

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

Memorandum

To: Members, House Committee on Small Business
From: Committee staff
Date: April 16, 2012
Re: Hearing: "The Tax Outlook for Small Businesses: What's on the Horizon?"

On April 18, 2012 at 1:00 p.m., the House Committee on Small Business will meet in Room 2360 of the Rayburn House Office Building for the purpose of receiving testimony on the tax outlook for small businesses. Witnesses will include Aparna Mathur, Resident Scholar, American Enterprise Institute, Washington, DC; Leonard Steinberg, Principal, Steinberg Enterprises, LLC, West Windsor, NJ, testifying on behalf of the Small Business and Entrepreneurship Council; Martin J. Mitchell, Vice CEO, Mitchell & Best Homebuilders, LLC, Rockville, MD, testifying on behalf of the National Association of Home Builders; and Margot Dorfman, CEO, U.S. Women's Chamber of Commerce, Washington, DC.

I. Introduction

In a 1789 letter to Jean Baptiste LeRoy, Benjamin Franklin wrote, "In this world, nothing can be said to be certain except death and taxes."¹ Even when Franklin wrote those fatalistic words many years ago, taxes were seen as inevitable as death. Today, taxes are viewed with just as much or more contempt. For small business owners, who spend a disproportionate amount of time and money to comply with laws and regulations,² even the threat of a new tax or tax increase may cause heartburn.

For small firm owners, tax rates can drive business decisions. Higher tax rates mean small firms have less capital to invest back into their companies or for creating jobs. Tax changes are always problematic for small firms, not only because of the economic impact, but also the time needed to stay current with the law, the paperwork and recordkeeping. Because small businesses

¹ Letter from Benjamin Franklin to Jean Baptiste LeRoy, November 13, 1789.

² See UNITED STATES SMALL BUSINESS ADMINISTRATION, OFFICE OF ADVOCACY, THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS (2010), available at <http://archive.sba.gov/advo/research/rs371tot.pdf>.

are the economy's job generators, tax policies could have critical importance for the economic recovery. In fact, taxes have been called the defining issue for 2012.³

II. Small Businesses, Tax Complexity and Tax Compliance

According to testimony by former Comptroller General David Walker,⁴ the design of the current system of business taxation is widely viewed as flawed. Complexity can promote the use of tax shelters and reduces the perception of fairness and public confidence that other taxpayers are paying their fair share.⁵ Simplification and increased uniformity could encourage greater compliance.

Small and large businesses provide a significant portion of tax revenue to the federal government. The additions and changes to the code over the years result in confusion and difficulty with compliance, especially among small business owners.

According to the National Taxpayer Advocate, tax issues are a significant set of regulatory burdens for most small businesses.⁶ A recent National Federation of Independent Business (NFIB) Research Foundation study of Small Business Problems and Priorities found that four of the top ten problems small businesses identified were tax related.⁷ Entrepreneurs struggle to decipher the code, file paperwork and pay their taxes, all while keeping their businesses running. Small businesses face unique challenges when dealing with the code. As new taxes are implemented, and tax rates increase, small business owners must familiarize themselves with these laws, or hire a professional to do so, and ensure that their company complies.

Small businesses are disproportionately affected by tax complexity. A study by the Small Business Administration's (SBA) Office of Advocacy disclosed that small firms pay 67% more to comply with the tax code than large firms do, with tax complexity a contributing factor.⁸ The growing number of code provisions, along with the fact that small firms frequently do not have an in-house accountant or tax attorney, means that small business owners must hire outside experts or add those duties to another employee's workload.

Tax complexity is also important because it affects tax compliance. Individuals who do not understand the law have more difficulty complying with it, and the result is less revenue in the U.S. Treasury. Individuals who "feel distant" from the code have lower rates of voluntary tax

³ Gerald F. Seib, *Taxes Emerging as Defining Issue for 2012 Campaign*, WALL ST. J, September 19, 2011, available at <http://online.wsj.com/article/SB10001424053111903374004576580710594126704.html>.

⁴ *Simplification and Increased Uniformity of Taxation Would Yield Benefits: Hearing Before the United States Senate Committee on Finance* (September 30, 2006) (testimony of David M. Walker), available at <http://www.gao.gov/new.items/d061113t.pdf>.

