

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 8, 2013  
Re: Hearing: Small Businesses Tax Reform: Growth Through Simplicity

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On April 10, 2013 at 1:00 pm, the Committee on Small Business will meet in room 2361 of the Rayburn House Office Building for the purpose of receiving testimony on tax reform and how it could affect small businesses.

I. Background

Over time, our tax code has become more complex and truly temporary, with 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, regulations and the weak economy, have made it difficult to plan or grow their companies.

For the past few years, Members of Congress and the Administration have said that tax reform is an important agenda item. The Finance and Ways and Means Committees have held numerous hearings on tax reform.<sup>1</sup>

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.<sup>2</sup> During Committee on Small Business hearings, small business owners have asked for simplification of the tax code and reduced tax rates, both for corporations and individuals.<sup>3</sup>

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<sup>1</sup> See, for example, *Tax Reform and the Treatment of Capital Gains: Joint Hearing Before the Senate Finance Committee and House Ways and Means Committee*, 112<sup>th</sup> Cong. (September 13, 2012), available at <http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=308354> and *The Tax Outlook for Small Business: What's on the Horizon? Hearing before the House Committee on Small Business* (April 18, 2012), available at <http://smallbusiness.house.gov/calendar/eventsingle.aspx?EventID=289704>.

<sup>2</sup> Sam Goldfarb, *Facing the Uncomfortable Realities of 'Tax Reform,'* CONGRESSIONAL QUARTERLY (October 22, 2012), available at <http://www.cq.com/doc/weeklyreport-4167564>.

<sup>3</sup> *The Tax Outlook for Small Business: What's on the Horizon? Hearing before the House Committee on Small Business* (April 18, 2012) (testimony of Leonard Steinberg), available at [http://smallbusiness.house.gov/uploadedfiles/steinberg\\_testimony.pdf](http://smallbusiness.house.gov/uploadedfiles/steinberg_testimony.pdf).

At the same time, increasing budget deficits have been a concern of Members of Congress on both sides of the aisle. Several congressional panels have been charged with proposing ways to reduce the deficit. In 2010, the National Commission on Fiscal Responsibility and Reform<sup>4</sup> issued a report that proposed broadening the individual and corporate income tax base and eliminating most business and individual tax expenditures.<sup>5</sup> However, the report failed to garner the votes needed to formally endorse it. The Budget Control Act of 2011 created the United States Congress Joint Select Committee on Deficit Reduction to recommend a plan. The Committee's failure to reach an agreement led to the possibility of a "massive fiscal cliff"<sup>6</sup> -- mandatory spending cuts and tax increases scheduled to become effective in January, 2013 -- that the Congressional Budget Office estimated might lead the economy into another recession.<sup>7</sup> On January 2, 2013, President Obama signed legislation<sup>8</sup> to prevent some of the major spending cuts and tax increases from becoming effective.

Against this backdrop, on March 10, 2013, Chairman Camp issued a discussion draft of a tax reform plan for small businesses.<sup>9</sup> As part of a larger effort entailing various portions of the tax code, Chairman Camp's small business draft would address small business owners concerns by making Section 179 expensing for equipment and property permanent; simplify and expand the use of cash accounting for certain small firms; and create a unified deduction for start-up and organizational expenses.<sup>10</sup>

## II. 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, LLCs or partnerships. These 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.<sup>11</sup>

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<sup>4</sup> This Commission was also known as the Simpson-Bowles Commission, after its co-chairmen, former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles.

<sup>5</sup> A MOMENT OF TRUTH, REPORT OF THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM, December 2010, *available at* [http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12\\_1\\_2010.pdf](http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf)

<sup>6</sup> Speech by Ben Bernanke, Chairman, Federal Reserve Bank Board of Governors, to Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, WY (August 31, 2012), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm>.

<sup>7</sup> CONGRESSIONAL BUDGET OFFICE, ECONOMIC EFFECTS OF REDUCING THE FISCAL RESTRAINT THAT IS SCHEDULED TO OCCUR IN 2013 (May 2012), *available at* [http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint\\_0.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf).

<sup>8</sup> Pub. L. No. 112-240, 126 Stat. 2313, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-112publ240/pdf/PLAW-112publ240.pdf>.

