

SMALL BUSINESS AND TAXES

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Level the Playing Field and Unleash Small Business Potential

by Tom Sullivan, Chief Counsel for Advocacy

As chief counsel for advocacy, one of the things I hear regularly is of the need to “level the playing field.” Anyone who has run or worked for a small business knows it is more than clever rhetoric. Nowhere is the difference between large and small businesses more apparent than in government regulatory compliance—tax compliance in particular. About 80 percent of the federal paperwork burden is imposed by tax and wage reporting.

Using government-supplied data, a study sponsored by the Office of Advocacy (Crain-Hopkins, 2001) found that tax compliance costs the smallest businesses (those with fewer than 20 employees) twice as much as large businesses (those with more than 500 employees). That means 90 percent of businesses start each day with a huge government-

imposed disadvantage relative to their larger competition. That’s something we need to fix.

In creating this office, Congress recognized that the burdens imposed on our economy by the tax system pose a real hardship for small businesses. Thus, Advocacy’s authorizing legislation instructs the chief counsel to “determine the impact of the tax structure on small businesses and make legislative and other proposals for altering the tax structure to enable all small businesses to realize their potential.”

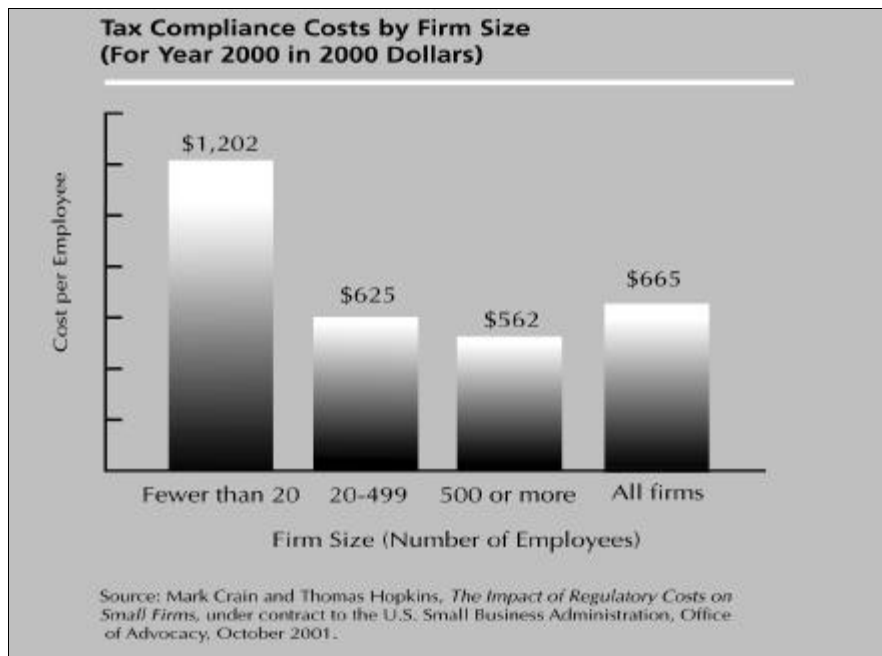
In so doing, Congress recognized that tax compliance has a dramatic impact on every small business. The total time spent complying with tax laws by small businesses came to a staggering 1.1 billion hours in 1999. The Tax Foundation reached this figure by

simply multiplying government estimates of the time needed to complete a given form by the number of the forms completed by small businesses. Using the chart below, we multiply the tax compliance cost per employee by the total number of employees and conclude that the annual cost to small businesses for tax compliance was about \$47 billion (adjusted for 2001 dollars).

We should try to do something each year to reduce the burden, for example by allowing more businesses to use cash accounting or expanding the amount of equipment small businesses can expense instead of depreciate. If we just reduced the burden by 10 percent, that would be like giving a \$4.7 billion tax cut to our smallest businesses. And I am not even talking about the taxes that are paid, only the tax compliance costs!

Cutting tax compliance costs in half means \$23.5 billion left in the pockets of small business owners each year. This is money that could be used to expand plants, hire new employees, and purchase more productive equipment.

Just days after Federal Reserve Board Chairman Alan Greenspan pronounced that a slow economic recovery is underway, Congress passed an economic stimulus bill (the Job Creation and Worker Assistance Act of 2002) that will provide some help for small businesses in retaining cash for growth. In my view, we could be doing a lot more to unleash the potential of small businesses by taking strong action to reduce the paperwork burden and simplify the tax system.



Tax compliance costs the smallest firms twice as much as large firms.

Too Good to Be True? Then It Probably Isn't

Each year at tax time, tax scams abound. Con artists shamelessly take advantage of people, charging fees for their illegal tax schemes. Small businesses should be alert to several illegal tax dodges.