⁵ INTERNAL REVENUE SERVICE, OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, REPORT TO CONGRESS (JANUARY 5, 2011), available at http://www.irs.gov/pub/irs-utl/2010arcmsp1_taxreform.pdf.

⁶ *Tax Burdens Facing Small Businesses: Hearing Before the United States House of Representatives Committee on Small Business*, 109th Congress, Second Session (September 21, 2005) (testimony of Nina E. Olson), available at http://www.irs.gov/pub/irs-utl/nta_small_business_comm_testimony_v4_single.pdf.

⁷ William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC, series.

⁸ See Nicole V. Crain and W. Mark Crain, *The Impact of Regulatory Costs on Small Firms* (2010), available at <http://archive.sba.gov/advo/research/rs371tot.pdf>.

compliance,⁹ although it is uncertain what makes one feel “connected” to it. The Taxpayer Advocate’s 2011 Report to Congress states the code is so complex that even the IRS has difficulty administering it.¹⁰ The IRS has found it more challenging to answer the millions of phone calls and taxpayer correspondence it receives each year.¹¹ The expectations are so low that IRS set its Fiscal Year 2010 telephone customer service goal at 71.2%. That means almost three out of ten callers to the IRS were not expected to get through.¹²

With the continued increases in federal spending, businesses are concerned about the possibility of higher taxes. A 2009 Tax Foundation survey revealed that a majority of adults believe that taxes are too high, and four in every five adults say the tax code is too complex.¹³ Eighty-five percent say that the tax system needs to be completely overhauled.¹⁴ Complexity harms taxpayers and the United States Treasury, since taxpayers who are unable to discern the code often underpay taxes, which reduces revenue.¹⁵ In addition, the IRS must expend time investigating and auditing taxpayers it believes may be non-compliant.

Over the past few years, the Report of the National Taxpayer Advocate identified the need for tax reform as one of the top priorities in tax administration.¹⁶ Taxpayers and preparers spend about 6.1 billion hours annually to comply with the complex requirements of the law.¹⁷ It has also been estimated that U.S. taxpayers spend over \$160 billion annually just to comply with income tax requirements.¹⁸ Because of complexity, more than 60% of taxpayers pay a preparer to complete their returns, and about 22% purchase tax software to assist them in preparing their own return.¹⁹ This means that individuals and businesses are spending resources on tax preparation that could otherwise be invested back into their own business and job creation.

⁹ INTERNAL REVENUE SERVICE, OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, REPORT TO CONGRESS (December 31, 2011), *available at*: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ SURVEY OF ATTITUDES ON TAXES, SPENDING AND WEALTH DISTRIBUTION, TAX FOUNDATION, April 2009, *available at* <http://www.taxfoundation.org/taxdata/show/24585.html>.

¹⁴ *Id.*

¹⁵ *How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth: Hearing Before the United States House of Representatives Committee on Small Business*, 111th Congress, First Session (April 13, 2011) (testimony of Nina E. Olson), *available at* http://smbiz.house.gov/UploadedFiles/Olson_Testimony_REV_4_13_11.pdf.

¹⁵ *Tax Burdens Facing Small Businesses: Hearing Before the United States House of Representatives Committee on Small Business*, 109th Congress, Second Session (September 21, 2005) (testimony of Nina E. Olson), *available at* http://www.irs.gov/pub/irs-utl/nta_small_business_comm_testimony_v4_single.pdf.

¹⁶ Pub. L. No. 111-148, 124 Stat. 119 (2010).

¹⁷ *Id.*

¹⁸ INTERNAL REVENUE SERVICE, OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, REPORT TO CONGRESS (January 5, 2011), *available at* <http://www.irs.gov/advocate/article/0,,id=233846,00.html>; *See also* INTERNAL REVENUE SERVICE, OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, REPORT TO CONGRESS (December 11, 2011), *available at*: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

¹⁹ Nina E. Olson, *We Still Need a Simpler Tax Code*, WALL ST. J., April 10, 2009.

