Written Testimony of

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How Tax Complexity Hinders Small Business: The Impact on Job Creation and Economic Growth

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Introduction

Chairman Graves, Ranking Member Velázquez, and members of the Committee, thank you for the invitation and opportunity to appear before the U.S. House of Representatives Committee on Small Business and to offer my testimony on how tax complexity hinders small business and the resulting impact it has on small business job creation and economic growth.

I am an independent tax and consulting practitioner with a national practice. My practice focus is in the support of entrepreneurs with a primary emphasis in business ownership transition planning and support services and a secondary emphasis in retirement planning specifically in plan design, administration and fiduciary services.

Small Businesses and Their Owners

For a small business, the division between the small business and the small business owner often becomes blurred because every business decision has a direct and often significant impact on the small business owner and the small business owner's family. This is because the business is often at the epicenter of a small business owner's life.

A small business impacts the life of a small business owner in a significant way. Small business owners learn to adapt to the demands required of a small business and the sacrifice that comes with small business ownership.

This sacrifice can be summed in the following five life segments:

- **Family:** A small business absorbs the precious and limited time available to enjoy being with family. Vacations, attending kid's school activities, spending good conversation time with a spouse, or simply going to the park on a weekend are all controlled by the business.

- **Friends:** A small business often makes outside relationships with friends challenging and sometimes almost impossible. In fact, the friendships which can develop frequently occur with people met as a result of the business.

- **Free Time:** A small business can tie a person to the business. Small business owners often have no time for themselves let alone time for others. Pursuing hobbies, taking time off or just finding quiet time are, in many instances, put on hold for another day in order to tend to the needs of the business.

- **Finances:** A small business quite often impacts all of a business owner's financial decisions. The business most often is the center of a family's financial infrastructure providing the majority, if not all, of the family's current and future income.

- **Future:** A small business sets the direction for a business owner's future opportunities.

> Where a business owner and a business owner's family will be in the future can be traced to the success and / or failures of the business.

For the small business owner these life segments are often a challenge to manage simply because the small business regularly takes precedence over them or the small business is the driving force behind other life options.

The burdens of owning a small business expand exponentially when the confusion and complexity of the tax system is introduced to the small business ownership equation. Maintaining compliance with the various governmental regulatory bodies is extremely time consuming and this is especially true for tax compliance. Additionally, maintaining tax compliance comes at cost and for many small business owners this cost can be quite significant.

The cost to properly maintain regulatory compliance is really the small business owner's opportunity cost associated with expending the same resources on business operations and business development. These resources include both money and time. Between the money spent on tax professionals and time focused on maintaining compliance as opposed to spending the same time running the business, a small business owner's opportunity cost can be quite significant.

Compliance Time + Compliance Fees = Business Opportunity Cost

Based on a non-statistical poll, conducted in preparation for this hearing, of 20 small business owners with businesses ranging in revenue from $1,000,000 to $5,000,000, the average amount of time and fees extended to maintain tax compliance is 1) Time = 104 to 156 hours per year and 2) Professional Fees = $5,000 to $15,000 per year.

Note: When considering penalties and interest associated with a failure to maintain compliance, business opportunity cost grows even larger.

Small business owners often start their business on a passion based foundation doing something they enjoy only to quickly learn that running a small business has many complex and confusing compliance requirements. Mail received from the various regulatory bodies becomes overwhelming. Unfortunately, many small business owners get out of tax compliance simply due to a failure to interpret correspondence being received from the IRS. This is especially true for small business owners who cannot afford the services of a tax professional.

Understanding tax matters is confusing and tax compliance comes at a cost. This cost results in lost resources that could have been used for business operations and business development.

The Changing Entrepreneurial Landscape

Small Business Ownership is taking on a new look. Over the past 20 to 30 years entrepreneurialism has been ruled by youth primarily due to advancements in the technology sector. Now though new business ownership is moving the way of experience as people in their 40s, 50s, 60s and older are becoming entrepreneurs.

This entrepreneurial trend is part of a major societal influence underway which is the aging of the baby boomers, the approximately 79 million people born in the United States from 1945 to 1965. This generation has about 27 million more people than the one that preceded it, and about 10 million more than the one that follows.

For decades, the academics and economists have been postulating that the baby boomers would revolutionize retirement in America. The workers in this generation have been portrayed as being healthy energetic retirees with few worries and having the ability to improve their communities by the giving of their time after retirement.

