TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB
The Voice of Small Business®

Testimony by Mr. Dewey Martin, CPA, CMA
Owner of Dewey Martin, CPA, CMA
Professor and Chair of the Accounting Department
Husson College, Hampden, ME

Senate Finance Committee Hearing
on the date of June 5, 2008
on the subject of

C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform

Good morning, Chairman Baucus, Ranking Member Grassley, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee continues its series of hearings on tax reform. The complexities of the current tax code are especially onerous on small businesses, so I appreciate that the Committee is interested in discussing this important issue from the perspective of a small business owner.

As a member of NFIB since 1990 and also serving on the NFIB Tax Advisory Board since 1996, I am honored to give a unique view from the eyes of a CPA about tax reform for small businesses. It is important for the Committee to hear from an active accountant who has worked with hundreds of small business owners in the past get the help they needed to keep up with the changing federal tax laws. I will provide a perspective from Main Street that can be used by the Committee to improve tax laws for the benefit of small business.

The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. The typical NFIB member employs about eight to ten employees with annual gross receipts of about $500,000. While there is no one definition of a small business, the problems our members confront relative to the tax code are representative of most small businesses. A few consistent concerns are raised regardless of the trade or industry in which the small business is engaged.

As part of representing small business owners the NFIB pays close attention to the concerns of our members and taxes consistently rates high on the list. The NFIB Research Foundation's Small Business Problems and Priorities consistently ranks tax issues, whether tax rates or complexity, at the top of the list.[1] In addition, the monthly Small Business Economic Trends (SBET) survey regularly ranks taxes as amongst the most important problems.[2]

Taxes and Small Business

Tax law matters to small business owners, and they adjust their business practice to changes in the law. Small businesses face distinct challenges directly related to the structure and management of a typical small business. Small businesses are not simply miniature versions of larger corporations. While tax law impacts each small business in a number of specific ways, there are a few key issues common to most small businesses. These issues are important to keep in mind when considering any changes to the tax laws.

<u>The business and the business owner cannot be separated</u>.

No matter what business structure the small business owner chooses, you cannot separate the business owner from the business. The majority of small businesses are organized as

---

[1] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.

[2] In the latest Small Business Economic Trends Survey, taxes ranked first among important problems. *Small Business Economic Trends*, NFIB Research Foundation, Washington, DC, May 2008.

pass through entities, with nearly 75-percent choosing a pass through business structure.[3] This means that most small businesses will pay their taxes at the individual level rather than the corporate level.

The business structure is chosen for a variety of reasons. According to an NFIB Small Business Poll of the few businesses that changed their business structure, 39-percent of small businesses changed to avoid liability and 27-percent for tax reasons.[4] Liability and tax issues were the top two responses. From a tax perspective, the pass through model makes sense for the typical small business. A small business has fewer financial resources than a typical larger corporation, so to pay a double tax – first at the corporate level and then on wages or on a return of business investment - would be especially onerous.

While a business structure like a sole proprietor or a partnership will protect the business from double taxation, the liability protection that a C-Corp offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. The Tax Reform Act of 1986 made several changes to the taxation of S-Corps, reducing the tax liability for small businesses, but also providing the liability protection of a C-Corp. The passage of those changes has led to an explosion in the number of S-Corps. In 1985 22-percent of all corporations were S-Corps, by 1990 the figure has risen to 43-percent, and today the majority of corporations are S-Corps.[5]

For example, consider the kind of decisions a one-person retail business selling flowers out of a greenhouse from their home would make as the business starts and then if the business grows. At first it would be wise to choose a business structure such as a sole proprietorship, since the business probably has limited gross receipts and a single layer of tax is probably all the owner can afford. Under most state laws, setting up a corporation requires the establishment of a board of directors and with a one-person business this is unnecessary. A simple business structure fits a simple business such as this.

A few years later, the flower shop owner and a fellow business owner decide to go into business together and open a store on main street. To help operate the store, they decide to hire their first employee. The business has now matured to point where the owners might consider a more complicated structure than a sole proprietorship. They have a number of options including pass through entities like S-Corps, partnerships, or a Limited Liability Corporation (LLC) or they could set up a C-Corp.