Last year, the Taxpayer Advocate has named tax complexity as the most serious problem facing taxpayers, citing the 4,4280 changes to the tax code in the past ten years and 579 in 2010 alone.²⁰ That level of complexity falls on all taxpayers, but it falls very heavily on small businesses, which often lack the resources to hire expensive accountants or legal representation.²¹ Since Congress instituted the income tax in 1913, it has passed numerous pieces of legislation that increased the length and complexity of tax laws. In 1939, Congress segregated tax law into the Internal Revenue Code, a permanent codification of federal tax statutes that is now Title 26 of the United States Code. The 1939 Code had major revisions in 1954 and 1986. There are reportedly over 1,638 different tax forms, and the Internal Revenue Service estimates that it takes over 37 hours to complete the basic 1040 short form.

Small businesses face the code's confusing patchwork of provisions that includes equipment depreciation, net operating loss carryover, home office deduction, employment taxes, classification of workers and the earned income tax credit. For small businesses, compliance is tedious and expensive.

The number of federal income tax returns that the Internal Revenue Service (IRS) examined increased over the past five years, with one out of every 90 taxpayers examined in Fiscal Year 2010.²² That represents an increase of 23% from Fiscal Year 2006, when about one of every 108 individual tax returns was examined.²³ The IRS has also strengthened its use of enforcement tools, such as liens, levies and seizures.²⁴

In recent years, the IRS has attempted to reduce the tax gap – the difference between what the IRS collects on time and what it believes taxpayers owe. As a result, the IRS increased its audits of businesses.²⁵ Simplifying the code could help reduce audits of small business owners who are non-compliant simply because they cannot decipher the code.

III. Small Business Organization and Individual Tax Rates

When a business starts, its owner selects an organizational structure. The owner can choose to operate as a "C" corporation,²⁶ or some kind of "pass-through" entity. The most common types of pass-throughs are S corporations and partnerships. The decision about the type of

²⁰ INTERNAL REVENUE SERVICE, OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, REPORT TO CONGRESS viii (December 31, 2011), available at <http://www.taxpayeradvocate.irs.gov/userfiles/file/2011ExecSummary.pdf>.

²¹ *Buried in Paperwork: A 1099 Update*: Hearing Before the United States House of Representatives Committee on Small Business, 111th Congress, First Session (February 9, 2011) (testimony of Jerol Kivett), available at http://smbiz.house.gov/UploadedFiles/kivett_sbc_2_9_11.pdf.

²² TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2010, TREASURY INSPECTOR GENERAL FOR TAX COMPLIANCE 9, July 18, 2011, available at <http://www.treasury.gov/tigta/auditreports/2011reports/201130071fr.pdf>.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ "C" corporation refers to subchapter C of the section of the Internal Revenue Code, which provides the rules that govern the tax treatment of corporate entities.

organizational structure selected is based on a number of factors, including tax rates, the desired number of shareholders, level of liability and the types of stock it plans to issue, if any.²⁷

In the United States, pass-through entities, such as S corporations, LLCs, partnerships and sole proprietorships, are the most common form of business structure. About 95% of businesses are organized as pass-through entities.²⁸ Taken together, pass-throughs account for 54% of all business net income, and they employ 54% of the private sector workforce.²⁹ Pass-through businesses are becoming more prevalent; between 1986 and 2005, their number more than doubled, while the number of C corporations declined.³⁰ Because the majority of new jobs are created by small businesses, the majority of which are pass-throughs, keeping their taxes low helps them to create jobs and invest. These pass-through entities pay federal taxes at the individual rate.³¹ The income of the small business is “passed through” to the business owner, who pays the firm’s taxes on their individual tax return.

Not all of the companies which file business taxes on an individual return are small businesses,³² but many are. According to a report by the Joint Committee on Taxation, raising the marginal tax rates for individuals making \$200,000 and families making \$250,000 would affect about 750,000 taxpayers, and account for 50% of the estimated \$1 trillion in business income reported in 2011.³³ A study prepared by Ernst & Young³⁴ found that pass-through owners would pay roughly \$27 billion more per year if Congress passes only corporate tax reform.³⁵

According to the National Federation of Independent Business, about 10% of small business owners report more than \$250,000 in income, and the businesses most likely to report income above that threshold are businesses with 20 to 250 employees.³⁶ In fact, over 30% of firms with

²⁷ Ephraim P. Smith, Philip J. Harmelink & James R. Hasselback, CCH FEDERAL TAXATION ¶14,001 (2009).