<sup>9</sup> WAYS AND MEANS COMMITTEE DISCUSSION DRAFT (March 12, 2013), *available at* [http://waysandmeans.house.gov/uploadedfiles/final\\_sm\\_bus\\_passthrough\\_legislative\\_text\\_03.12.13.pdf](http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_legislative_text_03.12.13.pdf) [hereinafter "Discussion Draft"].

<sup>10</sup> SUMMARY OF DISCUSSION DRAFT 2, *available at* [http://waysandmeans.house.gov/uploadedfiles/small\\_biz\\_summary\\_description\\_03\\_12\\_13\\_final.pdf](http://waysandmeans.house.gov/uploadedfiles/small_biz_summary_description_03_12_13_final.pdf).

<sup>11</sup> *Small Business Uncertainty: Perspectives on the Tax Cliff: Hearing by the House Committee on Small Business*, 112<sup>th</sup> Cong. 3 (Sept. 13, 2012) (testimony by Theresa Kern, President, MA Steel Erectors, Inc.), *available at* [http://smallbusiness.house.gov/uploadedfiles/9-13\\_kern\\_testimony.pdf](http://smallbusiness.house.gov/uploadedfiles/9-13_kern_testimony.pdf). See also *Tales of Resilience: Small Business Survival in the Recession: Hearing by the House Committee on Small Business*, 112<sup>th</sup> Cong. (July 25, 2012) (testimony of Elise Mitchell, President and CEO, Mitchell Communications Group), *available at* [http://smallbusiness.house.gov/uploadedfiles/7-25\\_mitchell\\_testimony.pdf](http://smallbusiness.house.gov/uploadedfiles/7-25_mitchell_testimony.pdf).

Small business organizations have urged Congress to undertake comprehensive tax reform; that is, reform of both corporate and individual rates.<sup>12</sup> The Chairman of the House Committee on Ways and Means, Dave Camp, has said he would like Congress to undertake comprehensive tax reform. 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 and Tax Compliance.

According to testimony by former Comptroller General David Walker,<sup>13</sup> 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.<sup>14</sup> 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.

According to the National Taxpayer Advocate, tax issues are a significant set of regulatory burdens for most small businesses,<sup>15</sup> and the most recent report singles out tax complexity as the most serious problem facing taxpayers.<sup>16</sup>

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.<sup>17</sup> 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.

In recent survey of 12,500 National Federation of Independent Business (NFIB) members, 85% said they favor fundamental reform of the tax code.<sup>18</sup> Small businesses face unique challenges when

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<sup>12</sup> Discussion Draft, *supra* note 9.

<sup>13</sup> *Simplification and Increased Uniformity of Taxation Would Yield Benefits: Hearing Before the United States Senate Committee on Finance*, 110<sup>th</sup> Cong. (September 30, 2006) (testimony of David M. Walker), available at <http://www.gao.gov/new.items/d061113t.pdf>.

<sup>14</sup> INTERNAL REVENUE SERVICE, NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 18 (JANUARY 9, 2012), <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report>.

<sup>15</sup> *Tax Burdens Facing Small Businesses: Hearing Before the United States House of Representatives Committee on Small Business*, 109<sup>th</sup> 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](http://www.irs.gov/pub/irs-utl/nta_small_business_comm_testimony_v4_single.pdf).

<sup>16</sup> INTERNAL REVENUE SERVICE, NATIONAL TAXPAYER ADVOCATE SERVICE, 2012 ANNUAL REPORT TO CONGRESS, VOLUME ONE 3 (January 9, 2013), available at <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report>.

<sup>17</sup> 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>.

<sup>18</sup> NATIONAL FEDERATION OF INDEPENDENT BUSINESS RESEARCH FOUNDATION, NFIB STUDY: SMALL BUSINESSES OVERWHELMINGLY FAVOR COMPREHENSIVE TAX REFORM, available at <http://www.nfib.com/research-foundation/surveys/tax-survey>.

dealing with the code. Entrepreneurs must struggle to decipher the code, file paperwork and pay their taxes, all while keeping their businesses running. As new taxes are implemented, and tax rates increase, small business owners must familiarize themselves with these laws, or hire a professional to do so, and ensure that their company complies.