The expanded shop is likely to do more business than the single flower shop owner, but probably not enough to sustain two levels of taxation. Again, choosing a business structure that limits their tax liability is a wise decision. In addition, now that they have

---

[3] Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

[4] *Ibid*.

[5] *SOI Bulletin*, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data – table 13, Winter 1999-2000.

separate business space and an employee, the business will have additional expenses that they will need to account for. They also face greater liability risks and may want to protect their personal assets. This growing business probably would choose some form of pass through entity to avoid liability and to lower their tax burden.

About a quarter of small businesses are organized as a C-Corp. Even in the case of a small business organized as a C-Corp, you should not separate the business owner from the business. In many cases, the corporation pays down its annual receipts in business expenses and salary, such that the corporation itself has almost no tax liability.[6] In addition, while the law requires establishing a board of directors in the majority of cases the business sets the board up to meet the legal requirement and not necessarily as an entity to govern the business. [7]

While the variety of business structures may lead to additional rules in the code, various models provide the business owner with more flexibility and choice to organize their business in a way that best suits the needs of the business. Entities such as sole proprietorships and S-Corps can ensure that a small business is not overburdened with extra layers of taxation. In other cases, structures like C-Corps, S-Corps, and LLCs can protect the business owner from personal liability. In the end, the structures promote the maximum amount of flexibility to allow the business owner to make decisions based on the fundamentals of their business. If the business grows or changes, the different structures allow the business owner to adapt in such a way that the business continues to operate effectively.[8]

<u>The importance of cash flow</u>.
Cash flow is an especially difficult challenge for small businesses that is made worse by increasing taxes. One in five small businesses experiences a continuing cash flow problem and one in two businesses face regular cash flow problems.[9] This is a problem common to all small businesses and is just as true for a larger small business as it is for the smallest business.[10]

This is why lost revenue as a result of higher taxes when starting or expanding a business is such a problem. The most common source of capital for starting a business is personal income, in fact many small businesses are started with less than $10,000, and the most important source of capital for expanding a business is earnings retained from business profits, i.e. the amount of money kept after taxes.

---

[6] *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.
[7] *Ibid*.
[8] Small businesses rarely change their business structure, with only about seven-percent of businesses making a change. The change is usually made in response to a major change in the business itself. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.
[9] *The Cash Flow Problem – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 1; Issue 3; 2001.
[10] *Ibid*.

Related to the cash flow challenge is the impact that payroll taxes have on small business operations. While the business's tax liability is directly related to its profitability, a payroll tax is levied no matter what the tax liability of the small business is. In many cases, payroll taxes are the highest taxes a lot of small businesses pay each year.[11] In an especially trying year, payroll taxes can exacerbate the small business cash flow challenge.

Keep it Simple.

The typical small business spends annually between 1.7 billion and 1.8 billion hours on tax compliance and $18 billion to $19 billion on compliance costs.[12] The result is that 88-percent of small business owners now hire a paid tax preparer to complete their returns.[13] Small business owners also spend on average $74.24 per hour on the paperwork associated with tax compliance – the highest paperwork cost imposed on small business by the federal government.[14] Unlike a larger business, the small business does not have a finance department or a staff of accountants and lawyers to focus on the nuances and changes in the tax laws. Nor does the typical small business have a full-time human resources specialist to keep up with the tax changes impacting health care and retirement plans.

The complicated and, in many ways unpredictable tax code, places a heavy burden on small business owners. In the end this leads to additional costs and takes money away from the day-to-day business operations or investing in and expanding their business. The current estate tax is a good example of this problem. Small business owners spend considerable resources ensuring that their business is passed on to the next generation. These challenges are only made more difficult with the fluctuating rates and exemptions under current law and the impending return of the full tax after 2010.

The confusing tax code leads to more errors, which we believe is the main cause of the tax gap amongst small business owners. The vast majority of small business owners comply with their tax obligations, but a direct correlation exists between the willingness and ability to comply and the small business owners actually meeting their tax obligations.