• “Put Your Money in a Trust and Never Pay Taxes Again.”

Scam artists promote fraudulent foreign and domestic trusts as a means to protect assets and evade taxes. They usually target wealthy individuals, small business owners, or high-end wage earners, and may charge from \$5,000 to \$70,000 for “trust” packages. The fee enables taxpayers to have trust documents prepared, to utilize foreign and domestic trustees as offered by promoters, and to use foreign bank accounts and corporations. Two arrangements that are frequently offered are “business trusts” and “equipment or service trusts.”

Although these schemes give the appearance of the separation of responsibility and control from the benefits of ownership, these schemes are in fact controlled and directed by the taxpayer. A legitimate trust is a form of ownership that completely separates responsibility and control of assets from all of the benefits of ownership.

• **Improper Home-Based Business.** This scheme purports to offer tax “relief” but in reality is illegal tax avoidance. The promoters of these schemes claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. But, the tax code firmly

establishes that a clear business purpose and profit motive must exist in order to generate and claim allowable business expenses.

• **No Taxes Being Withheld From Wages.** Some illegal schemes instruct employers not to withhold federal income tax or employment taxes from wages paid to their employees. These schemes are based on an incorrect interpretation of tax law and have been refuted in court.

• **Claim Disabled Access Credit for Pay Phones.** Con artists sell expensive coin-operated pay telephones to individuals, contending they can claim a \$5,000 disabled access credit on their tax return because the telephones have volume controls. In reality, the credit is limited to bona fide businesses that are coming into compliance with the Americans with Disabilities Act.

• **African-Americans Get a Special Tax Refund.** Thousands of African-Americans have been misled by people offering to file for tax credits or refunds related to reparations for slavery. There is no such provision in the tax law. Some unscrupulous promoters have encouraged clients to pay them to prepare a claim for this refund. But the claims are a waste of money. Promoters of reparations tax schemes have been convicted and imprisoned. Currently, there is no law that allows the U.S. government or the IRS to pay slavery reparations or refunds.

Promoters of these scams frequently warn their clients against

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For More Information

The list doesn't end here—these are just some of the most common scams. If you think something may be unscrupulous, you can report suspected tax fraud to the IRS at (800) 829-0433. For updates and further information, visit the IRS's Criminal Investigation Branch on the web, www.ustreas.gov/irs/ci.

contacting the IRS on the pretext that the IRS does not want the general public to know about these incredible tax savings. This type of advice should be a red flag to taxpayers that there is a problem. If the tax benefits sound too good to be true, taxpayers should check them out before sharing personal and financial data with strangers.

Remember—seek the advice of a trusted tax professional or the IRS before you subscribe to any scheme that offers instant wealth or exemption from your obligation to pay taxes. There's no such thing as a free lunch!

New 2001 Tax Changes for Small Business

by Russell Orban, Assistant Chief Counsel for Tax Policy

The Job Creation and Worker Assistance Act of 2002 was passed on March 7, 2002, and may reduce your taxes for 2001 if you acquired depreciable property after Sept. 10, 2001. It also allows some taxpayers to carry back a net operating loss from a tax year ending in 2001 or 2002 to the five preceding tax years. If you have already filed your 2001 tax return, you may wish to file an amended return using Form 1040X.

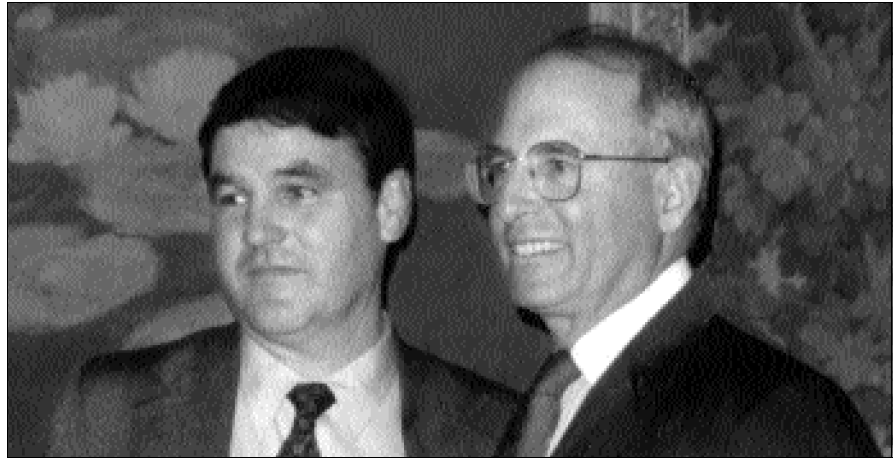
Special Depreciation

Allowance. A new 30 percent first-year special depreciation allowance may be available to you if you acquired depreciable property after Sept. 10, 2001, with a recovery period of 20 years or less. If you acquired a passenger automobile used more than 50 percent in a qualified business after Sept. 10, 2001, you may also be able to claim the additional 30 percent first-year depreciation allowance. More generous depreciation rules apply to certain property acquired after Sept. 10, 2001, and used in the area of New York City damaged in the Sept. 11, 2001, terrorist attacks.