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. The Taxpayer Advocate has reported that individuals who “feel distant” from the code have lower rates of voluntary tax compliance,<sup>19</sup> although it is uncertain what makes one feel “connected” to it. The code has become so complex that even the IRS has difficulty administering it.<sup>20</sup> And the IRS has found it more challenging to answer the millions of phone calls and taxpayer correspondence, the main ways it communicates with taxpayers,<sup>21</sup> it receives each year.<sup>22</sup> The expectations have been so low that IRS set its Fiscal Year 2010 telephone customer service goal at 71.2%. That meant almost three out of ten callers to the IRS were not expected to get through.<sup>23</sup> The situation today is no better. The IRS received over 100 million telephone calls in Fiscal Year 2012, and more than 30% went unanswered, and for Fiscal Year 2013, the IRS set a goal of answering only 63%, a 7% decrease.<sup>24</sup>

### III. Proposals for Reform

Chairman Camps’ discussion draft includes several bipartisan provisions to make expensing of investments and property under Section 179 of the tax code permanent; expand the use of simpler cash accounting practices; and simplify the due dates of tax returns for partners and S corporations. We will now consider some of the proposal’s key provisions.

#### A. Permanent Section 179 Expensing.<sup>25</sup>

In 1981, the passage of the Economic Recovery Tax Act<sup>26</sup> allowed business owners who make qualified capital investments in their companies to deduct the investment in the year it is made, rather than having to deduct the cost over a longer period, such as its useful life.<sup>27</sup> Initially enacted to help stimulate the economy, it encourages business owners who might be contemplating a capital equipment purchases to make it in the current year.<sup>28</sup> Now known simply as “Section 179 expensing” after the section of the tax code in which it appears, the provision is widely used by small business

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<sup>19</sup> INTERNAL REVENUE SERVICE, NATIONAL TAXPAYER ADVOCATE, 2010 ANNUAL REPORT TO CONGRESS (DECEMBER 31, 2011), available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

<sup>20</sup> *Id.*

<sup>21</sup> INTERNAL REVENUE SERVICE, NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 18 (JANUARY 9, 2012), <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report>.

<sup>22</sup> INTERNAL REVENUE SERVICE, NATIONAL TAXPAYER ADVOCATE, 2010 ANNUAL REPORT TO CONGRESS (DECEMBER 31, 2011), available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

<sup>23</sup> *Id.*

<sup>24</sup> INTERNAL REVENUE SERVICE, NATIONAL TAXPAYER ADVOCATE, 2012 ANNUAL REPORT TO CONGRESS 18 (JANUARY 9, 2012), <http://www.taxpayeradvocate.irs.gov/2012-Annual-Report/FY-2012-Annual-Report-To-Congress-Full-Report>.

<sup>25</sup> Discussion draft § 211; Internal Revenue Code § 179.

<sup>26</sup> Pub. L. No. 97-34, 95 Stat. 183 (1981).

<sup>27</sup> “Useful life” is generally defined as the period during which an asset is productive for the purpose it was acquired.

<sup>28</sup> *The Tax Outlook for Small Businesses: What’s on the Horizon? Hearing Before the House Committee on Small Business*, 112<sup>th</sup> Cong. 3 (2012) (testimony of Leonard Steinberg, Steinberg Enterprises LLC), available at [http://smallbusiness.house.gov/uploadedfiles/steinberg\\_testimony.pdf](http://smallbusiness.house.gov/uploadedfiles/steinberg_testimony.pdf).



owners. In response to economic slowdowns, Congress has extended and enhanced expensing allowances to encourage greater investment by businesses.<sup>29</sup> The discussion draft would permanently allow businesses to expense new equipment and property up to \$250,000, with the deduction phased out at \$800,000 (both amounts indexed for inflation).<sup>30</sup>