Well, the baby boomer generation has received a wake-up call and many members of the traditionalist generation, the generation just prior to the baby boomers, have also received this same call. This call is the realization that a paradigm shift is required regarding the concept of retirement. Retirement was once viewed as a destination received as the reward for years of hard work and sacrifice. Retirement though for many people is now nothing more than a life event leading to a change of employment but not a removal from it.

Many factors have led to this realization including:

- The downturn of the economy and its impact on retirement savings accounts
- Corporate downsizings resulting in job loss
- Excessive personal debt
- Significant declines in housing prices resulting in reduced net worth
- Costs associated with health care coverage and direct medical expenses
- Financial requirements to care for parents or children who return home
- Increasing prices of food, gasoline and utilities

Becoming an entrepreneur is the decision being made by many people as they decide to take control of their own destiny by starting or buying a business. Owning a small business is an important means by which many people will either prepare for retirement or by which they will afford retirement.

Since most people will likely enter into a nonagricultural related business, the best representation of the type of entrepreneurial growth being experienced from those in the baby boomer generation or earlier is the increase in self-employed people in nonagricultural industries.

Self-employed people in nonagricultural industries by age
Change between Year 1990 and Year 2010
(in thousands)

Age	Year 1990	Year 2010	Change	% Change
16 to 19	76	71	-5	-6.6%
20 to 24	341	302	-39	-11.4%
25 to 34	2,486	1,773	-713	-28.7%
35 to 44	3,718	3,182	-536	-14.4%
45 to 54	2,821	4,077	1,256	44.5%
55 to 64	1,811	3,156	1,345	74.3%
65 and older	799	1,324	525	65.7%
Total	12,052	13,885	1,833	15.2%

Source: U.S. Bureau of Labor Statistics

This chart clearly shows that between Year 1990 and Year 2010 the baby boomer generation and the earlier generation, those 45 years of age and up, have embraced entrepreneurship.

Between Year 1990 and Year 2010, self-employment among people age 45 to 54 increased 44.5%, age 55 to 64 increased 74.3% and age 65 and older increased 65.7%. The aggregate increase among this age group of people 45 and up is 57.6%.

The decision to own a small business generally comes down to the economics surrounding the decision. For example, a person with $300,000 of money in various market investments can hope to make $15,000 to $24,000 at best per year in the stock market with the risk of seeing the principal decline or a portion of these funds can be used to start a small business which can be developed to generate $100,000 to $300,000 or more in cash flow per year. As can be seen, the annual cash flow from the small business far outweighs the results of placing the same funds in the market. Additionally, the business in this example, depending on its specific industry, may be able to be sold for as much as $900,000 or more.

Motivating people to self develop retirement resources has been on the U.S. Government's agenda for years. The straining of the social security system, the elimination of pension plans in favor of 401(k) plans and an overindulgent lifestyle have caused many people to be ill-prepared for retirement. Small business opportunities are becoming and will continue to become an important means by which many people will develop retirement resources.

Tax simplification will enhance an entrepreneur's ability to achieve business success which in turn will increase an entrepreneur's ability to develop retirement resources.

Complexities of the Tax System

The complexity of the tax system is as perplexing as a foreign language. For most small business owners, understanding their tax compliance requirements is beyond their reach. Due to limited discretionary cash flow, many small business owners do not have the ability to retain the services of a tax professional on an ongoing basis. As a result, many small businesses are attempting to maintain a substantial amount of required compliance through the efforts of untrained and unknowledgeable tax advisors; these advisors being themselves. A lack of funds for ongoing professional assistance and a misinterpretation of the regulations often lead to failed compliance.

The ever growing tax code along with its temporary provisions and interpretations make it increasingly difficult for small business owners to do any substantial long-term planning. This leads to small business owners being placed in the position to make decisions in a vacuum due to the unknown results which may occur. Almost every decision made in a small business has some form of tax implication. Since the tax system directly impacts so many decisions, small business owners will standby on making business development and new hire decisions when they have a lack of confidence in what will occur due to unknowns in the tax system. This, in part, has added to and is currently adding to the soft business expansion and a lack of new hiring which is desperately needed as a part of the United States' current economic recovery.

Due to the provisions of the tax code which impact small businesses being so numerous, it's impossible to reference all of them. Accordingly, the following are some select burden and complexity examples which adversely affect small businesses and their willingness and often ability to expand or hire new employees:

Patient Protection and Affordable Care Act Form 1099 Reporting

The Form 1099 reporting requirements of the Patient Protection and Affordable Care Act requiring that all payments from businesses aggregating $600 or more in a calendar year to a single payee, including corporations, be reported is an excellent example of the burdens and complexity placed on small businesses under the tax system. Although the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 repealing the Form 1099 reporting requirements has been passed by both the House and Senate and is waiting to be signed into law by the president as of the preparation of this testimony, small businesses felt the impact while it was in the regulations. The time and money spent to start getting prepared for the reporting requirements has been quite considerable for many small businesses.

