

SETRA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS

HEARING BEFORE THE COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

WASHINGTON, DC, JUNE 9, 1999

Serial No. 106-18

Printed for the use of the Committee on Small Business



U.S. GOVERNMENT PRINTING OFFICE

61-230

WASHINGTON : 2000

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HEARING ON SETRA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS

WEDNESDAY, JUNE 9, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 10 a.m., in room 2360, Rayburn House Office Building, Hon. James Talent (Chairman of the Committee) presiding.

Chairman TALENT [presiding]. Good morning. I want to apologize to the Committee for being late. When I was in school, we used to give the professors about 15 minutes, and you gave me 10. I imagine I was at the end of the rope there.

Over the last few years, largely through the determined and united efforts of the members of this Committee, we have succeeded in convincing the rest of the Congress to give some modest tax relief to America's small businesses and family farmers, including restoring the home-office deduction, increasing the deductibility of health insurance premiums, and modest estate tax relief.

Clearly, more is needed. Small entrepreneurs are the backbone of our economy. They run local, national, and international businesses. They provide the bulk of the services we need. They raise our children. They care for the elderly, and they grow our communities. They unambiguously need fair and simple tax relief from today's complicated tax code.

I am introducing a bill today, the Small Employer Tax Relief Act of 1999, called SETRA, on which we're going to have a hearing today, and I want to recommend it to my colleagues. It squarely faces the realities that small businesses confront under today's tax code. SETRA calls for deducting 100 percent of small employer's health insurance costs, restoring the meal deduction, increasing expensing, lowering taxes, including payroll taxes, and simplifying complex tax accounting IRS rules.

The bill tackles these important changes to complement, not compete with, leading proposals by other Members of Congress to eliminate the death tax and to reduce taxes across the board for all Americans.

In particular, I think that repealing the death tax, or eliminating it gradually, as proposed by Representatives Dunn and Tanner in H.R. 8, is essential. We should protect small farmers, family-owned businesses, and women business owners from having their life's work confiscated by the Internal Revenue Service after their demise.

In addition, there is no reasonable justification, in my mind, for denying small businesses healthcare, business meal, and other business expenses to run their business, so they can keep more of their hard-earned money, create more jobs, and grow the economy.

High taxes, a complex tax code, and IRS tax traps, now penalize unnecessarily an otherwise vibrant small business economy. Small business Americans should be able to afford to save and invest in their children, in their communities, and in their future. I hope that SETRA, or legislation like it, will simplify and lower small business taxes and help small businesses continue to excel.

I want to now yield to my friend and distinguished colleague, the ranking member, for any statement she may wish to make.

[Mr. Talent's statement may be found in the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Before we begin, I would like to take this opportunity to introduce our new member of this Committee, Ms. Shelley Berkley, from Nevada. She has a law degree and has worked extensively in the private sector. As such, she is bringing with her a strong background in business issues and a knowledge of trade groups. Representative Berkley also comes from one of the fastest-growing cities in the Nation, and I look forward to having her insights on what small businesses on the front line need to succeed.

Over the past few years, America has experienced an unprecedented economic boom, and no one can deny the importance of small businesses in helping create this growth and strengthening our communities. Our Nation's entrepreneurs provide jobs, represent a major tax base for our schools and roads, and embody the spirit of entrepreneurship that has made this country great.

However, too often, small businesses lack the capital they need to grow. They do not have enough money at the end of the day to make being their own boss a reward. One of the reasons for this is that our tax system often creates disincentives for our Nation's small businesses.

An easy way to ensure that small businesses continue to grow and are able to compete with large corporations is to provide them with some sort of tax relief. The additional revenue, although small by the standards of Wall Street, can often be the difference between a successful, growing firm and one that fails.

I would like to take this opportunity to commend Mr. Talent on his continued efforts to relieve the tax burden on the small business community. He has been a strong advocate of tax relief for small business and I am glad that I have been able to join him in this fight.

One of the most important roles of this Committee is to educate the rest of Congress about tax relief for small business. Today we will be looking at the Small Employer Tax Relief Act of 1999, introduced by the chairman. I am a strong supporter of many of the provisions contained in this legislation, and I would like to thank Mr. Talent for providing us with the opportunity to examine some of the other tax relief proposals which haven't been as thoroughly examined.

Both last year and again this year, I have joined Mr. Talent as an original co-sponsor of legislation that calls for an immediate, 100 percent deduction for small businesses of their healthcare ex-

penses. This is crucial, not only for our small businesses, but for millions of Americans who are currently without health insurance. Since large corporations can already deduct 100 percent of their healthcare insurance, small firms are suffering from an unfair tax burden, and this must stop.

Small businesses also do not have the million dollar advertising budgets that larger corporations do. Much of their advertising is done face to face over lunch or dinner. The value of this type of marketing should not be underestimated and it is a legitimate business expense. To help small businesses offset this portion of their marketing, I am a strong supporter and co-sponsor of legislation to increase the meal expense deduction from 50 percent to 80 percent.

Increasing this deduction is a common-sense proposal that should be made a priority by Congress. It is a win-win situation for everyone involved. Our small businesses win because they will be able to compete with the million dollar advertising budgets of large firms, and our restaurants, most of which are small businesses run by families, will also benefit. This is a practical thing that we can do, and it is also a smart, common-sense initiative that will help strengthen our small businesses.

I would like to thank the chairman for providing the Committee with an opportunity to examine other aspects of the tax relief to small businesses. One of the proposals that we are examining today would repeal the temporary Federal surtax added in 1976 to repay loans from the government to the unemployment trust fund. Even though this loan was repaid in 1987, the surtax is still in effect. Today we will be able to examine why this still exists and determine whether it is fair to small businesses.

