

Testimony of Tim Reynolds

President

Tribute, Inc.

On behalf of the National Small Business Association



House Small Business Committee

"Start-ups Stalled? The Tax Code as a Barrier to Entrepreneurship"

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1156 15th Street, N.W., Suite 502
Washington, DC 20005
202-293-8830
www.nsba.biz

Good Morning. Chairman Chabot, Ranking Member Velázquez and members of the House Small Business Committee, I want to thank you for inviting me to testify today on the biggest tax problems facing America's small businesses, and discuss ways the tax code operates as a barrier to business creation and growth.

My name is Tim Reynolds, owner and President of Tribute Inc., a software company located in Hudson, Ohio. Our 38 employee company develops and markets software for industrial distributors. The company focuses primarily on distributors of hydraulic and pneumatic equipment, specialty and industrial hose and rubber, and gasket products. By way of example, many customers are Eaton or Parker Hannifin distributors. Tribute develops and markets two Enterprise Resource Planning (ERP) products: the Tribute Software System, a UNIX-based solution, and TrulinX, a Windows-based solution. Both provide a fully integrated business system supporting virtually all of the distributors' business system needs.

I am pleased to be here representing not only my company, but also the National Small Business Association (NSBA), where I currently serve as an Honorary Trustees member and Past Chairman. NSBA is the nation's oldest small-business advocacy organization, with over 65,000 members representing every sector and industry of the U.S. economy. NSBA is a staunchly nonpartisan organization devoted solely to representing the interests of the small businesses which provide almost half of private sector jobs to the economy.

In recent years, there have been ambitious policy efforts in Congress to replace the current U.S. Tax Code. I welcome the eagerness of lawmakers to fix America's broken tax system, but I also recognize there are significant challenges with enacting comprehensive tax reform legislation in the near future. Therefore, in the interim, simplification of the most complex provisions of the Code may help to significantly reduce the burden on individual taxpayers and small businesses.

While there are many obvious problems with the current tax system, there are two paramount issues that must be addressed. The first major problem with the system is the generally high marginal rates of taxation on income. The other, oftentimes more significant dilemma is the almost impossible task of compliance with all the rules and regulations. It is time that Congress acts to reexamine the tax code and simplify or repeal some of its most complex provisions.

Compliance Costs

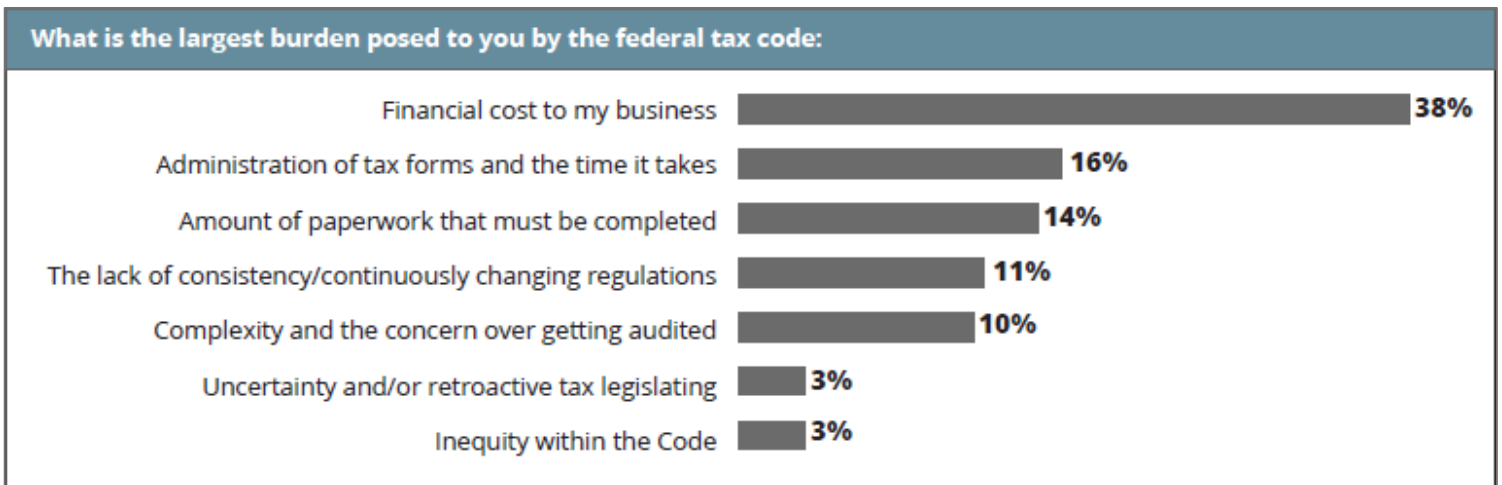
Although NSBA's members operate a wide variety of businesses, they all consistently rank tax simplification and reducing the tax burden among their top issues for Congress and the administration to address. The compliance burden on taxpayers, because of the complexity of our Code, is truly staggering. While the actual tax liabilities for small firms is a huge issue, the sheer

