Office of Advocacy
A Voice for Small Business

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

Date:	July 23, 2003
Time:	2:00 P.M.
Location:	Room 2360 Rayburn House Office Building Washington, D.C.
Topic:	Assisting Small Business through the Tax Code— Recent Gains and What Remains to be Done

Chairman Manzullo, Representative Velazquez and Members of the Committee:

Thank you for this opportunity to testify 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 so the views expressed in this statement do not necessarily reflect the views of the Administration or the SBA. My statement was not circulated within the Administration for comment or clearance.

You have asked that I testify regarding the tax relief granted to small businesses as a result of the recent enactment of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the Jobs and Growth Act). In addition, you have asked for suggestions about what else needs to be done. The Office of Advocacy takes its direction from small business. With their help our team of economists and regulatory experts seek to fulfill our statutory responsibility 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 for contributing to the improvement of the Nation's economic well-being… [1]

We welcome this opportunity to share small business' views on the President's tax relief package of 2003 and additional areas for improvement.

The Impact on Small Business of the Jobs and Growth Tax Relief Reconciliation Act of 2003

Advocacy promoted a number of the provisions in the President's Jobs and Growth package and we were pleased with the bill's emphasis on small business. Many of the provisions in the law received widespread support from small business during

[1] 15 USC §634b(4).

Congressional consideration. These provisions will have a significant positive impact on small businesses.

First and foremost, the Jobs and Growth Act provided useful changes in section 179 expensing that had been long sought by Advocacy and the small business community. The new law increased the amount of equipment purchases a small business can expense directly, rather than depreciate over time, from $25,000 to $100,000. In addition, the threshold for phasing out expensing was doubled to $400,000. Each of these numbers will be indexed to inflation beginning in 2004.

The Treasury Department had estimated that at least half a million businesses would directly benefit from expensing provision changes that were similar (though not as generous) to those enacted.

Section 179 has been very useful for small businesses. Using 1999 tax data, 69 percent of the businesses that elected to "expense" their purchases were sole proprietors and individual farmers (2.9 million businesses). Expensing simplifies capital purchases and has the effect of reducing the cost of purchasing capital goods. The increase in the amount of purchases covered by section 179 should provide an economic boost as businesses buy new equipment they would otherwise forego.

Additionally, first year "bonus" depreciation was increased from 30 to 50 percent for investments acquired and placed in service through 2004 and in some cases through 2005. When combined with section 179, this creates a substantial additional incentive for small businesses to make their capital equipment purchases quickly. Likewise, equipment dealers and manufacturers benefit from the sale of new, more productive equipment to these businesses.

The Jobs and Growth Act accelerated most of the tax cuts enacted in 2001 to take effect this year. The top tax rate for individuals, for example, was reduced from 38.6 percent to 35 percent. The impact of individual income tax rate cuts is widely felt in the small business community since over 90 percent of all businesses are taxed at the individual, not corporate, level. For example, in 1998 there were 17.1 million sole proprietorships; 2.1 million farm proprietorships, 1.9 million partnerships and 2.6 million S corporations all of which pay taxes on the individual owners' return. The Treasury Department estimated that 23 million U.S. small business owners would benefit under the Jobs and Growth Act and that 79 percent of the $12.4 billion in tax relief from reducing the top tax rate goes to small business owners.

In addition, the maximum tax on capital gains and dividends will each fall to 15 percent under the Jobs and Growth Act. For taxpayers in the 10 to 15 percent tax brackets, the rate for both will be five percent until 2007 and zero percent in 2008. The capital gains tax reduction applies to gains realized on or after March 6, 2003, and to dividends received in 2003 or after. Capital gains tax reductions and dividend tax reductions, which free up capital otherwise held for tax reasons, increase the pool of funds available for investment in small businesses.

Earlier this month, employees received an increase in their take-home pay reflecting the immediate implementation of the lower tax rates in the Jobs and Growth Act. And, beginning this week, the Treasury Department will mail advance payment checks reflecting the increased child tax credit to approximately 25 million eligible families. These provisions will increase consumption and spur purchases from small businesses.

What still needs to be done?

Mr. Chairman, your panel today is full of talented specialists. Our office has worked with each of them regularly over the years.

Being tax experts they can dissect the minute details of needed changes. If I had to summarize in one point what needs to be done to help small business, based on our research, it would be this: Simplify taxes for small businesses as much as possible. We should work to limit the rollercoaster ride of changes and confusion that exist in the Tax Code and make permanent key small business benefits.

Simplicity is the Key - It was reported a couple weeks ago that the number of regulations that have an impact on small businesses was down by ten percent.[2] While I find that statistic gratifying and I hope our office played some part in that decline, I continue to have concerns about the burden of tax regulations and tax compliance on small employers.