Additionally, we will hear about possible changes to small business accounting rules to make it simpler and more cost effective for small firms to comply with current tax laws. Today the Committee will have the opportunity to examine these simplified accounting rules. I believe that we should take a serious look at any proposal which simplifies the accounting procedures for small business.

Finally, the legislation before us today would lower the maximum individual income tax rate from 39.4 percent to 34 percent on productive income of small and family-owned businesses and the self-employed. The net result of this change will be to reduce the highest tax bracket for a small business to that of larger corporations. I believe that we must provide a level playing field between small firms and large corporations, and this may be one of the ways of doing just that.

Once again, I would like to thank the chairman for holding today's hearing. Creating a fair and equitable tax structure for our Nation's small businesses is crucial to their long-term success. At the same time, we must work to ensure that by solving one problem, we do not create a more serious problem elsewhere. I look forward to hearing the testimony of today's witnesses, and I thank the chairman again for his hard work on this issue.

Chairman TALENT. I thank the gentlelady for her comments, and we'll go right to the first panel. We have two panels today, and the first witness in the first panel is Mr. James M. Wordsworth, who is the owner of J.R.'s Steakhouse of Virginia, in Fairfax, Virginia,

who is testifying on behalf of the National Restaurant Association. Mr. Wordsworth.

**STATEMENT OF JAMES WORDSWORTH, OWNER, J.R.'S
STEAKHOUSE OF VIRGINIA**

Mr. WORDSWORTH. Yes, good morning. Mr. Chairman, members of the Committee, thank you for the opportunity to testify before this Small Business Committee on legislation that would help thousands of restaurateurs across the country, the Small Employer Tax Relief Act.

I am pleased to see that the Committee is addressing such an extensive package of tax issues that have long been a burden on small business. My name is Jim Wordsworth. I have been a small business employer in this area for a quarter of a century.

In 1974, I was a marketing manager for a large, high-tech corporation, and decided to open my own restaurant. So I did that, in Fairfax, Virginia, and we called it J.R.'s Steakhouse. With a lot of hard work and probably miracle upon miracle, we were successful. That enabled me to open another restaurant and catering businesses shortly thereafter. Today, we employ 250 people, both part-time and full-time.

Privately, I am proud of the success of our business, and throughout the years I have learned many, many lessons, too numerous to mention. One of the lessons is that you do everything in your power to treat your employees well, to serve quality meals to your customers, and to give back to the community. That is within your building. Yet, you will never have total control over whether or not you succeed, and that is outside your building.

There are barriers that hurt your business and keep you from breaking even. These barriers can make or break your business, regardless of your own efforts. One of the barriers, one of the largest barriers, is the heavy hand of the Federal Government. To those of you in the business world, and to us in the business world, the Internal Revenue Code is probably the thing we fear most.

It is not just the rules that can't be deciphered without the aid of lawyers and accountants, it is the tax burden itself. It is substantial, and it is constantly changing. Looking at the Small Employer Tax Relief Act, it is clear that Chairman Talent understands the barriers that are caused by the tax code. In fact, almost every provision will have a direct impact on my business.

However, it will not surprise any of you to hear that what I'd like to focus on in my comments is the provision to increase the business meal deduction to 80 percent for small businesses and the self-employed.

As most of you remember, in 1986, Congress lowered the business meal deduction from 100 percent to 80 percent. In 1993, it was lowered again to 50 percent. As far as I can tell, the reason it was lowered, aside from bringing a large amount of revenue to the Federal Government, was that Congress really considered it some sort of fat-cat tax loophole that people used so that they could have three martini lunches. I would like to assure you that Congress could not have been further from the truth.

When I walk around my restaurant at noon on a day like today, here is what I see. At one table I see a salesman up here from

North Carolina trying to sell his outdoor signage to a guy who is down the street who has a shop in a strip mall that is down the street from our restaurant.

At another, I see a female who is new in business and is venturing into her own human resources consulting business talking to a guy from a start-up high-tech firm in Tysons Corner about how they can work together.

At still another is a friend of mine, Monty Coleman, a former Redskin, who is with an emerging high-tech company, meeting with the president of United Cerebral Palsy to arrange a sponsorship and a golf tournament. That is not really a direct business to business, but it is an effective thing that is happening.

But, in short, the business men and women who are having lunch in my restaurant are the same people that you see testifying here today. They are traveling sales representatives that they pull off the Beltway, the start-up business working on new clients, or the self-employed. Each one of them considers my restaurant his or her conference room. For many of these small business people, this is the best—and sometimes the only—way they can do business. There is no less legitimate business expense than any other form of marketing, but right now the tax code is telling them that it is just 50 percent legitimate.

When Congress first reduced the business meal deduction, I, like restaurateurs throughout the country, saw an immediate impact on my business. And while that is very important to us in the restaurant business, what is even more important is to look at the impact of Congress' decision on the business meal user.

Since Congress first dropped the allowable business expense in 1986, our association's research shows that the number of business meal users has declined by more than 2 million. A great majority of these were small businesses.

Let me take a minute to talk about who really uses the business meal, because it is important not to generalize or stereotype based on any misconceptions, and I think you'll be surprised. On the chart over here, if I can direct your attention, two-thirds of the business meal users make less than \$60,000 a year, with almost 40 percent making less than \$40,000. One-fifth of the business meal users are self-employed. One-half of all business meal spending occurs in small towns and in rural areas. The average cost of a business meal per person is \$11.60.

For people in the business world, a business meal is just that; it is business. They are not trying to scam the system for a tax break. They are not out to waste a hard-earned marketing budget on something that won't help them grow their business, and they are not out to eat a meal for their own personal enjoyment, and to heck with the business. They are business people simply trying to drum up business.