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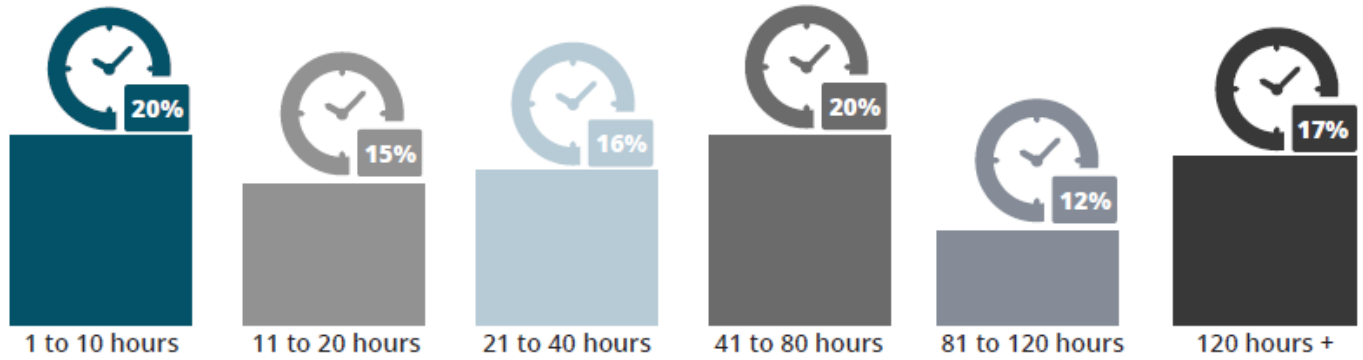
complexity of the tax code—along with the mountains of paperwork it necessitates—is actually a more significant problem for America’s small businesses. For a small business, such as Tribute, Inc., the proportionate cost is significant, and the investment of time is even more consequential because it takes away from our productivity and growing the firm. Unlike larger corporations which have in-house accountants, benefits coordinators, attorneys, personnel administrators, etc. at their disposal, small businesses often are at a loss to keep up with, implement, afford, or even understand the overwhelming regulatory and paperwork demands of the federal government and Tax Code.

My company is a Subchapter S firm. As such, the income of my company flows to my personal tax return. I have an MBA from the University of Michigan, run a company that develops and sells accounting software and have been in business for more than 20 years. Yet, I would view it as taking an irresponsible risk to attempt to do my own tax returns. The Code is so complicated that I feel certain I would inadvertently run afoul of the law. So I have to pay an accounting firm to do these taxes. No doubt the CEO of a Fortune 500 company feels the same way. But as a small-business person, the cost of compliance is disproportionately large.

According to the NSBA 2016 Mid-Year Economic Report, federal taxes are a huge issue facing small business—and we have seen the administrative burden outpace the financial burden. This year is no different with 56 percent citing administrative burdens as their largest issue with federal taxes and 38 percent citing the actual financial cost.

