular areas of the tax law, to the inability of agents to resolve matters on their own without escalation to supervisor(s). When ranking IRS performance, our surveys show that most small businesses and their advisers believe IRS service has gotten worse in every category we surveyed over the past 5 years. Ranked from greatest to least areas of decline in service are: (1) ability to resolve controversies in a timely manner, (2) timeliness of IRS response to inquiries, (3) performance of IRS personnel, (4) knowledge of IRS personnel, (5) ability to resolve controversies without escalation to a supervisor(s) and (6) clarity of IRS correspondence.

Specific Areas Of Complexity

One area where our surveys have shown consistency over the past three years are the specific substantive provisions of the tax law that small businesses view as the most complicated. While there is some variation year to year, the specific areas of the Code that seem to be causing the most difficulty for small businesses are: (1) accounting methods (2) depreciation/expensing (including what will the rules be from year to year), (3) inventory rules and the requirement to use the accrual method if you have inventory, (4) independent contractor/employee determinations, (5) the ACA for small employers with enough employees to have to worry about these rules and (6) the rules governing retirement plans.

Recommendations

Given the challenges mentioned in my testimony, I would like to put forward two legislative recommendations: (1) a simplified method of accounting and (2) a unified tax rate schedule for all businesses no matter what their legal form.

Simplified Cash Method Of Accounting

When you look at the challenges mentioned in my testimony, it becomes readily apparent that complexity is at the heart of every one of them. This complexity stems from an effort to measure “taxable income.” I believe that the single most important change that can be made to the Internal Revenue Code to profoundly simplify the tax law for small businesses, improve their ability to understand their obligations under the tax law and reduce their costs of compliance would be to adopt a “simplified cash method of accounting”(SCM) . A simplified cash method of accounting would deal directly with the complications arising from the three top areas of complexity mentioned above: accounting methods, depreciation/expensing and inventory. It would substantially simplify tax

compliance for most small businesses, allow small businesses to understand how their taxes are computed and reduce their costs.

Under current law, the cash method of tax accounting is substantially simpler than the accrual method of accounting, but it still has unnecessary complications. The most challenging of these complications is the calculation of deductible expenses. There are currently four exceptions to the general rule that a deduction is permitted when payment is made under the cash method: prepayments, depreciation, inventory, and capitalization of some expenses. For example, prepayments for property or services are not deductible if the goods or services are provided more than one year after the prepayment; and costs exceeding \$5,000 associated with creating a new business are not deducted when paid but amortized over 15 years. For inventory, the costs of its acquisition or production are deducted only when the inventory to which the costs are matched is sold. Similarly, property with a useful life of more than one year that exceeds the limits for expensing (Section 179) is generally subject to depreciation, requiring its deduction be spread over recovery periods ranging from three to 39 years. Section 179 helps many small businesses but sometimes it is not enough.

The fact of the matter is the cash method of accounting is too often based not on cash receipts and disbursements, but rather on principles that attempt to match costs with income similar to the accrual method. For small businesses that have no government regulators to whom financial statements must be submitted and have no banks or other creditors that require profit and loss determinations conforming to the rules of generally accepted accounting principles, tax rules based on the accrual method serve no practical purpose, especially when economic success and taxable income can simply be measured on cash receipts and expenditures – that is, cash flow.

Small businesses would be better served by a cash method of accounting that more clearly reflects the cash flow of a small business from which taxes could be paid. Under a “simplified cash method of accounting”, the computation of taxable income would be reduced to the simple following formula:

Cash Receipts
Less: Cash Expenses including cash paid for:
• Inventory
• Prepayments
• Materials/Supplies
• Depreciable Property
Taxable Income

In short, derivation of taxable income would be based solely on cash actually received or paid during the tax year. Under this method, tax returns could be completed by simply examining the taxpayer's checkbook for when checks were written and deposits made.