Clearly, it was the small business that was hardest hit by the cut in the deduction. I think it was part of TEFRA-86. That is why, on behalf of the National Restaurant Association, I applaud the inclusion of the business meal provision to increase deductibility from 80 percent for small businesses and self-employed. This mirrors the stand-alone bill introduced by Congressman McCrery

and Congressman Tanner, H.R. 1195, which has received strong bipartisan support.

Ideally, we would like to see the deduction go back up to 100 percent for everybody, because we believe that conducting business over a meal is a 100 percent legitimate cost of doing business. However, we also realize that the revenue impact of such an increase would be very difficult to enact in one bite, and that is a pun.

Again, Mr. Chairman, I would like to thank you and all of the members of the Committee for the opportunity to tell you my story and hopefully provide some insight on this tax issue. The thing I would like to end with, and I think is so appropriate, is the Department of Commerce has declared this year, 1999, this is the second time now, as the year of the restaurant. It is an acknowledgement of what restaurants have been in our business community. I think it would be appropriate, since we are the industry of the first experience for so many Americans, this is the year of the restaurant, that if the sweeping changes that this bill would have on all of us were passed in this year, I think that would be extremely appropriate, and I thank you.

[Mr. Wordsworth's statement may be found in the appendix.]

Chairman TALENT. Thank you, Mr. Wordsworth, for your testimony.

Our next witness is Mr. Frank S. Joseph, who is the owner of Key Communications Group of Chevy Chase, Maryland. He has testified before this Committee before, and we welcome him back. I urge the members to take a look at the resume of each of these witnesses. Mr. Joseph's resume is quite impressive, both as a businessperson, and, before that, as a reporter, and we're happy to have him here.

STATEMENT OF FRANK JOSEPH, OWNER, KEY COMMUNICATIONS GROUP, INC.

Mr. JOSEPH. Thank you. Thank you, Mr. Chairman. Chairman Talent, members of the Committee, good morning. I am Frank Joseph. I am a publisher and publishing consultant in Chevy Chase, Maryland, six miles from here.

My wife and I have been the self-employed owners of Key Communications Group Incorporated for 17 years. We publish the Federal Personnel Guide. You may be familiar with it.

Key has been a home-based business for the last eight of those years. I am very happy to endorse your bill, the Small Employer Tax Relief Act of 1999, speaking both personally and on behalf of the National Association for the Self-Employed.

There are many good ideas in the bill. But, above all, I commend this bill for keeping up the effort to immediately raise the health insurance deduction for the self-employed to 100 percent. For millions of self-employed Americans, this deduction represents the difference between having no health insurance, being under-insured, and having real health insurance. Almost six million self-employed people and their dependents are uninsured. That includes nearly two million children. This is a very real national problem. Thank you for fighting to get those people insured.

It is also a fundamental issue of tax fairness. When I worked for a larger company, my employer provided my health insurance. I

had a policy that covered my family. A small premium was deducted each month from my gross pay, and I barely noticed the cost. My employer excluded his entire cost for that health insurance from his taxable income, 100 percent.

Now I am self-employed. My wife and I operate Key as an S corporation under the tax law. I can only deduct a fraction of my health insurance cost. It is same thing for other self-employed people, like sole proprietors and partners. Sometimes it seems like the smaller your company, the less the government wants you to have health insurance. A mile or two away from me is Phillips Publishing International. Like me, Phillips publishes newsletters. Tom Phillips is an acquaintance of mine, friend of mine. He has done very well. Last year they recorded gross revenues of about \$600 million. That is orders of magnitude larger than my publishing business, which is in my basement.

Yet, when it comes to health insurance, Congress has legislated an advantage for Phillips over me, lower taxes. But, thanks to your past efforts, Congressman Talent, as well as those of a few other Members of Congress, like Senator Bond, we self-employed are finally on a schedule to deduct 100 percent of our health insurance costs by the year 2003.

Still, as the SETRA bill acknowledges, people without health insurance should not be asked to wait four years to get sick, and the many people who struggle to get by with 60 percent deduction now should not have to wait four years to get a tax advantage that General Motors has enjoyed for half a century.

I would like to add one other personal note. When I came before you in this Committee two years ago, I said that if Congress increased the health insurance deduction for the self-employed, I could use the money to hire more part-time help for my company. Well, you did, and I did. Today I use more part-time help than I did then, thanks, in part, to the higher health insurance deduction. I also have one full-time person working for us, and, because I try to be a good employer, I provide her with 100 percent of her health insurance.

But think about this: Since she is an employee of my business, the insurance that I offer her is fully excludable from my business' taxable income. That is a better deal than I can get for my own family. The insurance that I purchase for my own family, same policy, same providers, same everything, because my wife and I are self-employed, still is only 60 percent deductible. Luckily, I can afford to buy health insurance for my family, but I'm sure that there are many self-employed people who cannot.

The statistics show that somewhere between one-fifth and one-fourth of us don't have health insurance, and cost is, by far, the most important reason. The current tax law undoubtedly is creating situations where self-employed people with employees can afford to buy health insurance only for their employees, but not for themselves and for their own families. Certainly some people will be selfless in such a situation. They will buy the health insurance for the employee and not for themselves, but other people will think, "How can I possibly explain it to my family that I'm buying health insurance for someone else, and not even for us?" Therefore, they might not offer the health insurance to their employees.

Increasing the self-employed health insurance deduction to 100 percent could help more than the self-employed. It may well result in more employees of small business getting employer-provided health insurance, and in a time when an estimated 40 million Americans don't have health insurance, anything that could help a few more Americans get health insurance would certainly be in the social interest of the country.

Thank you again for all of your work to get this deduction up to 60 percent. I hope we can finish this job this year. Thank you for allowing me to testify.

[Mr. Joseph's statement may be found in the appendix.]

Chairman TALENT. Thank you, Mr. Joseph.

Our next witness is Mr. Eric Wallace, a CPA with Carbis Walker and Associates, of Pittsburgh, Pennsylvania, who is testifying on behalf of the Associated Builders and Contractors, Inc. Mr. Wallace.