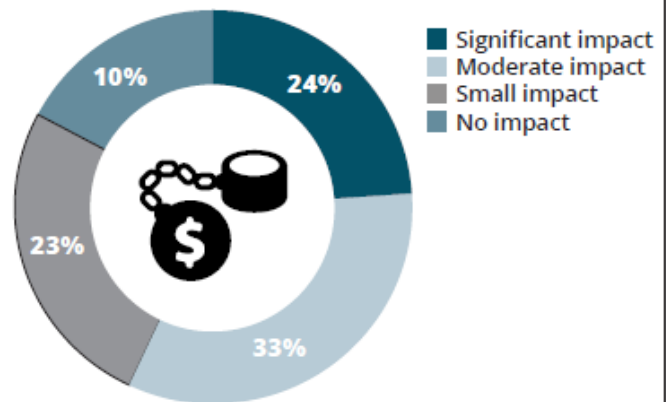


Approximately how much TIME do you spend each year dealing with federal taxes, i.e.: calculating payroll, self-employment or any other business-related tax, filing reports, working with your accountant, estate planning, etc...?



Nearly half of small businesses spend more than 40 hours per year to comply with federal taxes, and nearly one-in-three spend more than 80 hours—two full work weeks each year. The majority of small businesses, 68 percent, spend more than \$1,000 per year on the administration alone of federal taxes. More than half say that federal taxes have a significant to moderate impact on the day-to-day operation of their business. Just imagine the collective business and job growth that could be done absent that burden. My company pays our accountants more than \$14,000 each year to

How much of an impact would you say federal taxes have on the day-to-day operation of your business?

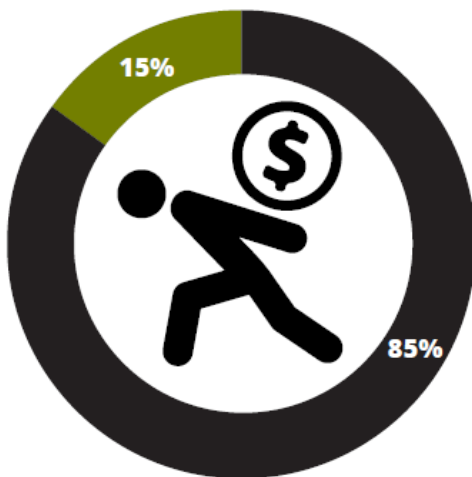


prepare our

taxes. In addition, we spend about 40 hours a year preparing various forms and making various estimated payments required to comply with tax law.

How do you prepare your company's taxes?

- External tax practitioner/accountant
- I or a member of my staff handles it



More than half of NSBA members have fewer than five employees—few, if any of whom is a tax specialist—leaving business owners such as myself with no other choice but to hire outside help to keep track of all their additional reporting and filing requirements. In fact, according to the NSBA 2015 Small Business Taxation Survey, only 15 percent of small-business owners handle their taxes internally—meaning 85 percent are

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forced to pay an external accountant or practitioner—this data should send a strong message to the IRS and Congress that the Tax Code is far too complex.

In addition to outside consultants, our company controller and bookkeeper spend significant time each week in the administration and filing of monthly and quarterly income and payroll reports, as well as trying to stay informed of changes to the Tax Code, changes to regulations, the status of current and expired tax extenders that may affect my business and so on. The aggregate cost of this represents thousands of dollars per employee and time away from doing more productive work to manage and grow my business.

According to a U.S. Small Business Administration (SBA) Office of Advocacy report entitled, “The Impact of Regulatory Costs on Small Firms,” the compliance costs incurred by businesses are estimated to be about \$95 billion annually but may be as much as 50 percent higher. Individual and not-for-profit compliance costs are, of course, quite substantial as well.