The SCM would offer enormous simplification for virtually all small businesses. Under the SCM, all current expenditures, including those for the acquisition or production of inventory, would be deducted when paid. Although a technical violation of the matching principle of accounting, allowing for the immediate deduction of the cost of inventory simplifies small business recordkeeping at relatively little cost to the government. For a small business to stay in business, inventory paid for and deducted in one year likely will be sold no later than the next year to ensure sufficient cash flow for business operations. Permitting the expensing of inventory before its sale recognizes the hard fact that IRS audits reveal more than 50% of cost of goods sold calculations by small businesses are incorrect under current law. That is not likely to change unless small businesses divert even more valuable but limited resources to the maintenance of better inventory tax books and records. Allowing immediate expensing of depreciable property can be viewed as continuing 100% bonus depreciation that was available for property acquired in 2011 and expanding on the Section 179 expense allowance rules currently available for small businesses. Not only that, the latest capitalization rules issued by the IRS for determining which expenses can be immediately deducted and which must be capitalized make the current inventory rules look downright simple. These rules are just starting to go into effect so expect to hear more about them in the coming years. While the IRS has provided some relief for certain small businesses, for those businesses that do not qualify for the exception, the likelihood they will get these capitalization calculations right without spending substantial resources on professional help is remote at best. In fact, even if they do spend substantial resources on professional help, the likelihood of small businesses getting these calculations right is still remote. Finally, with respect to prepayments, some might suggest that small businesses will “manipulate” their taxable income by making prepayments at the end of the year to offset any net income. The fact of the matter is small businesses simply do not have the resources to prepay expenses in an effort to manipulate their tax liability.

Some may believe a dollar limitation on how much depreciable property or how much inventory can be expensed in a single year is necessary but from a simplification point of view limitations in these two areas would add complexity. First, they would result in taxpayers maintaining two sets of calculations, one for expenses below the threshold and one for expenses above. Second, taxpayers may end up spending time and effort focused on managing the timing of purchases from year to year to stay below the threshold. Neither of these types of behavior does anything to create jobs or grow businesses.

The following chart contrasts the current cash method and the SCM proposal for the treatment of some common business expenditures.

Type of Expenses	Current Cash Method	Simplified Cash Method
Prepayment of expenses	Deductible when paid if prepayment does not exceed one year	Deductible when payment is made
Prepayment of interest	Deductible over period it covers	Deductible when payment is made
Inventory	Capitalized	Deductible when payment is made
Business start-up expenses	Deductible up to \$5,000	Deductible when payment is made
Section 179, bonus depreciation, research and development expenditures	Immediately deductible	Deductible when payment is made
Bonus depreciation	Immediately deductible (only 2011)	Deductible when payment is made unless either (1) aggregate cost of depreciable assets exceeds certain dollar threshold or (2) asset is a "long-lived asset"
Materials, supplies, and improvements	Capitalized or deducted	Deductible when paid
Expenditures related to tax-exempt income	Nondeductible	Same as current law
Expenditures contrary to public policy	Bribes, kickbacks, fines, and penalties are nondeductible	Same as current law
Political contributions and lobby expenses	Nondeductible if lobbying or political campaigning is an integral part of the business	Same as current law

Eligibility For Simplified Cash Method

Based on research we have done at the Tax Center, we believe that the appropriate level for allowing businesses to use the SCM is average gross receipts of \$10 million. At that level, nearly 99% of all businesses would be eligible to use this new method of accounting.

Because most businesses would qualify for the SCM and its reduced tax compliance burdens, small businesses would be able to better maintain their **own** accounting records and prepare their **own** returns. This would reduce the need for costly tax professionals and free up more resources that could be put to work in adding jobs and growing businesses. The SCM would offer better compliance at lower cost both to taxpayers and the government, with little or no loss of tax revenue. In addition, because the calculation of tax would be understandable by small business owners it would deal with the frustration, skepticism and resentment that we see reflected in our surveys.