STATEMENT OF ERIC WALLACE, CPA, CARBIS WALKER AND ASSOCIATES, LLP.

Mr. WALLACE. Thank you. I know how loved attorneys are in Washington, and apparently CPA's are getting in the same light, so thank you.

My name is Eric Wallace, CPA, and I speak on behalf of the Association of Builders and Contractors. ABC is a national trade organization representing more than 20,000 firms in the construction industry. ABC's diverse membership is bound by a shared commitment to the philosophy of rewarding work based on merit. With 80 percent of the construction today performed by open shop contractors, ABC is proud to be their voice.

I am a practicing CPA with over 20 years of experience serving construction contractors and service providers from across the country in the fields of taxation, accounting, and consulting. I recently researched, published, and authored an article titled, "The IRS and Cash Basis Contractors," that appeared in the Construction Financial Management Association, as well as the ABC publication. My extensive experience dealing with this issue enables me to provide to you specific expertise and insight regarding the proposal in SETRA to clarify that small business taxpayers are allowed to use the cash method of accounting without limitation.

Ms. Velazquez referred to the accounting rules, and I am trying to bring some reality to what we are talking about here when we talk about accounting. A lot of people seem to go into a gray matter when we talk about accounting. I am trying to bring some perspective as to how this really affects a lot of contractors from across the country and how serious this is from them.

The IRS is targeting just about all contractors and service providers who report their taxable income on the cash method of accounting. One of the most onerous audit adjustments a contractor or service provider can face is an IRS initiated change in its accounting method from the cash to the accrual method. The IRS proposed audit changes typically subject the taxpayer to six figure assessment, with the majority of this based on accrued interest and penalties, not necessarily a tax increase.

The difference between the cash method and the accrual method is not that the accrual method necessarily results in a greater taxable income, and, therefore, greater revenue. It is a matter of timing. Under the cash method, we report all of our income as we collect it, and our deductions as we pay them. For example, if we collect our income earlier and don't pay our payables, we actually report our income sooner.

But, now more than ever, the IRS is pushing their cash audit position change on a national level. They are basing this on a publication in late 1997, titled the Construction Audit Technique Guide, or ATG, as part of its national market segment specialization program.

In their ATG, it states to the IRS examiners, that they should generally conclude that a contractor or service provider should be changed from the cash basis of accounting when their material costs as a percentage of their receipts is 15 percent or more, and, depending on the facts and circumstances, they can make this assessment when the ratio is less than 15 percent.

This position is not based on any code section, but is a result of several court cases successfully litigated by the Service. This push is based upon an IRS certain logic flow. Their foundation flow is summarized as follows: materials are merchandise. If the cost of merchandise is over 15 percent of the gross receipts, it is a significant income-producing factor. If material is a significant income-producing factor, the contractor or service provider must use inventories. If the taxpayer is required to use inventories, it is required to use an accrual method of accounting.

The result of this arbitrary national push by the Service would leave few, if any, contractors or service providers remaining on the cash method of accounting. One of the IRS authors of the Audit Technique Guide stated to me that the only type of cash basis contractor that the Service is permitting to stay on the cash basis is an asphalt contractor who does not produce asphalt in their own plant.

Think about that for a second. Of all of the potential contractors and type of contractors there are, the IRS is saying there is only one type left to be able to be on the cash method.

Chairman TALENT. Mr. Wallace, let me interrupt for just a second, because we're going to have a vote and I don't know if everyone will come back, and I want them to understand this issue, because they are probably being contacted by the contractors, so I am going to take the unusual step of interrupting. A few of us up here are not accountants. So, when you talk accrual method, that means that if a guy or gal is a painting contractor and they paint your house and finish the painting, the IRS says you have to report the income from that job the day you finish the painting and are entitled to be paid, even if the homeowner doesn't pay you for 60 days. Is that correct?

Mr. WALLACE. That is almost correct. When you are invoiced is where you recognize the revenue, even if it might take them six months to pay you. So you are paying taxes prior to your collection.

Chairman TALENT. So they want you to pay taxes on income that you have, admittedly, not received at that point?

Mr. WALLACE. That is correct.

Chairman TALENT. Okay. Go ahead.

Mr. WALLACE. Thank you. Thank you for your question. The IRS denies that there is a national coordinated effort to focus on construction contractors and service providers, and that they are merely enforcing the laws as they interpret it. I do believe, however, that there is a national effort based upon the calls that I have received from across the country from contractors, service providers, and other practicing CPA's saying, "here is the situation I face, what are my alternatives in this situation?"

For example, a carpet installer from Michigan called me. He was being audited by the IRS, doing \$1.2 million in revenue. He had materials and supplies equaling 12 percent of his revenue, not very significant at all. Again, this is less than that 15 percent. The IRS only audit change was to change him from the cash to the accrual method. The cost to him was over \$100,000. The IRS auditor had told him that, "I am basing this upon the new audit technique guide."

I advised an underground utility pipeline contractor to voluntarily change before the IRS came after him. It would cost him \$100,000. It would put him out of business.

A window installer from Texas called me. He had 20 percent of revenues in material cost of revenue. He was fearful of the IRS coming in, and, if they do, based on mandatory assessed interest and penalties, would literally put the guy out of business.

The Service believes that, based upon a series of court decisions, their position to change all contractors and service providers from the cash method to the accrual method is justified. That is in past conflict with the congressional intent. I have a quotation in my testimony related to the Tax Reform Act of 1986 where Congress said, "The Committee recognizes the cash method is generally a simpler method of accounting, and that simplicity justified its continued use by certain types of taxpayers and for certain types of activities. Small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher cost of compliance which will result if they are forced to switch from the cash method."

