TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB

The Voice of Small Business®

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The Treatment of Closely-Held Businesses in the Context of Tax Reform

Good morning, Chairman Camp, Ranking Member Levin, 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 current tax code impacts small and closely-held businesses in several important ways, so I appreciate that the Committee invited me here today to discuss these important issues from the perspective of someone who is both a small business owner and a tax practitioner for many closely-held businesses.

The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. I have been a member of NFIB since 1990, and have also served on NFIB's Tax Advisory Board since 1996. I have been a full-time professor at Husson University in Bangor, Maine for 32 years. In addition, I have had an accounting practice for the same 32 years, which provides services to 125 small business clients. They range in size from $10,000 to $30,000,000 in sales and from 1-125 employees. Prior to this segment of my life, I was a tax manager at PricewaterhouseCoopers in Boston.

The typical NFIB member employs about 8 to 10 employees with annual gross receipts of about $500,000. All of NFIB's members are independently owned, which is to say that none are publicly traded corporations. 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, NFIB frequently conducts surveys of both the NFIB membership and small businesses as a whole, and taxes consistently rank as one of their biggest concerns. In the most recent publication of the NFIB Research Foundation's *Small Business Problems and Priorities*, 4 of the top 10 small business concerns are tax-related.[1] In addition, the monthly Small Business Economic Trends survey consistently ranks taxes as among the most important problems facing small businesses.[2]

Business Structure

One of the first organizational issues encountered when forming a business is its legal form. The legal form chosen has implications for taxes, liability, startup costs, continuity, composition of ownership, and other matters of concern for the business owner. Critical to the business owner is the total cost to operate over the life of the business, including succession or termination. The owner cares about the variety of tax costs (income, payroll, return filing, etc.) that will be incurred as well as the cost of compliance with the related laws. A first meeting with a client would include all those topics.

[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 third among important problems. *Small Business Economic Trends*, NFIB Research Foundation, Washington, DC, February 2012.

The vast majority of small businesses are taxed as 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. From a tax perspective, the pass-through model makes sense for the typical small business.

Small businesses are also overwhelmingly privately held and independent. Nearly 60 percent of small (employing) businesses are owned by one individual, and publicly traded small businesses amount to only one-tenth of 1 percent of small employers.[4] Moreover, small employing businesses are also overwhelmingly *not* held by another entity—only 4 percent are even partially owned by another business or non-profit.[5]

While most small businesses start off as sole proprietorships or partnerships, the liability protection that a corporation 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-Corporations, reducing the tax liability for small businesses, but also providing the liability protection of a C-Corporation. The passage of those changes has led to an explosion in the number of S-Corporations. In 1985, 22 percent of all corporations were S-Corporations, by 1990 the figure has risen to 43 percent, and today the majority of corporations are S-Corporations.[6]

Businesses change their structure very infrequently and the tax code contributes to this.[7] For example, there can be tremendous costs when an S-Corporation elects to convert to a C-Corporation, particularly the built-in gains tax, which subjects assets which are appreciated at the time of conversion to a corporate level tax if sold within five years (10 years beginning in 2012). There are several instances where this tax would be due in the year following conversion when there is not necessarily the cash on hand to pay it.

Additionally, it should be noted that, while there are important liability protections offered to incorporated businesses, there are also both startup and ongoing costs associated with that structure versus non-corporate structures. Filing articles of incorporation, paying a registration fee with the state, drawing up corporate bylaws, changing all signage and corporate correspondence to indicate the new type of entity, setting up a board of directors, and filing an additional tax return are just a few possible examples of administrative startup costs. In addition, while most state laws require establishing a board

[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] *Ibid.*
[6] SOI Bulletin, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data – table 13, Winter 1999-2000.
Also see: SOI Tax Stats – S Corporation Statistics, Internal Revenue Service, U.S. Department of the Treasury, available at: http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96405,00.html
[7] In an NFIB survey, only 7 percent of businesses had changed their legal form within the previous 3 years. Of the small businesses that did change their business structure, 39 percent changed to avoid liability, and 27 percent changed for tax reasons. *Business Structure* – NFIB Small Business Poll, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004

of directors, more than two-thirds of small employers, virtually all of whom are privately held, say that their board exists primarily to fill legal requirements and not necessarily as an entity to govern the business.[8] In other words, incorporation makes sense for some businesses and would serve as barrier to entry for others.