In the case of small businesses these costs include the time of small-business owners and their accounting staff devoted to collecting necessary information and filling out Internal Revenue Service (IRS) forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. Small-business compliance costs relative to income, revenues or per employee is disproportionately high. The SBA study quantifies this disproportionate impact, showing that the impact on small firms in terms of per employee costs is three times that of larger firms.

Tax Compliance Cost per Employee by Firm Size, According to SBA Office of Advocacy

	All Firms	Firms with <20 Employees	Firms with 20-499 Employees	Firms with 500+ Employees
Tax Compliance Cost per Employee	\$800	\$1,584	\$760	\$517

There will always be some compliance costs in any tax system. But today these costs are very high and if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent

growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment.

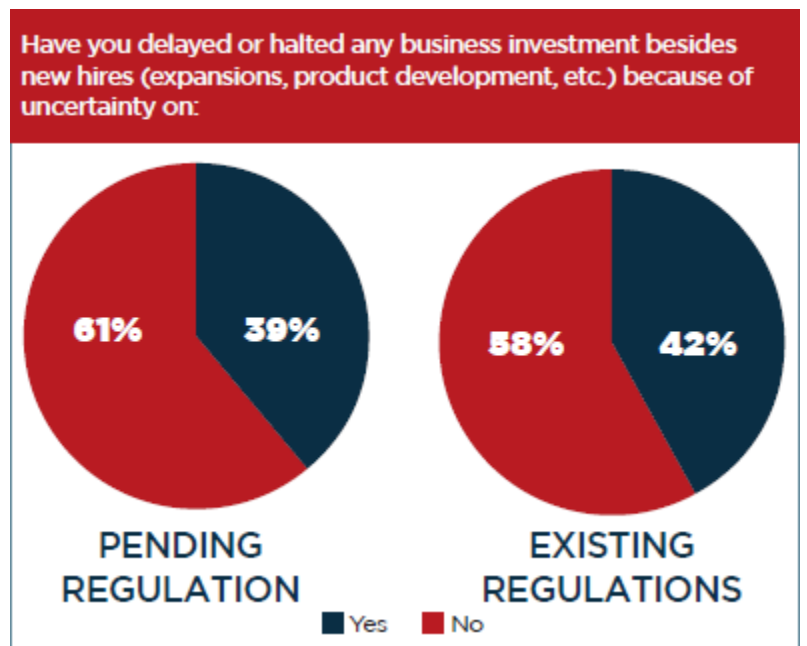
These costs also represent a significant drag on the economic growth, on job creation and on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress.

Regulatory Burdens

I firmly believe efforts to reduce the regulatory and administrative burdens on small businesses must focus on overall simplification, eliminating inequities within the Tax Code, and enhancing taxpayer education and outreach. A simpler tax code that is more easily understood by taxpayers would have many benefits, not the least of which would be reduced cost of compliance and reduced unintentional errors. Small businesses struggle to deal with the complexity of ambiguous terms, intricate technical language and difficult sentences. The increased burden causes us to have trouble understanding the requirements. This forces us to spend more time trying to interpret the rules and ensure we are completing the forms accurately thus avoiding being fined by the agency for noncompliance.

My company has been audited by the IRS twice. In both cases the eventual result was no errors found and therefore no penalties. In one case, the initial auditor did not understand the rules around deferring software sales revenue. After multiple appeals we finally were referred to her supervisor, who agreed with our interpretation of the deferral rules. My point is that in some cases even the IRS cannot easily interpret the rules! Yet, the cost of compliance falls on us.

The impact of regulatory burden cannot be overstated, according to the recently released 2017 NSBA Small Business Regulations Survey, more than one-third of small businesses have held off on business investment due to uncertainty on a pending regulation, and more than half have held off on hiring a new employee due to regulatory burdens.



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Furthermore, the average small-business owner is spending at least \$12,000 every year on regulations, and nearly one-in-three spends more than 80 hours each year dealing with federal regulation. We spend at least this much and more trying to understand and comply with IRS regulations, Department of Labor regulations as well as those of other agencies. Our biggest fear is that we don't know what we don't know! It is nearly impossible for us to keep up with new regulations and new rules.