A head IRS construction industry specialist stated to me that based upon the current IRS approach and court cases, cash basis contractors and most service providers will not be able to maintain the cash basis position or have it supported in court. "Their only solution is a congressional change."

Section 7 of the SETRA would provide such a needed congressional solution. The IRS makes a statement in their audit technique guide that the use of an inventory accounting method is required in every case where the sale of merchandise is an income producing factor. It doesn't matter that inventory accounting methods may result in inventory balances that are zero or minimal. They are not maintaining inventories. It is clear that the Service position is inappropriate. The SETRA would stop the Service's universal push against the cash basis contractors and service providers, and enable these small business to utilize the simpler cash method without fear of IRS reprisal.

I want to thank you. I want to thank Chairman Talent and Representative Phil English for leading the effort to end IRS abuse of

the cash basis contractors, and for introducing this straightforward legislation to solve this problem. Thank you for letting me present ABC's views on this important issue, and I welcome any questions you may have.

[Mr. Wallace's statement may be found in the appendix.]

Chairman TALENT. I'm going to ask a couple of questions and then I will recess the hearing. I certainly understand if members want to get over there and vote and get back. I will hurry.

I want to follow up on this subject a little bit, Mr. Wallace. What they're basically doing is taking a method of accounting that is appropriate when a business has a lot of inventory and applying it to contractors who don't keep any inventory, who only buy paint or asphalt per job. And they call that inventory?

Mr. WALLACE. That is correct. That is a good observation. If I've got a contractor who builds a building, say, for example, they put up one of these pre-manufactured buildings, and the only thing he does is put up the pre-manufactured building, he doesn't have to buy the material; maybe the owner supplies the material; the IRS is coming in and saying, "I don't care, you bought it for this job. You still have to——"

Chairman TALENT. That is, in effect, your inventory. The accrual method, which means that you take your deductions and you report your income, at that time where you have a legal obligation to pay or a legal right to be paid, makes some sense when a business carries a lot of inventory because you're getting your inventory. You are not necessarily paying the cash for that right away, but you get to take the deduction right away?

Mr. WALLACE. That is right.

Chairman TALENT. So, if you are not getting paid for the sale right away, but you're having to report when you have a legal right to pay, at least there is a balance there. You're getting your deductions earlier and you're reporting the income earlier. That is the logic behind it?

Mr. WALLACE. That is the logic. If I am buying inventory, I should not be able to write off the cost of my inventory, because I am not selling it yet. If you are a contractor, that is not what they face. They are not doing inventory; they are doing job costing.

Chairman TALENT. Right. It doesn't make any sense at all when a business doesn't have a lot of inventory, because then they don't have the accounts payable that they would not be paying for 30 days or 60 days, but taking a deduction on early.

Mr. WALLACE. That is correct.

Chairman TALENT. So there is an imbalance there. That is the reason the people have done it on a cash basis all of these years.

Mr. WALLACE. That is right. A contractor faces a lot of obligations. People want to be paid, and they want to be paid quickly. The cash basis really is a good reflection of what their income is.

Chairman TALENT. Would you, as an accountant, apart from the tax consequences, recommend to these people a cash method for these purposes just as the best way of keeping the books?

Mr. WALLACE. Yes, that is how they manage their business. It is really difficult for me to sit down with an owner, contractor, or service provider and say, "You manage your business on the cash method, but the IRS is going to ask you to pay taxes a lot earlier

based upon the accrual method.” They look at me and they get very frustrated.

Chairman TALENT. I took the member’s time to go into that before we go voting in case people didn’t come back. That is the aspect of this that I think may be the most difficult to understand, if you are not familiar with it. But, certainly, these other issues are important.

And I will recognize the gentlelady from New York as soon as we come back. We’ll recess the hearing to be able to go and vote.

[Recess.]

Chairman TALENT. We’ll reconvene the hearing.

I want to ask one more question, very briefly, and then I will recognize the ranking member. I have a press conference at 11:30, so I just want to make sure I have a chance to explore this a little bit.

Mr. Wordsworth, the provisions in the bill relating to the meal deduction apply to smaller businesses. I, personally, would like to expand it and apply it to everybody, but there is a reason for that. You talked about it a little bit in your testimony how small business people, I don’t mean the size of the person; I mean the size of the business. [Laughter.]

People who run smaller businesses or participate in small business use restaurants like yours to develop business in a way that larger companies might use a corporate conference room or the golf course, or something like that. Go into how restaurants are used, maybe especially by the smaller-type businesses.

Mr. WORDSWORTH. My colleague here, for example, has his business in his basement. You couldn’t go out and meet with a large company and invite them over to your basement through the back lawn. I believe what you would do is pick a lunchtime, and you would make a reservation for 4:00 to 6:00 or 8:00, and it gives you a window of time. If you work intently at this—and as a small business person, everything you do has to be intent, because you can’t fool around—you will set the meeting for two hours, and it is four to six people, and you can do that over lunch—in somebody else’s real estate, and in an office that you don’t have to maintain that has public accommodations, that is geographically located, so you have the largest number of people. So, it is the ideal way to conduct a business.

If I can just take a moment to contrast it, put a box around it—to run an ad in The Washington Post, a small ad, for one day, let’s say it is \$424.60, one time. That is a shotgun approach to meeting with people. If you take a rifle approach, because as a small business you can’t just throw out shotgun approaches, a luncheon at my restaurant in Tysons Corner, which is a fine dining, tablecloth restaurant, at lunch averages \$11.85. So, it is far more effective for you to have an eye-to-eye contact with the principal at \$11.85 capped cost, and that includes everything—desserts, beverages, whatever you have—versus this shotgun approach. So, people have done that for years that can’t maintain meeting facilities. You just can’t do it for an occasional meeting—if that is a good example.