²⁸ Robert Carroll & Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, April 2011, available at <http://www.s-corp.org/wp-content/uploads/2011/04/Flow-Through-Report-Final-2011-04-08.pdf> (hereinafter Carroll & Prante).

²⁹ Karen Hube, *Corporate Taxes: Wake up, Small Business!* THE FISCAL TIMES, August 5, 2011, available at <http://www.thefiscaltimes.com/Articles/2011/08/05/Corporate-Taxes-Wake-up-Small-Business.aspx#page1>.

³⁰ STAFF OF THE JOINT COMMITTEE ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY 9, JCX-48-08 3, June 4, 2008, available at <http://www.jct.gov/publications.html?func=startdown&id=1291>.

³¹ Carroll & Prante *supra* note 27, at i.

³² Glenn Kessler, *Is Obama Aiming to Hike Taxes on ‘Small Businesses’?* WASH. POST, April 15, 2011, available at http://www.washingtonpost.com/blogs/fact-checker/post/is-obama-aiming-to-hike-taxes-on-small-business/2011/04/14/AFqvmPfd_blog.html.

³³ STAFF OF THE JOINT COMMITTEE ON TAXATION, TAX REFORM: SELECTED FEDERAL TAX ISSUES RELATING TO SMALL BUSINESS AND CHOICE OF ENTITY, JCX-48-08, June 4, 2008, available at <http://www.jct.gov/publications.html?func=startdown&id=1291>.

³⁴ Carroll & Prante, *supra* note 27, at i.

³⁵ *Id.* at ii.

³⁶ *Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividend: Hearing Before the United States Senate Committee on Finance*, 112th Congress, Second Session 4 (September 14, 2011) (testimony of Bill Rys), available at <http://finance.senate.gov/imo/media/doc/Rys%20Testimony.pdf>.

between 20 and 250 employees would see their taxes increased if individual rates are increased for those reporting more than \$250,000 in income.³⁷

IV. The Importance of Individual Tax Reform

Small businesses do not benefit if Congress tackles only corporate reform. Many have expressed support for individual and corporate reform to be considered in tandem. So far, Congressional hearings have been held, but no further action is scheduled. In March 2012, Ways and Means Committee Chairman Dave Camp (R-MI) said that he would like to reduce the top individual and corporate rate to 25% to help promote job creation.³⁸ Chairman Camp said that the Republican budget proposal adopted the Ways and Means Committee's "recommendation to simplify taxes for American families" and "reform our outdated tax code and unleash innovation and investment."³⁹

At the direction of Chairman Camp and Senate Finance Committee Chairman Max Baucus (D-MT), the Joint Committee on Taxation has been researching legislative methods of lowering tax rates and broadening the tax base. Several members of the Congressional Joint Select Committee on Deficit Reduction, which was charged with reducing the federal deficit, said that comprehensive tax reform may be a way to bring down the deficit and spur economic growth.⁴⁰

V. The Landscape of New Taxes and Tax Increases for Small Businesses

Taxes are a problem for small businesses. New tax provisions and tax increases complicate the tax code. They also drain off capital that small firms use to reinvest in their businesses and to hire workers.⁴¹ Over the past few years, numerous new tax provisions and tax increases have been passed.⁴² Some have taken effect, and more are scheduled to become effective over the next two years. Some tax incentives are scheduled to expire. Listed are several of the provisions that may affect small firms.

³⁷NATIONAL FEDERATION OF INDEPENDENT BUSINESS, NFIB RESEARCH FOUNDATION, FINANCE QUESTIONS – NFIB SMALL BUSINESS POLL, available at <http://www.411sbfacts.com/files/Financial%20Questions.pdf>.

³⁸ Editorial, *Camp: Tax Plan Aims for 25% Cap*, WALL ST. J., March 11, 2011.

³⁹ Press release, Camp Statement on House Republican Budget, March 20, 2012, available at <http://waysandmeans.house.gov/News/DocumentSingle.aspx?DocumentID=285649>.

⁴⁰ Robert Pear, *Deficit Commission May Need Push*, N.Y. TIMES, October 18, 2011, available at <http://www.nytimes.com/2011/10/19/us/politics/congressional-deficit-panel-still-not-close-to-a-plan.html>.