While the variety of business structures might 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-Corporations can ensure that a small business is not overburdened with extra layers of taxation. In other cases, structures like C-Corporations, S-Corporations, and Limited Liability Corporations (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.

In addition, we recommend making three changes to current law that could provide additional flexibility to small businesses.

First, other than certain non-profits, corporations are currently not allowed to own stock in S-Corporations.[9] Allowing such ownership would be helpful to small business owners and would prevent the involuntary termination of S-Corporation status, which is usually a surprise to the business owner. At the very least, it would decrease administrative costs if one S-Corporation could own shares in another S-Corporation.

A second issue with business structure choices that could make owners' lives simpler is in the area of fringe benefits. If a business owner is employed by a C-Corporation, he or she can have fringe benefits like other employees. If the S-Corporation or partnership forms are elected, the owner can have no fringe benefits.[10] This would result in complex planning to help these owners have similar coverage, and the tax results differ as well. This is needlessly complex. We should require that the fringe benefits be non-discriminatory, but they should be allowed no matter what form the business entity is.

Finally, reducing the holding period for the built-in gains tax would do much to promote flexibility for small businesses. The built-in gains tax locks-in capital assets if a C-Corporation elects to change to S-Corporation status, and reduces economic efficiency. NFIB appreciates that the holding period has been reduced from 10 years to 5 years, and, at the very least, this should be extended.

Goals for Small Business Tax Reform

As the Committee considers tax reform, I would encourage you to keep these most important goals in mind. Achieving these goals will greatly enhance the ability of small and closely-held businesses to thrive in the 21st century: 1) permanently keep the tax rates low, 2) do not create disparity between the

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[8] *Ibid.*
[9] 26 USC § 1361 (b)(1)(B)
[10] 26 USC § 1372

corporate rate and individual rate, 3) reduce complexity, and 4) do not separate the business owner from the business.

Permanently Keep the Tax Rates Low

According to a February 2012 Small Business Economic Trends survey, 18 percent of small businesses reported that taxes was the single most important problem facing them today.[11] Small businesses need permanency in the tax code to make important business decisions, such as hiring workers and making capital expenditures. While small businesses much appreciated the work done in late 2010 to keep rates low for another two years, we are again faced with the possibility that that rates will increase for individual income taxes, estate taxes, capital gains taxes, and dividends taxes at the end of 2012. Without knowing what their tax liability will be at the end of this year, business planning becomes very difficult for our nation's number one job creators.

Individual income tax rates are paid by pass-through businesses, which are responsible for 54 percent of our nation's private sector workforce.[12] One in five small businesses experiences a continuing cash flow problem and one in two businesses face regular cash flow problems, which is exacerbated by higher taxes. Higher individual income taxes eat away at the ability of small businesses owners to spend money on their business. One of the main sources of capital for expanding a business is earnings retained from business profits (i.e. the amount of money available after taxes have been paid). As businesses are faced with the threat that taxes will go up next year, they may suspend plans to hire and expand their businesses.

The annual congressional tax extenders game, which for several years has included the Alternative Minimum Tax (AMT), creates even more uncertainty for business planning. This is especially true for tax preparers and makes tax planning for a client even more of a challenge and increases the potential for errors. A more certain tax code will help to promote prudent business planning and decisions and improve compliance.

The uncertainty of the estate tax is major problem for family owned businesses. The planning costs associated with this tax are not only a drain on business resources, but also take money away from the day-to-day operations and investing in the business. Between 2002 and 2012, the exemption and tax rate have changed nine times, which makes it especially hard to plan for family businesses. Next year, the rate is set to increase to 55 percent with only a $1 million exemption.