Chairman TALENT. That is exactly what I am getting at. It is a fitting point to recognize the young lady from New York because of her excellent work on all of these subjects. In particular, I think,

I know she has a very powerful interest in the meal deduction, and I am very pleased to recognize her for such questions that she may wish to ask.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Joseph, I just would like to say that, based on the kind of support that we have seen here in this Committee, where it is pretty even Republicans and Democrats supporting 100 percent deductibility, it is important that we understand that the only way we could enact this legislation is by getting bipartisan support, and we are going in that sense to make sure that we pass such legislation.

I would like to ask you, do you have an idea of how many of these 6 million people would be covered by health insurance if we had 100 percent deductibility?

Mr. JOSEPH. I don't have any idea. There is no doubt that it would be more people.

Ms. VELAZQUEZ. I'm sorry. I'm sorry. I wasn't listening, please.

Mr. JOSEPH. I said I don't have any numbers or estimates, but it stands to reason that more people would be covered.

Ms. VELAZQUEZ. Have there been any surveys or other attempts to quantify the likely impact of this change?

Mr. JOSEPH. I am not aware of any, but I will ask the people at NASE to inquire about that and get back to you.

[The information may be found in the appendix.]

Ms. VELAZQUEZ. Well, I guess that you answered that question. I would like to ask some questions to Mr. Wallace.

First of all, Mr. Chairman, I would like to point out the fact that I wish that we had an IRS representative here, and I hope that in the next occasion that we have such an opportunity that we have a witness such as Mr. Wallace, that we bring in a person from the IRS to be able to react to your testimony, and in some way your accusations.

Chairman TALENT. If the gentlelady will yield for just a second, I agree totally. When he was saying what he was saying, which personally I agree with, we should have had the IRS to respond and to allow the Committee to inquire into how they've conducted things. If we have a hearing on this subject again, we definitely will have somebody from the IRS here.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Wallace, I used to be a college professor, and I have to tell you that, if I had a student who reached the conclusions in the way you did, I would have failed him. Having said that, I would like to ask you, your testimony seems to indicate that the IRS is guilty of unreasonably forcing small businesses to use the accrual method of accounting, as opposed to the cash method. My question to you is, if the IRS has won most of the court tests involving the accrual versus cash basis question, fair to accuse or imply that the IRS of being on some sort of vendetta in this area? It seems to demonstrate to me that the IRS is simply carrying out the law as Congress intended.

Mr. WALLACE. I appreciate the opportunity to respond to that. I have watched the IRS for 20 years go after construction contractors and service providers. They first tried it from an inventory approach and were consistently knocked down in court cases. There was a specific court case that was decided. It was a court case that

came out and said, "If your merchandise is 15 percent or more of your revenue, it is a significant income-producing factor and you should be on the accrual method." That court case was a casket case in a funeral parlor. The IRS has taken that case and has applied it to various industries, and because of their success, they have tried it in the construction and service-related industries, and they have been successful.

Ms. VELAZQUEZ. That is one court case compared to the many court cases that IRS won?

Mr. WALLACE. That is the foundation in their logic flow.

Ms. VELAZQUEZ. Mr. Wallace, I take it that you think the accrual method costs more to maintain, putting aside the tax consequences? Do you have an estimate of the relative costs of each method?

Mr. WALLACE. I appreciate that type of comment, and as a CPA, I should probably be here supporting the IRS. I should probably be here supporting their actions, because I make more money. I make more money when the IRS comes in and says, "You have to be on the accrual method, and because of that, you have to hire an experienced CPA who understands that."

But, coming down to what is common sense and how the industry can better function, I have to side with the contractor to say that, when we start in our business, we want to start and give our costs, whether they are attorney costs, CPA costs, insurance costs, whatever those obligations are, for the starting contractor or service provider to keep their costs as low as possible. The cash method can best make that happen.

Ms. VELAZQUEZ. Can you tell me how much it would cost a business with \$4 million in gross receipts to use the cash method, and how much more to use the accrual method?

Mr. WALLACE. From a tax and reporting—because we now have to hire personnel inside and outside to take care of that. If I was a guessing individual, based upon my experience, I would say \$20,000 more a year.

Ms. VELAZQUEZ. What about the tax implications of changing from the accrual method to the cash method? Does one method produce more tax savings than the other? Is one method potentially more easily abused than the other?

Mr. WALLACE. That is a good question. There are four basic methods a contractor can apply. There are two of them that we have talked about today; the cash and the accrual. The other one is the completed contract and the percentage of completion.

Depending on the type of contractor, depending on when they invoice, depending on when their jobs are completed, any of those four methods can—I don't want to say manipulate, but can change your income reporting. It is clearly only a matter of time—if we start the year and end the year with all of our monies collected and billed, every method produces the same result. It is only a matter of timing. So, from an IRS perspective, they will get their money. They do get their money. It might not be this year. It might be the year following. Where the IRS is coming in and going after the cash method, they are getting their money on that timing, and because of the mandatory law requiring interest and penalties, that is where they're looking for their funds.

Ms. VELAZQUEZ. Thank you, Mr. Wallace.

Mr. WORDSWORTH, I would like to ask you, in terms of the meal deductibility. Do you know what percentage of the typical small firm's marketing budget will be devoted to meals and expenses? How does this compare to large firms?

Mr. WORDSWORTH. I'm not sure I can answer your question in exactly that way. But, as I said before, and I want to comment, I enjoyed your comments so much in the beginning. I think you really have a handle on things.

If you are a small business, your contracts and your contacts are made one-on-one. If you're one-on-one, you must meet somewhere. You must have a contract. You must have a presentation. So, I would say, not necessarily in numbers of occasions, but in the importance of the occasion, that you be able to sit down somewhere. You couldn't do it in the drycleaners. You couldn't do it in the metro. So, that is why restaurants are chosen as the chosen venue.