⁴¹ *Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividend: Hearing Before the United States Senate Committee on Finance*, 112th Congress, Second Session 4 (September 14, 2010) (testimony of Bill Rys), available at <http://finance.senate.gov/imo/media/doc/Rys%20Testimony.pdf>.

⁴² See, e.g., Title IX of Pub. L. No. 111-148, 124 Stat. 119 (2010), available at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ148/pdf/PLAW-111publ148.pdf>.

A. *Expiration of the Tax Provisions in The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA)⁴³ and the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA)⁴⁴*

Unless Congress acts, beginning in 2013, the top tax rates on some small businesses are scheduled to increase. The top rate on ordinary income (such as salary) will go from 35% to 39.6%, and the top rate on long-term capital gains will go from 15% to 20%.

Small business decisions can be driven by tax rates.⁴⁵ Research by Glenn Hubbard and William Gentry found that increasing marginal tax rates interferes with long-term growth and discourages entrepreneurs from starting businesses.⁴⁶ Another study showed that a 5% increase in the individual tax rate reduces by 10% the number of entrepreneurs making new capital investments and reduces the likelihood of hiring workers.⁴⁷

In addition to marginal tax rate reductions, the 2001 and 2003 tax cuts provided tax relief for married couples with dual incomes who file jointly; increased the Child Tax Credit and the Adoption Credit; increased the dependent care and child care credits; increased incentives for retirement savings plans and education savings plans; and adjusted the Alternative Minimum Tax.

B. *Examples of Tax Increases in the Patient Protection and Affordable Care Act (PPACA)⁴⁸*

1. Employer Mandate

Beginning in 2014, employers with 50 or more employees who do not offer health insurance and have at least one full-time employee who obtains a premium tax credit will pay \$2,000 per full-time employee, excluding the first 30 employees from the calculation. Employers with 50 or more full-time employees who offer health insurance but have at least one full-time employee who obtains a premium tax credit will pay \$3,000 per

⁴³ Pub. L. No. 107-27, 115 Stat. 38 (2001). The tax provisions in Pub. L. No. 107-16, together with those in Pub. L. No. 108-27, are colloquially referred to as the “Bush tax cuts” or the “2001 and 2003 tax relief.”

⁴⁴ Pub. L. No. 108-27, 117 Stat. 152 (2003).

⁴⁵ *Tax Reform Options: Marginal Rates on High-Income Taxpayers, Capital Gains and Dividend: Hearing Before the United States Senate Committee on Finance*, 112th Congress, Second Session 4 (September 14, 2010) (testimony of Bill Rys), available at <http://finance.senate.gov/imo/media/doc/Rys%20Testimony.pdf>.

⁴⁶ R. Glenn Hubbard and William M. Gentry, *Tax Policy and Entry into Entrepreneurship*, November 13, 2002, available at:

http://web.williams.edu/Economics/gentry/Tax%20Policy%20and%20Entrepreneurial%20Entry_11_02.pdf.

⁴⁷ ROBERT CARROLL, DOUGLAS HOLTZ-EAKIN, MARK RIDER & HARVEY S. ROSEN, *Entrepreneurs, Income Taxes and Investment*, NATIONAL BUREAU OF ECONOMIC RESEARCH, Working Paper No 574, January, 1998, available at <http://www.nber.org/papers/w6374>

⁴⁸ Pub. L. No. 111-148, 124 Stat. 119 (2010).

employee receiving the premium credit *or* \$2,000 for each full-time employee, excluding the first 30 employees from the calculation, whichever is less.⁴⁹

2. Individual Mandate

Beginning in January 2014, the law requires non-exempt⁵⁰ United States citizens and legal residents to maintain minimum essential health coverage.⁵¹ Those who fail to maintain coverage are subject to a penalty that is equal to a flat dollar amount⁵² or a percentage of the individual's income,⁵³ whichever is greater.

3. Unearned Income Medicare Contribution (Surtax on Investment Income)

Effective January 1, 2013, the Health Care and Education Reconciliation Act⁵⁴ imposes a 3.8% surtax on net investment income⁵⁵ for single individuals with adjusted gross incomes over \$200,000 and families with adjusted gross incomes over \$250,000.⁵⁶ The surtax applies to dividends, interest, annuities, rent and royalties income, minus the expenses associated with earning the income. Small business owners and investors in small businesses (passive investors in S corporations and partnerships, for example) may face these increases, which could make it even more difficult for these businesses to raise capital.

