



Advocacy: the voice of small business in government

Testimony of

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***U.S. House of Representatives
Committee on Small Business***

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Created by Congress in 1976, the Office of Advocacy of the U.S. Small Business Administration (SBA) is an independent voice for small business within the federal government. The Chief Counsel for Advocacy, who is appointed by the President and confirmed by the U.S. Senate, directs the office. The Chief Counsel advances the views, concerns, and interests of small business before Congress, the White House, federal agencies, federal courts, and state policy makers. Issues are identified through economic research, policy analyses, and small business outreach. The Chief Counsel's efforts are supported by offices in Washington, D.C., and by Regional Advocates. For more information about the Office of Advocacy, visit <http://www.sba.gov/advo>, or call (202) 205-6533.

Chairman Manzullo and Members of the Committee, good afternoon and thank you for giving me the opportunity to appear before you today. My name is Thomas M. Sullivan and I am the Chief Counsel for Advocacy at the U.S. Small Business Administration (SBA). Congress established the Office of Advocacy to represent the views of small entities before Federal agencies and Congress. The Office of Advocacy is an independent office within the SBA, therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA.

The Committee has asked for Advocacy's views on small business tax reform and specifically, how the incremental reforms of the Small Employer Tax Relief Act of 2005 (hereinafter the Act) will affect small business. Advocacy takes its direction from small business. With the help of the small business community, our team of regulatory experts and economists seeks to fulfill our statutory responsibility to "determine the impact of the tax structure on small business and make legislative and other proposals for altering the tax structure to enable all small businesses to realize their potential for contributing to the improvement of the Nations economic well-being."¹ I am glad that the Committee has given me this opportunity to share the views of small business on tax reform and this important legislation.

This Committee certainly knows the contributions that small businesses make to the American economy. Of all U.S. businesses, 99% are small businesses which employ over 50% of the American workforce. When the Nation's economy has faced serious challenges small businesses have led the way to growth and prosperity. Therefore, tax reform must be focused to minimize unnecessary tax burden on this vital sector of the economy.

What Small Firms Need

Taxation affects the creation, financial performance, and growth potential of small business. To encourage and support the growth of small firms, tax reform must reduce the marginal rates, decrease the complexity and increase the predictability of the tax code.

Lower Marginal Rates

Small firms need tax reform that lowers marginal tax rates. Research shows that increasing marginal tax rates on business income reduces the chances that entrepreneurs will open new firms while it increases the likelihood that they will exit the market.² Conversely, the study reveals that decreasing marginal tax rates across the board would

¹ 15 USC §634(b)(4).

² In a study funded by the Office of Advocacy it was found that marginal tax rates have an effect on individuals' decision to enter into entrepreneurial activities. Reducing rates may lead to increased entrepreneurial activity and survival. See *Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data*, by Donald Bruce, Ph.D., and Tami Gurley (March 2005).

actually spur entrepreneurship by increasing the rate of new firm formation and slowing the rate of firm closure.³

Decrease Complexity of the Tax Code

A study released just this week by my office on Federal regulatory burden shows that tax compliance costs for firms with fewer than 20 employees were almost twice as much, per employee, as large firms with more than 500 employees.⁴ Tax compliance costs \$1304 per employee for very small firms versus \$780 for large firms.⁵ The smallest of the small firms pay just under twice as much as large firms to meet their tax responsibilities. The cost disparity between small and large employers described above is significant. However, when the same analysis is done comparing very small manufacturers to large manufacturers the differences are more extreme. Tax compliance costs \$2582 per employee for very small manufacturers compared to \$767 per employee for larger manufacturers.⁶ Very small firms in this sector pay more than three times more per employee than large firms.

A large portion of the cost is the time and effort required for the owner to collect and decipher the voluminous tax laws and regulations. This adds cost and administrative burden to small businesses. Simplifying the tax code will reduce the costs of compliance for small business.

Predictability

Advocacy's research shows that when there is less predictability in the tax code, then there is more uncertainty in the economic future of a business, which inhibits planning.⁷ Sunset provisions, phase-outs, and threshold levels introduce a higher level of variability in small firm expectations. Unexpected shifts in the tax rate and structure exacerbates the difficulties inherent in conducting a small business.⁸ This uncertainty requires business owners to make allowances for unknown changes in the tax laws, while planning for their future. Certainty in the tax code gives small business confidence and allows them to make decisions for the future.