In gathering information for this hearing I learned from several small business owners that they spent in excess of 100 hours getting prepared for the Form 1099 reporting requirement. The repeal of this reporting requirement is needed but the opportunity cost it created is significant.

Employee vs. Contractor

With business success comes a decision crossroad for many small businesses. The need to hire people develops and with the decision to hire people can come a set of complex compliance regulations. The question to be answered is whether to classify someone as an employee or as a contractor. If a new hire is misclassified as a contractor, penalties can be assessed and back due wages and benefits will be due. If a new hire is misclassified as an employee, unnecessary tax payments and benefits will be paid by the small business.

So, who is an employee? Unfortunately, there is no uniform definition of the term. Under the common-law rules an individual generally is an employee if the enterprise he works for has the right to control and direct him regarding the job he is to do and how he is to do it. Otherwise, he is an independent contractor.

To help determine whether an individual is an employee under the common-law rules, the IRS has identified 20 common-law factors. These factors, sometimes called the 20 factor test, indicate whether sufficient control exists to result in employee classification. The IRS developed these 20 factors based on examination of earlier cases and rulings considering worker classification. These 20 factors outlined in Revenue Ruling 87-41, attempt to identify the extent of a business's legal right to control how the worker performs the job.

Because of the complexity and ambiguity that arises when trying to properly class a new hire, the path chosen by some small business owners is to just stay small and not hire people as opposed to expanding and becoming exposed to regulatory compliance brought on by hiring people.

Section 179 Deduction

The Section 179 Deduction is a special tax provision that allows small businesses the option of claiming a deduction in the first year for the entire cost of such qualifying business assets limited to a maximum deductible amount which is set annually. This applicable amount is then further limited and reduced, but not below zero, by the amount of the total cost of all Code Section 179 property placed in service during the year that exceeds the threshold limitation. The maximum deductible amount is $500,000 for Year 2011.

For a C corporation, the Section 179 deduction is fully available based on the annual maximum deductible amount. A small business owner who owns interests in two or more pass-through entities (i.e., partnerships or S corporations) could be allocated Section 179 deductions for 2011 totaling more than $500,000. If this occurs, the small business owner's allowable Section 179 deduction is still limited to just $500,000. Any excess Section 179 deduction amounts allocated from pass-through entities can potentially be permanently lost without proper planning.

Unfortunately, under Section 179 a small business owner can actually be penalized for owning various businesses when each of them takes advantage of the available Section 179 deduction. Being limited and potentially penalized is a disincentive to make capital purchases. Loosing the ability to take a Section 179 deduction reduces cash flow by increasing tax and this in turn impacts other expansion decisions such as hiring people.

Capitalize vs. Expense

Whether particular business expenditures should be capitalized or expensed is one of the most common tax questions encountered. Certainly, an expenditure that results in the acquisition or enhancement of a separate and distinct asset with a useful life of more than a year should be capitalized.

Generally, repair expenditures are deductible in the year incurred as ordinary and necessary business expenses under IRC Section 162 if they neither materially add to the value of the property nor appreciably prolong its useful life, but merely help to maintain the property in an ordinary efficient operating condition.

The final decision as to whether an expenditure, especially a repair related expenditure, should be capitalized or written off as a period expense will be based on the facts of the specific expenditure. Whether an expenditure should be capitalized or expensed is left up to interpretation because there is no absolute on how to apply the characteristics of what is or is not a capital expenditure.

Conclusion

Small businesses face many obstacles. Buying or starting a small business is often one of the most significant financial events ever experienced by an entrepreneur. Entrepreneurs approach the process with a hope and desire of creating something better for their future while often exposing themselves to a large investment and debt. For many entrepreneurs their small business is the center of their family's financial infrastructure providing the majority, if not all, of their family's current and future income.

This hearing is not just about small business tax complexities. Nor is it just about how tax complexities hinder small business job growth. Nor is it just about how tax complexities hinder small business economic growth.

It is about enhancing the opportunity for small businesses to achieve success which in turn results in job and economic growth. Lowering the burdens and barriers caused by the tax system is a positive step in the support of small businesses.