4. Increase in Medicare Payroll Tax

Under current law, employers and employees each contribute a payroll tax of 1.45%. Effective January 1, 2013, the employee share of the Medicare payroll tax will increase from 1.45% to 2.35% for individuals earning \$200,000 and families earning \$250,000.⁵⁷ Married taxpayers filing separately are subject to a \$125,000 threshold. Any income over those thresholds is subject to the .09% surtax. The threshold is not indexed for inflation.

⁴⁹ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 37 (JCX-18-10) (MARCH 21, 2010), *available at* <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁵⁰ Individuals are exempt if they are incarcerated, not legally present in the United States, or maintain religious exemptions. *Id.* at 32.

⁵¹ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 31 (JCX-18-10) (MARCH 21, 2010), *available at* <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁵² The flat dollar penalty is \$95 for 2014, \$325 for 2015 and \$695 for 2016. *Id.* at 32.

⁵³ *Id.*

⁵⁴ Pub. L. No. 111-152, 124 Stat. 1029 (2010).

⁵⁵ Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 1402, 124 Stat. 119, *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-111publ152/pdf/PLAW-111publ152.pdf>;

⁵⁶ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 134 (JCX-18-10) (MARCH 21, 2010), *available at* <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁵⁷ *Id.* at 103.

5. Eliminate the Tax Deduction for Employers Who Receive Medicare Part D Retiree Drug Coverage
Under current law, employers who provide Medicare-eligible retirees with prescription drug coverage may be eligible for federal subsidy payments of 28% of their spending for prescription drug costs over \$250, not to exceed \$5,000.⁵⁸ These subsidies were excluded from the employer's gross income when calculating corporate income tax. Employers were also able to take a business deduction for retiree prescription drug expenses. Beginning in 2013, employers must reduce the amount claimed as a deduction by the amount received as a subsidy.
6. Pre-Tax Flexible Spending Account (FSA) Cap
Beginning in 2013, PPACA imposes an annual cap of \$2,500⁵⁹ on FSA contributions.⁶⁰ The cap is indexed to inflation. Some small businesses, particularly those that do not offer health insurance, offer FSAs so employees may pay for health care expenses with pre-tax dollars.
7. Health Savings Account (HSA) Withdrawal Penalty Increase
In effect since January 2011, this provision increases the withdrawal penalty for non-medical HSA withdrawals from 10% to 20%.⁶¹
8. Annual Fee on Manufacturers and Importers of Branded Prescription Drugs
Effective since January 2011, the law assesses an annual fee on manufacturers of certain manufacturers and importers of branded prescription drugs.⁶² The fee will be structured so that certain federal revenue targets are reached each year; for example, \$2.8 billion in 2012-2013; \$3 billion in 2014-2016; \$4 billion in 2017; etc.
9. Tax on Medical Device Manufacturers
Beginning in 2013, the Health Care and Education Reconciliation Act⁶³ adds a new 2.3% tax on the revenues of medical device manufacturers, producers and importers.⁶⁴ Eyeglasses, contact lenses, hearing aids and other products purchased by the public for

⁵⁸ *Id.* at 94.

⁵⁹ Prior to PPACA, there was no limit on FSA contributions.

⁶⁰ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 74 (JCX-18-10) (MARCH 21, 2010), *available at* <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁶¹ *Id.* at 71. The IRA withdrawal penalty is currently 10%.

⁶² STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 84 (JCX-18-10) (MARCH 21, 2010), *available at* <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁶³ Pub. L. No. 111-152, 124 Stat. 1029 (2010).