While small businesses would no doubt welcome the opportunity to reduce individual income tax rates from their current levels, at a minimum, NFIB members overwhelmingly support permanently extending the current 2001 and 2003 tax rates.[13] In addition, NFIB members strongly support repeal of the AMT

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[11] *Small Business Economic Trends*, NFIB Research Foundation, Washington, DC, February 2012.

[12] Carroll, Robert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, April 2011.

[13] In a 2010 Member Ballot, 89% of NFIB Members supported extending all the individual tax rates. *NFIB Member Ballot, vol. 559, November 2010*.

and estate tax, but if this is not immediately possible, providing a long term solution to protect small businesses would be very beneficial to them.

Address Tax Reform Comprehensively and Do Not Create Disparity between the Corporate Rate and Individual Rate

Pass-through businesses, and the many small businesses that choose a pass-through structure, must be included in any reform of the tax code. The current tax rates for pass-through businesses are similar to a C-Corporation's. If the rates were to go down for C-Corporations but remain unchanged for pass-through businesses, it would put pass-through businesses at a competitive disadvantage. A similar outcome would be reached if, as has been proposed in the President's budget for the past 3 years, the top marginal tax rates on individuals are allowed to return to pre-2001 levels. At the very least, the tax rate paid by pass-through businesses should be the same rate that applies to C-Corporations.

If a significant disparity between tax rates for C-Corporations and pass-through businesses was enacted, this would be particularly harmful to small businesses and might lead them to change the form of their business solely for tax reasons. The change in cash outflows resulting from a change in the form of business could save one or more jobs in the business. If the current individual tax rates are allowed to rise in 2013, this will cost an even greater number of jobs. I would expect a number of my clients to change their legal form solely for that reason even if it costs them in the long run at the time of sale or dissolution of their business. Short term decisions win when it comes to cash flow.

Finally, if Congress pursues a "corporate-only" reform that eliminates deductions and credits for a lower corporate rate, many small businesses could end up paying additional taxes without any corresponding benefit. A 2011 study found that, in total, pass-through businesses benefited from 23 percent of the approximately $116 billion in annual business tax expenditures.[14] Repeal of these provisions could entail substantial tax increases for pass-through businesses that could negatively impact employment and growth in the pass-through sector. The study found that eliminating all businesses tax expenditures would increase the income taxes paid by individual owners of pass-through businesses, on average, by 8 percent or $27 billion annually.[15]

For all these reasons, NFIB strongly recommends that tax reform be pursued comprehensively, addressing both individual and corporate taxes.

Reduce Complexity in the Tax Code

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.[16] The result is that 88 percent of small business

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[14] Carroll, Robert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, April 2011.
[15] *Ibid.*
[16] 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.

owners now hire a paid tax preparer to complete their returns.[17] 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.[18] Unlike a larger business, 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. In fact, I function very much like a part-time chief financial officer for my clients.

There are some areas of the tax law that are significantly more complex than necessary. For example, the health insurance credit requires a 5-page worksheet in a tax return, and you do not know if there is a credit available until you have spent the time on the worksheet. Various credits for hiring employees have so great a paperwork burden that clients rarely take advantage of any of them; small businesses hire employees because they need them, not because of any credits they get from hiring them. And in general, most clients are not even aware they are getting a number of deductions in the code and certainly are not managing their business in a way to generate deductions.

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 confusing tax code leads to more errors, which we believe is the main cause of the so-called “tax gap” amongst small business owners.

While the Internal Revenue Service (IRS) recently calculated that the tax gap grew between from $345 billion in 2001 to $450 billion in 2006, it is very important to note that the compliance rate stayed virtually unchanged.[19] No one disputes that we should all strive to achieve the highest possible level of tax compliance, but the recent repeal of two high-profile provisions intended to reduce the tax gap illustrate the difficulties associated with doing so.