- Form 4562, Depreciation and

Other Tax Changes

The Economic Growth and Tax Reconciliation Act of 2001 included several changes that could benefit small business owners—tax rate reductions, pension plan incentives, estate tax relief. The July-August 2001 issue of *The Small Business Advocate* contains a full report on these changes. Another important tax change lets a half a million businesses switch to cash accounting. See the December-January 2002 issue for a report on this change. Both issues can be found on Advocacy's website, www.sba.gov/advo/news.



Assistant Chief Counsel for Tax Policy Russell Orban (left) with IRS Commissioner Charles O. Rossotti.

Amortization, and its instructions have been revised to reflect these changes. Publication 946 on depreciation will have a supplement about the new law.

- Form 2106, Employee Business Expenses, and its instructions have been revised to reflect the new depreciation rules for vehicle expenses. Publication 463 has more detailed information on car expenses.

Net Operating Loss Carry

Backs and Carry Forwards. If you carried back a net operating loss (NOL) from a tax year ending in 2001 or 2002, under the new law you may carry it back for five years (instead of two or three). If you owe alternative minimum tax, any alternative tax NOL deduction attributable to an NOL carried back from (or carried forward to) a tax year ending during 2001 or 2002 is allowed to offset 100 percent (instead of 90 percent) of your alternative minimum taxable income determined without regard to that deduction.

- Form 1045, Application for Tentative Refund, is generally used to carry back NOLs.
- Form 1040X, Amended U.S. Individual Income Tax Return, may be used to claim NOL carrybacks.
- The instructions to Form 6251,

Alternative Minimum Tax—Individuals, will explain the new 100 percent offset for the alternative tax NOL deduction.

Revised Forms and

Instructions. Several other IRS forms and instructions are being revised to reflect the new law.

- The instructions for Form 4626, Alternative Minimum Tax—Corporations, explain the new 100 percent offset for the alternative tax NOL deduction.

- The new Form 8884, New York Liberty Zone Business Employee Credit, will be developed to claim this credit, which is similar to the work opportunity credit.

- The new Publication 3991, Highlights of the Job Creation and Worker Assistance Act of 2002, explains the above in detail.

The e-Advocate

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Where To Go For Help

Tax Filing. For emergency filing help, call the IRS Help Line, (800) 829-1040. For forms only, call (800) 829-3676.

If you are unable to resolve a tax problem through the normal channels, contact the IRS Taxpayer Advocate Service, (877) 777-4778. You may also call, write, or visit your state's local taxpayer advocate office. Publication 1546 contains a list of taxpayer advocate service offices.

Tax Planning. There are a number of websites that can help you interpret tax law and stay up to date with the latest changes.

- www.irs.gov

The IRS site's small business section has many resources.

Publication 3693 (the CD-ROM pictured here) is an introduction to small business tax requirements.

Publication 3207 contains all the forms, publications, and instructions needed to manage a business.

- www.taxesites.com

This site contains links to hundreds of useful tax and accounting sites.

- www.house.gov/jct

The Joint Committee on Taxation's site contains objective (if lengthy) analyses of tax proposals.



Advocacy Seeks New Research Proposals

Periodically, Advocacy issues a request for proposals (RFP) seeking small businesses or independent researchers to perform economic research. There are five topics in the current RFP:

- Small business and foreign trade
- Non-U.S. born owners
- Federal government procurement
- Home-based businesses and regulation
- Financing

Graduate research proposals will also be considered.

Advocacy developed the topics with several criteria in mind: that they are researchable, show the status or role of small business, may lead to future research, or can affect public policy. For past Advocacy-funded research, see www.sba.gov/advo/research.

The RFP will be posted at FedBizOpps (www.eps.gov/spg). First-time submitters are strongly encouraged to contact a local SBA office and ask for assistance from a government-contracting specialist. Another information source is Billy Jenkins, SBA procurement specialist, (202) 205-7077 (ph.); (202) 481-0487 (fax); or via e-mail at billy.jenkins@sba.gov. Contracting rules bar Advocacy from responding to questions on the RFP.

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