⁶⁴ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 137 (JCX-18-10) (MARCH 21, 2010), *available at* <http://www.jct.gov/publications.html?func=startdown&id=3673>.

individual use are excluded. The medical device industry says it will pay for the tax by reducing jobs.⁶⁵

10. Over-the-Counter (OTC) Medicine Tax

In effect since January 2011, this provision prohibits the purchase of OTC medications with Flexible Spending Account (FSA) or Health Saving Account (HAS) health care reimbursement accounts without a prescription.⁶⁶

11. New Itemized Medical Deduction Threshold from 7.5% to 10%

Under current law, itemized out-of-pocket medical expenses may be deducted if they exceed 7.5% of the taxpayer's Adjusted Gross Income (AGI). Under PPACA, beginning in January 2013, these expenses must exceed 10% of the taxpayer's AGI to be deducted.⁶⁷ The increase will be waived for those ages 65 and older for tax years 2013-2016.⁶⁸

12. Tax on Indoor Tanning Services

Effective since July 2010, this provision added a new 10% tax on indoor tanning services.⁶⁹

VI. Health Insurance Tax Credit for Small Businesses

Along with tax increases, PPACA offers a temporary health care tax credit for certain small business owners who purchase health insurance.⁷⁰ In 2010, the law provided a 35% tax credit for an employer's health insurance costs if they met the criteria outlined below. The tax credit is effective from 2010 through 2013. Beginning in 2014, the law provides a 50% credit for an employer's health insurance costs. The credit is available for two additional years, and only if the employer purchases health insurance through one of the exchanges.

⁶⁵ *Id.* See also Ramesh Ponnuru, *Tongue-Depressor Tax Will Harm Jobs, Innovation*, BLOOMBERG, January 2, 2012, available at <http://www.bloomberg.com/news/2012-01-03/tongue-depressor-tax-will-harm-jobs-innovation-ramesh-ponnuru.html>.

⁶⁶ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 69 (JCX-18-10) (MARCH 21, 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3673>

⁶⁷ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 96 (JCX-18-10) (MARCH 21, 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁶⁸ *Id.*

⁶⁹ STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' 108 (JCX-18-10) (MARCH 21, 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3673>.

⁷⁰ 42 U.S.C. § 45R (2010).

Some small business owners and small business organizations believe the tax credit may be too narrowly tailored to help more than a few entrepreneurs.⁷¹ To be eligible for the full credit, a small business owner must: 1) have fewer than 10 full time equivalent employees, but at least one employee; 2) pay those employees an average annual wage of \$25,000 or less; and 3) offer health insurance to those employees and pay at least 50% of the premium. To be eligible for a partial tax credit, the small business owner must: 1) have 11 to 25 full time employees; 2) pay an average wage of \$25,000 to \$50,000; and 3) offer health insurance to those employees and pay at least 50% of the premium.⁷² The self-employed, although they represent 78% of all small businesses in the U.S., are not eligible for the credit.⁷³

Small business owners have said that the tax credit has been slow to be adopted because it is complicated and temporary, and there are a number of strings attached.⁷⁴ Others say that the credit may spur them to offer health insurance.⁷⁵ The Internal Revenue Service⁷⁶ and NFIB⁷⁷ have developed some tools to help small business owners determine whether they will qualify for the credit.

In his Fiscal Year 2013 budget, President Obama proposed expanding the health care tax credit.⁷⁸ Under the revised proposal, companies with up to 50 employees would be eligible, and companies with up to 20 employees would be able to claim the full credit. The plan would also make the credit's phase-out more generous. Self-employed workers would remain ineligible for any credit.

⁷¹ NATIONAL FEDERATION OF INDEPENDENT BUSINESS, *Will the Small Business Healthcare Tax Credit Help Small Business Owners?* available at <http://www.nfib.com/issues-elections/issues-elections-item?cmsid=52260>.

⁷² STAFF OF THE JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE 'RECONCILIATION ACT OF 2012,' AS AMENDED, IN COMBINATION WITH THE 'PATIENT PROTECTION AND AFFORDABLE CARE ACT' (JCX-18-10) (MARCH 21, 2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3673>. See also INTERNAL REVENUE SERVICE, *Small Business Health Care Tax Credit: Frequently Asked Questions*, December 3, 2010, available at <http://www.irs.gov/newsroom/article/0,,id=220839,00.html>.

⁷³ U.S. CHAMBER OF COMMERCE MAGAZINE, *Health Care Reform and Your Business*, May 1, 2010, available at <http://www.uschambermagazine.com/article/health-care-reform-and-your-business>.

⁷⁴ Michael Booth, *Small Business Tax Credits Not Catching on in Colorado Yet*, THE DENVER POST, December 6, 2010, available at http://www.denverpost.com/business/ci_16774968.