Tax compliance is a serious and costly problem for small businesses. Most businesses are very small. Over 90% of all businesses have fewer than five employees. The majority have no employees; they are simply run by the family. We know from our research that it costs businesses billions of dollars each year to comply with tax laws and regulations. The Tax Foundation found that it costs small businesses more to collect and keep tax records than they pay in taxes.[3] A huge chunk of that cost is the time and effort required for the owner to wade through and decipher volumes of new tax laws and regulations. Many businesses find it necessary to hire a tax expert to guide them through the tax maze, dig out the required information and make the correct computations and judgment calls.

Our study on the federal regulatory burden in 2001 showed that tax compliance costs for firms with fewer than 20 employees was twice as much, per employee, as large firms with more than 500 employees. Tax compliance cost $1200 per employee for the very small firms versus $562 for large firms.[4] That is a significant handicap for a small business. Anything Congress can do to simplify tax compliance would provide relief to small businesses from the burden of this disadvantage.

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[2] Clyde Wayne Crews, Jr., Ten Thousand Commandments – An Annual Snapshot of the Federal Regulatory State, CATO Institute, (2003).

[3] J. Scott Moody, *The Cost of Complying with the U.S. Federal Income Tax*. Tax Foundation, November 2000.

[4] See *The Impact of Regulatory Costs on Small Firms*, an Advocacy-funded study by W. Mark Crain and Thomas D. Hopkins (October 2001).

The "penalty" placed on small business by complex tax laws and the groundbreaking study done by Dan Mastromarco for the National Small Business Association, which revealed tax laws that exclude small businesses, inspired the Office of Advocacy to commission a study, not yet completed, of the most commonly used business deductions. We want to determine how much of each tax break goes to small businesses compared to large businesses. From this data, we hope to learn what can be done to make these deductions more useful to small businesses.

Too Much Change - Advocacy research shows that stable and predictable tax policies promote economic growth and that frequent tampering with tax policy has distortional effects on the economy. Taxpayers will adjust and shift the bulk of their expenditures to the period in which there is a tax benefit and away from future periods when the tax benefits disappear. Dr. Radwan Saade of our economic team recently presented a working paper that demonstrated that constantly changing tax laws can create problems for small businesses.[5] The paper said:

> Small business associations identify taxes as the single most important issue facing small businesses. Unexpected shifts in the tax rate and structure only exacerbate the already difficult circumstances involved in running a small business. Now in addition to the uncertainties inherent in operating a small business, business owners must make allowances for unknown changes in the tax code while making plans that extend beyond the next presidential election cycle.[6]

Dr. Saade found that permanence in the tax structure had desirable effects. Less predictability in the Tax Code meant less economic predictability. Less economic predictability means less economic growth. Sunset provisions, phase-outs, and threshold levels introduce a higher level of variability in small business expectations. Providing

[5] Dr. Radwan Saade's working paper entitled "Rules Versus Discretion in Tax Policy" can be viewed on Advocacy's website at http://www.sba.gov/advo/stats/wkpaper.html.

[6] Dr. Radwan Saade's working paper entitled "Rules Versus Discretion in Tax Policy" can be viewed on Advocacy's website at http://www.sba.gov/advo/stats/wkpaper.html see the Abstract, p.1.

certainty in the Tax Code gives small businesses the confidence to make decisions for their long term viability and growth. Giving small business the ability to invest with confidence in their future is good for the businesses and good for our economy.

Specific Recommendations

Make Increased Expensing Permanent - As mentioned earlier, the increase in expensing was a significant achievement of the Jobs and Growth Act. It is simple and efficient. It reflects the actual cash outlay of the small business and it ultimately reduces the cost of the capital acquisition that small businesses can then apply to another need. The expensing increase which is scheduled to end in 2005 should be made permanent so that businesses can plan future capital equipment purchases based on sound business decisions.

Make Estate Tax Relief Permanent - Under the current estate tax law, businesses cannot adequately plan for the death of an owner because of the annual changes and the final sunset of the estate tax repeal. Eliminating the estate tax was a top priority of the White House Conference on Small Business and has retained the strong support of the small business community since that time. The existing repeal of the "death tax" should be made permanent.

Repeal the Alternative Minimum Tax - For individual taxpayers who must perform Alternative Minimum Tax (AMT) calculations, the AMT has been steadily and relentlessly increasing its grip and is expected to apply to 33 million taxpayers by 2010. This is a far cry from the 156 "high income" non-taxpayers cited as one reason for creating the AMT. The AMT increases the marginal rate of those who must pay by denying them preferences granted by Congress.

For sole proprietors, partners, and S corporations shareholders, the individual AMT increases their liability on their business earnings by limiting 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 Internal Revenue Code 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 owners. Even in cases where the AMT does not apply, the small business taxpayer will still have had to perform (or more likely pay to have performed) 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 a thorough reform of the AMT.

Conclusion

In conclusion, the Jobs and Growth Act contained provisions which we believe are beneficial to small businesses and, through them, beneficial for the economy and job creation. As this Committee and the Congress move forward to consider other provisions to help small business, simplicity and predictability (permanence) are of critical importance so that small businesses can plan for certain tax consequences. I thank you for this opportunity to testify on this important issue. We look forward to working with the Committee to promote these and other tax reforms benefiting small business.