An example of how tax rates, complexity and the lack of predictability have created a difficult situation for both taxpayers and the Internal Revenue Service is the proposed National Research Program (NRP) focused on S corporations. On July 25, 2005, IRS Commissioner Mark Everson announced that the IRS plans to conduct an NRP study of S corporations. The NRP is the process by which the IRS measures payment,

³ *Id.*

⁴ See *The Impact of Regulatory Costs on Small Firms*, an Advocacy funded study by W. Mark Crain (September 2005).

⁵ *Id.*

⁶ *Id.*

⁷ See the working paper by Dr. Radwan Saade, *Rules Versus Discretion in Tax Policy*, located at www.sba.gov/advo/stats/wkp02rs.pdf.

⁸ *Id.*

filing and reporting compliance for different types of taxes and various sets of taxpayers. Essentially, NRP is an audit study to help the IRS select returns for greater scrutiny.

The NRP as directed by the IRS has a history of focusing on small business.⁹ This NRP is directed at small business in that the majority of S corporations are small firms. The study is supposed to help the IRS understand how income, deductions and credits are reported by S corporations. However, if measures were taken to lower marginal rates, simplify compliance and provide permanence to our tax system there would be less confusion on the part of taxpayers and the IRS about how entities use preferential taxing provisions granted by Congress. An argument can be made that any irregularities found in the NRP are a product of the disparate tax treatment of different types of income and not by improper activity on the part of S corporation taxpayers. Tax reforms focused on marginal rate relief, simplified compliance and predictability, would benefit both taxpayers and the IRS because it would permit them to devote more resources to achieving their business and regulatory goals.

Small Employer Tax Relief Act of 2005

The Small Employer Tax Relief Act of 2005 will help to improve the tax environment for small firms. The Act makes permanent the expensing provisions of Section 179,¹⁰ allows health insurance premiums to be deducted against self-employed payroll taxes and eliminates the individual Alternative Minimum Tax (AMT). These are key to achieving the tax reforms necessary for small business. These three cornerstones of tax reform are addressed by provisions in the Act, which are highlighted below:

Expanded Expensing Provisions

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRR) began the process of removing tax roadblocks for small business. The provisions of Section 179 were expanded by JGTRR. Section 179 permits small firms to expense the cost of purchased business equipment placed in service during the tax year. My office was pleased with the gains achieved by JGTRR at that time, but more can be done.

Prior to JGTRR small businesses were permitted to expense capital investments up to \$25,000. The phase-out limit was set at \$200,000 and reduced the expensing amount dollar for dollar. Thus, if capital investments exceeded \$225,000 the expensing privilege was lost. As a result of JGTRR, the expensing limit was indexed to inflation and set at \$100,000.¹¹ The phase-out limit was also indexed to inflation and increased to \$400,000.¹² Advocacy and the small business community have consistently applauded

⁹ Preliminary results of an NRP which studied the 2001 tax returns of high wealth individuals and Schedule C filers (sole proprietors) were released on March 29, 2005. The IRS used this information to state that small business is responsible for the majority of the tax gap. Testimony of Mark W. Everson, Commissioner Internal Revenue Service, before the House Committee on Small Business on *Closing the Tax Gap and the Impact on Small Businesses*, April 27, 2005.

¹⁰ All section references are to the Internal Revenue Code of 1986 as amended.

¹¹ In 2004 the expense allowance was \$102,000. The amount for 2005 has not been announced.

¹² In 2004 the maximum expensing allowance was \$410,000. The amount in 2005 has not been announced.

the benefits of the expanded Section 179 provision. The expanded limits will sunset on December 31, 2007.¹³ Small businesses have asked that the increased limits be made permanent. The President's 2006 budget request also proposes that the expensing provisions of Section 179 be made permanent. The Small Employer Tax Relief Act would grant permanence to the increased provisions of Section 179 as requested by the President and the small business community.

Without Section 179, small businesses must depreciate the cost of business assets by using permitted depreciation methods. Under Section 179 marginal rates are decreased for small firms because capital investments are allowed to be expensed instead of depreciated over several years. Section 179 also addresses simplified compliance because depreciation calculations do not have to be done yearly. Finally, permanence is achieved because small firms can count on the expensing provisions when they plan their future.

Tax Deduction on Self-Employment Taxes for Health Insurance

The Small Employer Tax Relief Act rectifies an imbalance in the tax code created in Section 162(l). In general, Section 162(l) provides that the costs of health insurance premiums are ordinary and necessary business expenses. This permits taxpayers conducting a business to deduct their health insurance premiums from their income when calculating their income tax liability. Under Section 162(l)(4) this deduction is not permitted when self-employed taxpayers determine their payroll taxes.