In 2010, a provision in the Patient Protection and Affordable Care Act would have expanded 1099 reporting for businesses that purchased more than $600 in goods and services from all other businesses.[20] Before that, in 2005, the Tax Increase Prevention and Reconciliation Act created a new requirement that federal, state, and local governments withhold 3 percent from payments for goods and services.[21] Both of these measures were strongly opposed by NFIB and others, and for good reason. The burdens that these provisions would have placed on small businesses were much higher than the additional income that the IRS would have potentially collected. Fortunately for everyone, these provisions were never allowed to go into effect and were repealed in 2011.[22] Future efforts to close the

[17] *Tax Complexity and the IRS – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 6; Issue 6; 2006.
[18] *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 3; Issue 5; 2003.
[19] *Tax Gap for Tax Year 2006*, Internal Revenue Service, U.S. Department of the Treasury, Jan. 6, 2012
[20] Section 906, P.L. 111-148
[21] Section 511, P.L. 109-222
[22] H.R. 674, which repealed the 3 percent withholding requirement became P.L. 112-253 on November 21, 2011. H.R. 4, which repealed the 1099 reporting requirement became P.L. 112-15 on April 14, 2011.

tax gap by forcing small businesses to be "information collectors" for the IRS, or by increasing federal withholding, will also be met with stiff resistance.

The tax gap is a symptom of a tax code that has grown far too complex. Fortunately, by taking concrete steps to simplify the code through tax reform, Congress can increase compliance, while also reducing the burdens on small businesses.

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. Since 2003, Congress has steadily increased the allowable expensing amount from $25,000 to $500,000 for tax year 2011. Additionally, Congress expanded Section 179 expensing to include real property with the passage of the *Small Business Jobs Act*.[23] With these efforts, Congress has provided the majority of small business owners with an immediate deduction for almost any investment they make in their businesses. While increasing the Section 179 deduction over $500,000 might not benefit many small businesses, the $125,000 limit (plus indexing) that is in effect for 2012 should be increased and should include real property.

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. When considering the stress of my clients on the topic of expensing the cost of long-lived assets, making the law permanent and eliminating the roller coaster of the maximum deduction would ease their minds considerably.

Another example of simplification is allowing the expanded use of cash accounting. Under the 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. Allowing any business entity with revenues less than $10 million to use cash basis accounting, as long as the cost inventories are not deducted until sold, would be a small but important change that would benefit small businesses.

Do Not Separate the Business Owner from the Business

A small business owner is inexorably tied to his or her business; no matter what business structure the small business owner chooses, you cannot separate the business owner from the business. While this is most apparent for businesses structured as pass-through entities, it is true even in the case of small businesses organized as C-Corporations. For many small business C-Corporations, the corporation pays down its annual receipts in business expenses and salary, such that the corporation itself has almost no tax liability.[24]

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[23] P.L. 111-240

[24] *Business Structure* – NFIB Small Business Poll, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

Attempts to tax small business or pass-through income and salary income at different tax rates would create many new problems for small business owners. It is also counter to the goal of simplifying the tax code. The required recordkeeping to determine qualified income and to allocate expenses would increase the cost and burden of compliance for small businesses and likely require professional accounting services to oversee and handle potential audit inquiries by the IRS and/or state tax authorities (for states that conform to the federal tax code).

Conclusion

Small businesses truly are the engine of economic growth. This isn't just a slogan, as small businesses created two-thirds of the net new jobs over the last decade. Small business owners are risk takers and entrepreneurs. They are the last businesses to lay off employees when business declines and slow to rehire when business picks up. The owner works additional hours until they can take it no more. When small business hires an employee, it is their intent to keep them on for the long run.

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 Committee on Ways and Means is taking a serious look at reforming the tax code and urge you to keep in mind the unique challenges that face small businesses.

CORE VALUES

We believe deeply that:

Small business is essential to America.

Free enterprise is essential to the start-up and expansion of small business.

Small business is threatened by government intervention.

An informed, educated, concerned, and involved public
is the ultimate safeguard for small business.

Members determine the public policy positions of the organization.

Our employees and members, collectively and individually, determine the success of the NFIB's endeavors, and each person has a valued contribution to make.

Honesty, integrity, and respect for human and spiritual values are important in all aspects of life, and are essential to a sustaining work environment.

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