It should come as no surprise, then, when NSBA asked what areas of regulations are most burdensome, the federal Tax Code and Affordable Care Act (ACA) were the top two. More specifically, three-in-four small firms say that federal Tax Code regulations are very or somewhat burdensome, and two-in-three say that the ACA regulations are somewhat or very burdensome. At Tribute, we have put tremendous effort into understanding and dealing with the ACA and ensuring that we offer a competitive and cost effective health care plan for our employees. Every single year we need to restart that effort because of the turbulence in the healthcare market place.

What makes regulatory compliance even more challenging for smaller firms, is that the small-business owner is the number one regulatory expert in most businesses and handles the bulk of federal regulatory compliance. My controller and I easily spend 10 hours each month ensuring that we stay in compliance with federal regulations. At the end of each quarter and at year-end the time spent nearly doubles as we scramble with filings.

Accurate tax reporting and compliance is extremely important to small business but vague rules and poorly defined regulations—often driven by vague, poorly defined and sunseting legislation—understandably result in mistakes. Those who make a good faith effort, yet are inaccurately complying should be assisted through education and tax simplification efforts.

Those willfully disregarding their tax liability should be held accountable. However, increased enforcement at the expense of taxpayer education will not in the long term accomplish sustained, improved compliance. The more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. The fact that “complexity of rules” and “difficulty interpreting and understanding rules” combined to compose nearly half of all regulatory difficulties in NSBA’s regulations survey, is clear indication of the need for eased complexity, overall streamlining and adherence to plain language statutes.

With the complexity facing many taxpayers, NSBA believes the development and implementation of initiatives to improve IRS guidance and assistance is important. The best thing for small businesses is simplicity: simplicity in instructions, in requirements, in consequences and an overall reduction in the size of the paperwork and the time necessary to complete the forms.

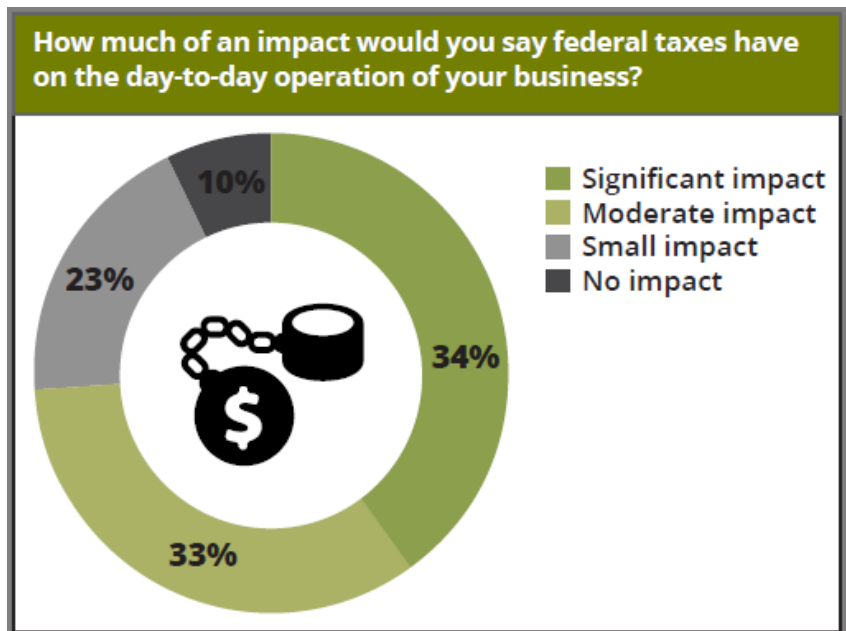
All Tax Credits are Not Created Equal

According to NSBA’s tax survey, the majority of small businesses, 67 percent, say that federal taxes have a significant to moderate impact on the day-to-day operation of their business and 59 percent say credits and deductions have a significant to moderate influence over their decisions about their company and employees.