Ms. VELAZQUEZ. Have you done any analysis of what an increasing meal deductibility might mean for those it benefits?

Mr. WORDSWORTH. I haven't done an analysis myself, but I am aware of one that I sincerely agree with. In my State of Virginia, tourism is a great cash-flow item for us, which I have chaired for several years. I know that the Bureau of Economic Analysis, I believe, using their formula, the National Restaurant Association has determined that in my State the impact for the life of this increase would be about \$145 million. Now, tourism annually in Virginia does about \$11 billion. So it is a significant increase, and it is mostly vested in smaller businesses.

Ms. VELAZQUEZ. Thank you.

Mr. MANZULLO [presiding]. Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman.

Mr. Wallace, I particularly enjoyed your testimony, having worked with construction people most of my life. I want to visit with you a little bit about the issue with regard to the cash basis accounting.

First of all, accrual accounting methods are far more complex. The reason that it is a good thing for small businesses to be able to do cash basis is that they can basically keep their records out of a checking account, or a very simple accounting system. In accrual accounting, you have to put receivables and payables and all that sort of thing. But, there are two kinds of accrual accounting systems that you made reference to. One is completed contract, and the other is percentage of completion.

The IRS forces contractors—I think it is \$5 million or more now have to go to percentage of completion method. The percentage of completion method is really complicated, isn't it?

Mr. WALLACE. Absolutely.

Mr. HILL. Would you just comment about the added complexities that come from the percentage completion accrual method of accounting?

Mr. WALLACE. The thresholds are \$5 million and \$10 million. There are a couple of different thresholds, if you'll permit me to make that statement. Like I'm saying, there is the cash, the accrual, the completed contract, and the percentage of completion. The percentage of completion and the completed contract are ac-

cruel methods, in that you first have to have an accrual method to recognize your basic accounting methods. The completed contract and percentage of completion deal with the accounting related to the contracts. So, in addition to the accrual method, we now have to track accounting for each individual contract.

Mr. HILL. It is like having a profit-and-loss statement for every job.

Mr. WALLACE. Correct. That is a good observation.

Mr. HILL. One of the things that I discovered working with construction companies, or small business in general, is that cash is key. Most small businesses struggle for cash. Many small businesses show profits but don't show cash. In fact, one of the most troubling things I've ever experienced is watching people borrow money to pay their taxes, rather than borrowing money to build their business. I think one of the reasons Congress supports the cash method of accounting is for that reason; that is wants small business to succeed.

Under the cash system—and you made this point in your testimony—it is a matter of timing. You don't avoid the tax. In fact, if you don't manage it well, you could wind up with a big tax problem. It could work the other way; you actually pay more in taxes. So, this isn't a tax avoidance; it is a tax timing. What it does is allow the business to pay the tax when it has the cash to do it.

Mr. WALLACE. That is correct. That is a good observation. So, if you look at the revenue, it is a neutral part of the provision when we talk about what it is going to cost the taxpayer to enact this. It is revenue-neutral.

Mr. HILL. I would agree with that.

Mr. Wordsworth, I happen to agree with you with regard to the deductibility of meals. I had a business where I had salesmen, and I decided when the IRS made this change that I was going to continue to pay those meal expenses, and that really made my accounting system complex, because then I had to do two profit and losses, one for the IRS and one for the bank, because of what was a deductible expense and what was not a deductible expense.

I just ask you this: Is another potential to get to the 100 percent to maybe put some limit on what is a deductible meal? Is that something that would make some sense as well?

Mr. WORDSWORTH. As a matter of fact, that is what I have thought many times as an approach that should be used. I think the inception of the original act itself was to stop abuse. I think abuse would occur more in higher numbers. If you had a \$50 lunch, I don't think that is middle America. I don't think that is small business. I think that is something else. But we, small business, and a reasonable lunch and a reasonable dinner got taken in the wake of pursuing the \$50 lunch, and I don't recall in my 25 years that lunch occurring in my business.

Mr. HILL. Your prices aren't that high? I can remember when I started my business, we had a two-room office. We had four people in those two rooms. When we had a customer come in, we took them to the coffee shop or we took them to the restaurant. As you said, that is where we did our business. The last thing you want to do, if you're prospecting, is let them pay the bill. So, the idea that we've taken that away, I mean, it is a legitimate business ex-

pense and it is important, particularly to small businesses, I think. So, I certainly will do whatever I can.

Mr. MANZULLO. Mrs. Christian-Christensen.

Ms. CHRISTIAN-CHRISTENSEN. Thank you, Mr. Chairman. I really don't have any questions. I want to thank the witnesses for coming, and let me just say, as a member of the travel and tourism caucus, we supported the increase in the meal deduction last year, and we are pleased to support it again this year. As a physician, it really just makes good sense to allow the self-employed to deduct their full insurance. The other issue is very, very complex, but I think what we're reaching for is simplicity and lifting burdens from small business. Thank you, Mr. Chairman, and thank you for your testimony.

Mr. MANZULLO. Mr. Pitts.

Mr. PITTS. I yield back to Mr. Hill. I was enjoying his questions. [Laughter.]

Mr. HILL. I apologize. I really don't have any more specific questions, other than—and any of you might want to address this—that Congress has been explicit in the past with regard to its intention for small businesses, and the IRS has consistently, in its interpretation, tried to shift that away from the intent of Congress. Do you believe that the language that is in this bill is sufficient to make adequate clarity to the IRS to deal with the concerns and issues that you have raised here? I would like to ask each of you to respond to that, and then I will yield back my time to the chairman. Thank you.

Mr. MANZULLO. Okay. Mr. Moore. Where are we? Oh, I'm sorry.