In addition to this unfair tax on health insurance premiums the cost of health insurance continues to rise at a rapid pace, especially for small firms.¹⁴ A recent study funded by the Office of Advocacy found that only 31.5 percent of workers in small firms with fewer than 10 employees had access to employer sponsored health insurance.¹⁵ Correcting this imbalance will provide some relief from the high cost of health insurance and will reduce the marginal tax rate on the self-employed.¹⁶

The current Section 162(l)(4) disadvantages sole proprietors, partners, and shareholders in an S corporation. The Tax Code generally views these types of business owners as self-employed taxpayers. Thus, these types of business owners are responsible for self-employment taxes. However, if these same business owners conducted their business as a C corporation, and were employees, then their health insurance premiums would not be included when calculating their employment taxes. The small business

¹³ The increased provisions of Section 179 was set to expire on December 31, 2005, but the American Jobs Creation Act of 2004 extended the provisions.

¹⁴ *Id.*

¹⁵ *Cost of Employee Benefits in Small and Large Businesses*, Popkin, Joel and Company, August 2005, U.S. Small Business Administration, Office of Advocacy (SBAHQ03M0562), available at <http://www.sba.gov/advo/research/rs262tot.pdf>.

¹⁶ In a study funded by the Office of Advocacy it was found that marginal tax rates have an effect on an individuals' decision to enter into entrepreneurial activities. Reducing rates may lead to increased entrepreneurial activity and survival. See *Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data*, by Donald Bruce, Ph.D., and Tami Gurley (March 2005).

community has repeatedly identified this issue as an area of major concern. The Small Employer Tax Relief Act of 2005 addresses this issue by repealing Section 162(l)(4). As a result, self-employed taxpayers would be permitted to deduct their health insurance premiums when calculating their payroll tax.

Increased Deduction for Business Meal Expense

Currently Section 274(n)(1) permits a 50 percent deduction for business meals. The proposed legislation would increase the permitted deduction to 80 percent for business meals. Small firms do not have large marketing budgets. They unlike larger businesses rely upon restaurants as their conference room to attract business. Much of small firms' business is generated by face to face interactions over meals.

Although the business meal deduction is not specific to small businesses, small firms realize on average a larger reduction in their effective tax rate than large businesses. Specifically, small firms' effective tax rate is reduced by 0.86 percent while large firms reduce their effective tax rate by only 0.11 percent.¹⁷ Increasing the deduction for business meal expenses assists small businesses by reducing their effective tax rate.

Repeal the Individual Alternative Minimum Tax

The individual Alternative Minimum Tax is an alternative income tax calculation. Its purpose is to ensure that individuals do not avoid paying taxes through the use of special credits and deductions. The AMT increases the marginal rate of taxpayers by denying them deductions and credits granted by Congress. When first enacted, the AMT was justified because there were 156 "high income" individuals that did not pay any income tax. The AMT is expected to apply to 33 million taxpayers by 2010.

For sole proprietors, partners, and S corporation shareholders, the individual AMT increases tax liability on their business earnings. This is done by limiting the use of depreciation and depletion deductions, net operating loss write-offs, deductibility of state and local taxes, and expensing of research and experimentation costs. Also, individuals who invest in Section 1202 Special Small Business Corporations are denied the tax incentive for the investment. The year-end AMT calculation distorts the tax considerations on which earlier business decisions were based to the detriment of small business taxpayers. Even in cases where the AMT does not apply, small business taxpayers still have to perform a calculation that the IRS acknowledges is one of the most difficult and complicated in the Tax Code.

For this reason, the small business community has consistently supported repeal or reform of the AMT. The Act phases out the AMT for individuals between 2006 and 2009 and eliminates it in 2010. Additionally, the corporate AMT would be limited so that small corporations are shielded from the AMT.

¹⁷ *The Impact of Tax Expenditure Policies on Incorporated Small Business*, Innovation & Information Consultants, Inc., April 2004, U.S. Small Business Administration, Office of Advocacy (SBAHQ-02-Q-0027, available at <http://www.sba.gov/advo/research/rs237tot.pdf>).

The cornerstones of tax reform for small business are addressed through the repeal of the AMT. Repeal of the AMT will lower marginal rates on small business, simplify compliance by eliminating a notoriously complex calculation for small business and increase predictability of the Tax Code. As a result, small firms will gain more time and capital to grow their business.

Conclusion

Tax reforms directed at marginal rate reduction, simplified compliance and permanence are of critical importance to small business. Advocacy and the small business community believe that the Small Employer Tax Relief Act will achieve the important reforms outlined in this testimony. We look forward to working with the Committee to promote these and other tax reforms benefiting small business.

Thank you for allowing me to present these views. I would be happy to answer any questions.