The discussion of tax policy must not occur in a vacuum. NSBA is firmly committed to

seeing the deficit reduced and, as such, we believe it is important to promote those tax credits that stand to offer the most benefit to the most people, both directly and indirectly.

While there are a number of tax deductions, credits and exclusions that are very beneficial to small-business growth and overall economic stimulation, some do little to promote economic growth. They may have other policy objectives and may or may not achieve those objectives, but they do not materially affect the incentives to work, to save or to invest. One in particular that,



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while good-intentioned, does not offer broad relief is the hiring tax credit whereby a firm would receive a credit for hiring a previously unemployed individual. Small firms are unlikely to hire a new person simply for that tax credit – those that are in a place to hire will likely do so regardless of a temporary, one-time credit, and they will look for the person best suited with the appropriate skills. Unfortunately, if that person is not among the long-term unemployed that will not likely be a factor in the employer’s decision making process. Tax credits play no role in our decision to hire. The cost of a new hire must ultimately be covered by additional revenues or reduced overall costs over the long run. Tax credits are temporary, unreliable and, for us, irrelevant.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace. It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind their domestic and foreign competitors, the firms will simply fail.

Not only do these kind of investment-spurring tax credits and deductions help the qualifying firm, it helps promote economic growth by encouraging firms to make investments and purchase equipment from other firms. These tax provisions are the epitome of stimulatory.

Disadvantage at Tribute, Inc.

As a software development company, Tribute spends a significant amount of time, money and resources each year on research and development. As such, we are entitled to take advantage of the Research and Experimentation (R&E) tax credit, which can produce significant tax savings to innovative companies such as mine. As most small innovators, we are always trying to improve what we do, be more competitive, reduce costs and increase market shares. However, because we are a sub chapter S corporation and the income of the business passes thru to my personal income taxes, I am often subject to the Alternative Minimum Tax (AMT). For years, this prevented my company from taking the R&E credit, or we were limited to such a small amount each year that our accounting firm did not take the time to calculate what the credit might be. In fact, the costs of calculating the credit usually would exceed the allowable credit. The R&E tax credit is meant to encourage additional research and development, yet I am penalized for the way I structured my business. Small businesses are often America’s greatest innovators, and yet the complicated tax code steps on its own foot in this area.

There is an ironic twist to this story. In 2015, Congress passed and the president signed into law, the Protecting Americans from Tax Hikes (PATH) Act, which made over a third of the so-called “tax extenders” into permanent law. The R&E tax credit was among the nineteen of the tax provisions that were made permanent parts of the Tax Code. Since 1981, this credit has expired and been renewed 16 times, making it one of the most unstable parts of the Tax Code. In doing research for today’s hearing, I learned that the PATH Act contained a provision which allowed small businesses (under \$50 million in gross revenue over the prior three years) to offset the AMT with R&E tax credits! So, I immediately thought—great, problem solved, BUT quickly learned it was too good to be true. Unfortunately, Congress limited the offset to C corporations, and as noted earlier in my testimony, most small businesses, including Tribute, are Sub(s) corporations. So with good intentions, the PATH Act missed the target on this provision. As complicated as the tax code is, this is not surprising. Often small businesses suffer from both unintended consequences and unrealized intended consequences. Further proving we desperately need to simplify.

Taxation of Pass-through Entities

As I previously mentioned, most small businesses are sole proprietorships, subchapter S corporations—such as Tribute, Inc.—or limited liability companies. Most of the remainder are partnerships (either limited or general). There also are some business trusts. All of these businesses (83 percent, according to NSBA data) pay taxes on their business at the personal income level, or are so-called “pass-through” entities that are subject to individual tax rates – not corporate tax rates. For my company, the pass-through tax implications are a major driver in our tax strategy each year. It is no surprise then, that income taxes and payroll taxes were ranked the top two most burdensome taxes by small firms.