B. Expand Use of Cash Accounting.<sup>31</sup>

Businesses that use the cash receipts and disbursements method of accounting typically recognize income when it is actually received, and expenses when they are paid.<sup>32</sup> Businesses that use the accrual method record expenses in the period the transaction is made, not when the cash is received.<sup>33</sup> Many small firms find that the cash method is easier for them to use, since it is similar to keeping their expenses and receipts in a checking account.<sup>34</sup> To encourage simpler accounting for small businesses, the discussion draft replaces the current array of complicated tax-accounting rules that apply to small businesses with a uniform rule under which all businesses with gross receipts of \$10 million or less may use the cash method of accounting.<sup>35</sup> The discussion draft would also repeal the required use of cash accounting by farming operations.<sup>36</sup>

C. Return Due Date Simplification.<sup>37</sup>

To ease compliance, the discussion draft would change the filing dates for S corporations, partnerships and corporations, better conforming the due dates to the time when required information is available.<sup>38</sup>

D. Changes to Partnerships and Corporations.<sup>39</sup>

*Option 1 – Revisions to Subchapter S and Subchapter K.*

For S corporations, the discussion draft includes provisions to allow non-resident aliens to be S corporation shareholders through a trust; eliminates the rule that terminates an S corporation's pass-through status if it has passive income for three consecutive years; simplifies the procedure and extends the time to make an S corporation election; and reduces the number of years following

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<sup>29</sup> See, e.g., The Economic Stimulus Act of 2008, Pub. L. No. 110-185; and the American Recovery and Reinvestment Act, Pub. L. No. 111-5.

<sup>30</sup> Discussion Draft at § 211.

<sup>31</sup> Discussion Draft at § 212.

<sup>32</sup> TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESSES AND PASSTHROUGH ENTITIES 3 (March 12, 2013), available at [http://waysandmeans.house.gov/uploadedfiles/final\\_sm\\_bus\\_passthrough\\_technical\\_explanation\\_03\\_12\\_13.pdf](http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_technical_explanation_03_12_13.pdf) [hereinafter "Technical Explanation"].

<sup>33</sup> S. ANDREASSEN, K. BALMER, C. BURR, L. CIRELLI, L. VESEY, BASICS OF ACCOUNTING FOR LAWYERS 28 (2008).

<sup>34</sup> Interview with Roger Harris, President and COO, Padgett Business Services, Dallas, TX (2013).

<sup>35</sup> Discussion Draft at § 448 (b)(1).

<sup>36</sup> Discussion Draft at § 213 (a).

<sup>37</sup> *Id.* at §§ 231-247.

<sup>38</sup> *Id.* at §§ 231-237.

<sup>39</sup> *Id.* at §§ 241-247.

conversion from C status to S corporation status for which the S corporation must pay the highest corporate tax rate on built-in gains.<sup>40</sup>

For partnerships, the discussion draft would repeal the rules regarding guaranteed payments to partners; require mandatory adjustment of a partnership's basis in partnership property when a partner transfers his partnership interest; clarifies that all distributions of inventory items are treated as a sale or exchange between the partnership; and adjusts the partner's share of losses to take into account charitable contributions and foreign taxes.<sup>41</sup>

*Option 2 – Simplified and Unified Pass-through Rules.*

This option addresses long-standing concerns about the separate tax rules for S corporations and partnerships and would harmonize the two. This section would repeal current Subchapter S and Subchapter K law, and provide simpler rules that apply to non-publicly traded businesses. Specifically, the draft would allow contributions of money and property on a tax-free basis; maintain pass-through of income, gains, losses or credits, so these items have the same character in the hands of the owners as in the entity; and ensure taxes are paid on real, economic gains (not on returns of capital) by limiting tax-free distributions to the owner's basis in the business.<sup>42</sup>

IV. Conclusion

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

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<sup>40</sup> *Id.* at § 231. As a general rule, when a corporation has converted its status from a C corporation to an S corporation and acquires assets from the C corporation in a tax-free transaction, it may be subject to "built-in gain" in addition to the tax levied on its shareholders. 26 U.S.C. § 1374. The amount of the tax is computed by applying the highest rate of tax specified in § 11(b) to the net recognized built-in gain of the S corporation for the tax year. Internal Revenue Code § 1374 (b) (1).

<sup>41</sup> *Id.* at §§ 241-247.

<sup>42</sup> *Id.* at § 231.