⁷⁵ Karen Klein, *How Health-Care Reform Will Affect Small Business*, BUSINESSWEEK, April 13, 2010, available at http://www.businessweek.com/smallbiz/content/apr2010/sb20100413_125807.htm.

⁷⁶ The Internal Revenue Service's tax credit calculator is available at http://www.irs.gov/pub/irs-tl/3_simple_steps.pdf.

⁷⁷ NFIB's tax calculator is available at <http://www.nfib.com/issues-elections/healthcare/credit-calculator>.

⁷⁸ THE WHITE HOUSE, FACT SHEET: PRESIDENT OBAMA'S BUDGET EXPANDS, SIMPLIFIES SMALL BUSINESS HEALTH CARE TAX CREDITS (Feb. 16, 2012), available at <http://www.whitehouse.gov/the-press-office/2012/02/16/fact-sheet-president-obama-s-budget-expands-simplifies-small-business-he>.

VII. Congressional Leadership's Tax Relief Proposals

A. H.R. 9, the Small Business Tax Cut Act

House Majority Leader Eric Cantor (R-VA) introduced H.R. 9, the Small Business Tax Cut Act of 2012, which would allow qualified small businesses⁷⁹ with fewer than 500 employees in 2010 or 2011 to take a tax deduction equal to 20% of their qualified 2012 business income. The deduction may not exceed 50% of their W-2 wages.⁸⁰

Example: a small business that under current law would pay a 35% federal tax on \$100 of income would have a \$35 tax bill. Under the proposal, the same small business would be able to deduct 20% of its income from tax (20% of \$100 = \$20), subject to the 50% W-2 wage limitation. The small business would then pay the same 35% tax on the remaining \$80, resulting in a \$28 tax bill. Under this proposal, the small business immediately saved \$7 in federal taxes.

H.R. 9 was reported by the Ways and Means Committee on March 28, 2012 by a 23-14 vote. The bill would be effective for the tax year beginning after December 31, 2011 at an estimated cost of \$45.950 billion.⁸¹

B. S. 2237, the Small Business Jobs and Tax Relief Act

Senate Majority Leader Harry Reid (D-NV) introduced S. 2237, a 10% tax credit for the first \$5 million of payroll expansion (capped at \$500,000) for businesses that expand their payroll by hiring or increasing wages in 2012.⁸²

The bill would also temporarily renew 100% first year bonus depreciation, allowing qualified equipment purchases to be written off immediately, rather than over several years. This provision would apply to property placed into service before January 1, 2013 or January 1, 2014 for certain longer-lived property.⁸³ This Senate proposal is estimated to cost \$23 billion.

⁷⁹ A qualified small business is an employer engaged in a trade or business if the employer had fewer than 500 full-time equivalent employees for calendar year 2010 or 2012. JOINT COMMITTEE ON TAXATION, DESCRIPTION OF H.R. 9, THE SMALL BUSINESS TAX CUT ACT (JCX-30-12), March 26, 2012, available at <http://www.jct.gov/publications.html?func=startdown&id=4416>.

⁸⁰ JOINT COMMITTEE ON TAXATION, DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE PROVISIONS OF H.R. 9, THE SMALL BUSINESS TAX CUT ACT (JCX-30-12), March 26, 2012, available at <http://www.jct.gov/publications.html?func=startdown&id=4416>.

⁸¹ JOINT COMMITTEE ON TAXATION, DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE PROVISIONS OF H.R. 9, THE SMALL BUSINESS TAX CUT ACT (JCX-30-12), March 27, 2012, available at <http://www.jct.gov/publications.html?func=startdown&id=4417>.

⁸² S. 2237, the Small Business Jobs and Tax Relief Act, § 2, available at <http://thomas.loc.gov/cgi-bin/query/z?c112:S.2237>.

⁸³ *Id.* at § 3, available at <http://thomas.loc.gov/cgi-bin/query/z?c112:S.2237>.

VIII. Conclusion

This hearing will offer the opportunity for Members to learn more about the current tax landscape for small businesses. The tax code is complex and daunting for small businesses. Complexity and high taxes affect their ability to invest in their business and hire workers, and more taxes are coming. Congress is considering tax reform and relief ideas that will help small businesses.