Please rank, in order of their ADMINISTRATIVE burden on you and your business, the following taxes. (1 is the most burdensome and 10 is the least burdensome)

1. Payroll taxes
2. Income taxes (I am a pass-through entity)
3. State and local tax compliance
4. Sales tax
5. Property taxes
6. Corporate taxes (I am a c-corp)
7. Alternative Minimum Tax
8. Capital gains taxes
9. Medicare surcharge under Affordable Care Act
10. Changes to deductibility of tangible property repairs
11. Estate tax
12. Excise taxes (i.e.: Medical Device Tax)
13. International taxes (I export)
14. Import taxes (I import)

Some small businesses are C corporations that are subject to the corporate income tax, but these are a relatively small percentage and a large portion of these companies’ net income before compensating the owners’ is usually consumed by paying the owners’ salary. This salary is also subject to the individual tax rates as, of course, are any dividends paid by the corporation to its shareholders. Thus, even for small C corporations, individual tax rates are key.

Broad reform of the entire tax code is necessary, not just for corporate entities. Many proposals have called for reducing the corporate tax rate while eliminating various business deductions and credits, which—if not examined more closely—sounds like a fine plan. However, many pass-through entities utilize these tax benefits that would be on the chopping block. So now I would be facing the same, high tax rate on my business income, but I could no longer take advantage of some important tax credits and/or deductions. The result is a tax increase on my firm while large corporations would be given a tax cut. Allowing the smallest businesses to pay a much higher tax on their business income than a multinational, multi-billion corporations undercuts any semblance of fairness.

I firmly believe that addressing just one piece of the puzzle—such as corporate tax reform—will only lead to even greater complexity and a massive tipping of the scales in favor of the nation’s largest companies at the expense of small businesses.

Imposing higher tax rates on small firms will stymie any growth from what is widely recognized as the source of much of the economic growth and dynamism in the U.S. economy: small business. For the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates. Since small businesses disproportionately contribute to job creation, raising individual marginal tax rates can be expected to have a disproportionate negative impact on job creation. It is this kind of shortsightedness that has made the IRS a major foe of small firms and why so many of us support broad tax reform.

If Congress overhauls the tax system by dramatically broadening the base —cutting the breaks that litter the tax code—and lowering ALL rates, we would see real economic growth and raise revenues.

Principles of Tax Reform

While NSBA supports the Fair Tax as a viable option for tax reform, NSBA understands the political landscape and need to move forward on broad reform, even if in a different iteration. As such, NSBA has developed nine principles as part of the NSBA Tax Reform Checklist to which any broad tax reform package ought to adhere. The nine principles are:

- ✓ Designed to tax only once
- ✓ Stable and predictable
- ✓ Visible to the taxpayer
- ✓ Simple in its administration and compliance
- ✓ Promote economic growth and fairness between large & small businesses

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- ✓ Use commonly understood finance/accounting concepts
- ✓ Grounded in reality-based revenue estimates
- ✓ Fair in its treatment of all citizens
- ✓ Transparent

This kind of broad reform is what small firms want: according to NSBA's 2015 Small Business Taxation Survey, a large majority, 70 percent, expressed support broad reform of the tax system that reduces both corporate and individual tax rates, coupled with reducing both business and individual deductions.

Conclusion

Complexity and inconsistency within the tax code pose a significant and increasing problem for small businesses. The ever-growing patchwork of credits, deductions, tax hikes and sunset dates is a roller coaster ride without the slightest indication of what's around the next corner. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required. However, unless and until Congress agrees upon a replacement, we must fix tax problems with the current Tax Code by developing simplification measures that are fair and fiscally responsible.

Weighing in at more than 70,000 pages, the Tax Code punishes work, investment, risk-taking and entrepreneurship. The Tax Code is unfair to small businesses, biased against savings and investment, and impossibly complex. A tax system dedicated to investment, savings and small-business growth must be put in its place.

Again, I would like to thank Chairman Chabot and the members of the Small Business Committee for the opportunity to speak today. I would be happy to answer any questions you may have.