Apply A Single Business Tax Rate

Schedule To All Businesses Regardless Of Their Legal Form

Finally, I would like to comment on an approach to tax reform that would make sure that income from all businesses, no matter their size or legal form, would be taxed at the same tax rates. This is not as much a simplification proposal as it is a fairness proposal. Under current law, income from businesses that are conducted as sole proprietorships, partnerships and S corporations is subject to tax at a maximum rate of 39.6%, while income earned by C corporations is taxed at the maximum individual rate of 35%. Many of the proposals for corporate tax reform rely on eliminating some business deductions, preferences, and credits to increase the amount of income subject to tax, i.e. broaden the tax base, and then apply a lower corporate tax rate to that broader income base. In some of the proposals that have been discussed, the base-broadening changes that would be made would apply to all businesses, including unincorporated businesses, but the rate reductions would be made only in the corporate rate.

If corporate tax reform moves forward in this way, nearly small businesses because they are not organized as C corporations will end up with an increased tax burden when many are already struggling to stay afloat. This seems to make little sense if we are interested in enhancing the competitiveness of our economy.

The country would be better served if “corporate tax reform” is approached as “business tax reform”. As part of the process of broadening the tax base and lowering the corporate tax rate, **I believe the time has come for Congress to consider a single tax rate schedule for all business income no matter what legal form a business uses to conduct business.** Given the importance of small businesses to our economy, it makes little sense that income earned by unincorporated businesses (which tend to be small businesses) is subject to tax at the higher individual rates while income earned by corporations is taxed at lower corporate rates. This is especially the case since the calculation of “taxable income” for both types of taxpayers, i.e. the determination of income and the determination of which business deductions are allowable, are virtually identical. While it is true that corporate earnings are subject to tax both at the corporate level and the shareholder level (when distributed) and earnings of unincorporated businesses are taxed only once, there are well documented approaches that can be used to effectively resolve this matter. I do not believe that the rate at which earnings from these two types of businesses are taxed should play any role in trying to reconcile the two levels of tax on corporate earnings with the single level of tax on unincorporated businesses.

A single integrated business tax rate schedule could, if so desired, use graduated tax rates, which are phased out as income rises similar to the current corporate tax rate schedule. This would provide a lesser tax burden to businesses with smaller amounts of taxable income. A single integrated business tax rate schedule would be a relatively simple system to implement and administer since the information to implement it already exists on tax returns being filed today. Income from follow-through businesses (sole proprietorships, partnerships and S corporations) already appears on separate schedules on individual tax returns. Income from sole proprietorships is reported on Schedule C and income from both partnerships and S corporations is reported on Schedule E of

the individual tax return (Form 1040). All that would be required would be for a taxpayer who is an owner of a flow-through entity to add his or her income on those two schedules (C and E) together and subject the total to the “business tax rate schedule”. This would be no different in practice than how individuals who have qualifying dividend income and capital gains on schedules B and D compute their taxes today.

In short, what is needed is “business tax reform” not simply corporate tax reform. A single business rate schedule would move us toward a more comprehensive system of business taxation – one that applies to all businesses equally across the board. If done right, it could ease the tax burden of small businesses while increasing simplicity and fairness. And ultimately, that could provide small businesses with some of the relief they need in order to compete and thrive.

Summary

The biggest tax problems facing small businesses today all stem from two sources: complexity and constant change in the tax law. What our Kogod Tax Center surveys reflect is that small businesses have outsourced their tax planning and tax compliance obligations to tax professionals. The increasing demands by the IRS for greater and greater specificity as part of the tax compliance process driven by the complexity of the law and regulations are challenging even the most experienced tax professionals to maintain the quality of their work at an affordable price for their small business clients.

With 81% of tax return preparers in the survey citing the time and complexity of data gathering by their clients as a significant problem, it is clear that small business owners don’t understand, or if they understand can’t or won’t maintain, the records required of them under the nation’s tax laws. This presents a substantial challenge to the integrity of the tax system and to the small business community. When you combine this with the fact that 46% of survey respondents said “New IRS or State Regulations” decreased their efficiency this year, it seems clear that the tax system is not headed in a good direction. Tax reform is needed, and tax simplification is needed even more, for the continuing viability of our voluntary tax compliance system and, more importantly, for the continued growth and vitality of our country’s small businesses.

Thank you for allowing me to testify today. I would be delighted to address any questions from any Member of the Committee or your staff today. I and others at the Kogod Tax Center would be pleased to address any further questions with you at any future date.