Tax Reform

As the Committee considers changes to the tax code, I would encourage you to keep these three principles in mind as you think about how tax law changes will impact small businesses. Not separating the business owner from the business, the importance that access to cash has on the operation of the small business, and simplifying the code will help to make the code more workable for small businesses.

---

[11] William J. Dennis, *NFIB Small Business Policy Guide*, Washington, DC 2000.

[12] Donald DeLuca, Scott Silmar, John Guyton, Wu-Lang Lee, and John O'Hare, "Aggregate Estimates of Small Business Taxpayer Compliance Burden," Proceedings of the 2007 IRS Research Conference.

[13] *Tax Complexity and the IRS – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 6; Issue 6; 2006.

[14] *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 3; Issue 5; 2003.

With those principles in mind, I would like to point to a few items that are especially important to small businesses and reflect these three basic principles. First, low individual rates are important. Because cash flow is so important, keeping rates low will provide the small business with the access to the capital it needs to operate the business as well as to expand the business and create new jobs. Again, the personal income and after tax receipts are the largest sources of capital for small business, so keeping the individual rates low is important, especially at time when traditional capital markets are squeezed and the cost of operating the business is rising. Keeping individual rates low also recognizes the important connection that the business owner has to the business itself.

Congress can also look to a few successful reforms to continue to simplify the code for small businesses. Section 179 expensing is a good example of simplification and providing the small business with an immediate source of capital. By increasing the allowable expensing amount from $25,000 in 2003 to $125,000 in 2007 (for 2008 the amount was increased to $250,000 as part of the Economic Stimulus Bill), Congress has provided the majority of small business owners with an immediate deduction for almost any investment they make in their business.

Expensing also reduces the complexity of the tax code. Instead of following complicated depreciation schedules and keeping the paperwork associated with the investment, the business owner can simply claim the deduction in the year the item is purchased. As Congress considers specific issues in the code, making the higher section 179 amounts permanent would go a long way to reducing complexity and providing an important tax benefit to small business owners.

Creating a standard home office deduction is one change the Congress could make that would reflect the same benefits created by expensing. Home-based businesses are one of the fastest growing areas of small businesses, but the current deduction is especially complicated requiring the business owner to determine how much of the house is used for business and keep detailed records to substantiate the deduction. Instead a simple standard deduction recognizes the use of the home for business purposes and reduces the complexity of the current deduction. Many small business owners avoid the deduction because of the complications and the fear of a potential audit. The standard deduction would allow the business owner to claim a deduction he is entitled to, reduce the filing burden, and ultimately improve tax compliance.

Another example of simplification is allowing the use of cash accounting. Under current law, a taxpayer with less than $5 million in gross receipts is able to use cash accounting rather than accrual accounting. The cash accounting method is much easier for small business owners to follow and more closely matches the way that a small business owner will keep his books. The Senate has already passed legislation to allow the use of cash accounting for small businesses with less than $10 million in gross receipts and I would encourage you to consider the expanded use of cash accounting as a simple but important change to the tax code.

Finally, more certainty in the code will help to reduce compliance and planning burdens on small businesses. Looming tax changes, such as the expiration of the 2001 laws like the estate tax and the lower individual rates, make business planning more difficult. Likewise, annual tax extenders and Alternative Minimum Tax (AMT) patches create even more uncertainty. This is especially true for tax prepares and makes tax planning for a client even more of a challenge and increases the potentially for errors. A more certain tax code will help to promote prudent business planning and decisions and improve compliance.

Conclusion

Small businesses truly are the engine of economic growth. This isn't just a slogan as small businesses created 60- to 80-percent of the net new jobs over the last decade. Small business owners are risk takers and entrepreneurs.

The current tax code has become a confusing and unpredictable challenge for the vast majority of small business owners. Our tax laws should not deter or hinder the ability of small business owners to create or expand their businesses. Taxes are a major issue for all small business owners. Tax law can dictate the business decision that an owner will make, whether it is the type of structure to adopt or whether to make an investment.

After decades of patchwork changes to the tax code, Congress needs to make major adjustments to our tax laws to reduce complexity and confusion and encourage business growth. I appreciate that the Senate Finance Committee is taking a serious look at reforming the tax code and urge you to keep in mind the unique challenges that face small businesses.