Mr. WALLACE. I believe there is adequate clarity, and if I have reading this from a CPA perspective, certainly the provisions for business meals, there is nothing left to doubt. The deduction for health insurance, there is nothing left for doubt there. I am sure that this cash-versus-accrual issue for the small service providers and contractors will, no doubt, continue to be—I know that there are some feelings that I have been overly aggressive in my comments, but I am more than able or willing to sit in front of an IRS representative, including the top dogs, because I have sat with them on many panels and had these same discussions, and I am adamant about my conversations related to this. I think this is absolutely needed.

Mr. JOSEPH. I've been brought here to talk about health insurance, but I have to tell you, listening to my colleagues here talking about these other things, these are issues for us, too. We're on the accrual basis. I would much rather be on the cash basis. I used to be on the cash basis when we weren't a subchapter S corporation. It was better. It was easier. It was less complicated. A big part of my business is consulting, and I was talking during the break to my colleague here. Consulting clients think nothing of waiting four to six months or so to pay you. You bust your brains out for them, and six months later maybe the check comes. By that time, it is the new year and you've paid the taxes in the old year.

Restaurants? I was in a restaurant yesterday in a business meeting. I'll be meeting a client in a restaurant tomorrow for probably four hours or so for a business meeting. It couldn't be more true. I used to have a larger business. I sold most of the business eight

years ago and moved the business into the house for a lot of reasons; personal reasons were large among them. We have to use my dining room as a conference room. Luckily, we have a very nice dining room and it works pretty well. But, most of the time, if I am having a meeting, I will go to Clyde's in Chevy Chase, or something like that, and we will meet there. It is not an extravagance. I am not trying to beat the system or anything; it just works better.

As far as health insurance goes, we aren't publishing in healthcare now. We used to publish in healthcare more, so I know a fair amount about uninsured Americans and stuff like that, and I think anything that will bring some more people into the tent will be good. I saw trends operating 10 years ago that I thought were going to bring more Americans under health coverage, and instead, it is going in the opposite direction. There are 5 or 10 million more Americans today than there were 10 years ago, when it was viewed as more of a crisis, it seemed.

So, I just want to associate myself with the other witnesses here and say that these are all important issues, not just for small business, but for America.

Mr. WORDSWORTH. I certainly hope there is clarity. I remember the Family and Medical Leave Act. Coming out of Congress, I think the bill was 47 pages. The legislation and the code ended up being something like 900 pages, and it was interpretation upon interpretation versus the spirit versus the letter. So, I hope there is great clarity in this. The reason that I do hope there is great clarity is because these items affect so many people. It is such good that can be done. I hope that in the implementation, that the regulators, the people who write the code, carry out the intent of your act.

Mr. MANZULLO. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Wordsworth, you and some of the other witnesses have made the point that, for small businesses, a lot of times a restaurant or other dining facility is the office, and I guess my question to you is that you also made the point that Congress, several years ago, addressed the issue of abuses by placing limitations on lunches or dinners.

My question to you, then, is: If a cap is appropriate, what would you suggest would be an appropriate cap? I guess I'm agreeing with you that for somebody to go out and have a three-martini lunch and spend \$50 or \$75 is probably abusive. But, what would be an appropriate cap? Twenty-five or \$30? Do you have an idea?

Mr. WORDSWORTH. Well, if you try to think about that comprehensively, geography has a lot to do with it. In North Carolina, a \$25 lunch is extravagant. In New York, it might just buy you a hot ham and cheese. [Laughter.]

Mr. MOORE. What's wrong with hot ham and cheese?

Mr. WORDSWORTH. Without mayonnaise. Hold the roll. But, I think a \$50 lunch almost anywhere is pretty extravagant. I think \$125 dinner is pretty extravagant, I would think. I would go so far as to say, I don't want to alienate my colleagues who may have those kinds of lunches, but small business, that people who qualified, and were covered under this act, if you were willing to spend \$50 for that lunch or \$125 for that dinner, it would have to be for a magnificent reason. This is the ultimate contract signing that

will give you two years of revenue. So, in that case, that might be an appropriate reason. In that case, I would be willing to lose the deduction if it were that magnificent. But what is impaired by this is the ordinary, everyday, fact-of-life, pedestrian kind of marketing activity, is what got caught in the wake of the ship.

Mr. MOORE. Well, I understand that, but if the fact brought up here is correct and the average lunch is \$11.60, the question is, if we are going to allow people to take 80 percent of \$125 meal deduction without any limitation, and asking the United States taxpayers to subsidize that—

Mr. WORDSWORTH. Well, in that case, as I said, in that case, if you had a \$50 lunch, I would say you don't get to deduct it at all, because it would be such a small occasion and be worth it. I wouldn't even cover it.

Mr. MOORE. I want to apologize to the other Committee members. I am the new kid on the block here, a relatively new Member of Congress, I guess five months now, but I don't know what discussion there has been regarding limitations placed on this, but I would think that might be an appropriate consideration. Thank you.

Mr. MANZULLO. Okay. We want to thank the first panel. But before we do, Jim, do you remember when I first got elected, I went to your restaurant when I think your dad was there with the finest barbecue ribs in the world. Do you remember that? [Laughter.]

Mr. WORDSWORTH. I think I have your picture in our lobby. I do remember that very well, and I appreciate that.

Mr. MANZULLO. It wasn't a \$92 lunch. It was very reasonable. We want to thank you for coming here. Is your father still involved in the restaurant?

Mr. WORDSWORTH. Yes, he is. He is 79 years old.

Mr. MANZULLO. Is he down in North Carolina with your brothers?

Mr. WORDSWORTH. Down in North Carolina with my brothers, who started a distribution company as a small business, and now they are the fourth largest in the U.S.

Mr. MANZULLO. That is great. That is a great example of a small business that was started by your grandfather. Is that right?

Mr. WORDSWORTH. Actually, by my father, J.R. We call him "Big Foot."

Mr. MANZULLO. That is great. We appreciate you taking your time to be here. Thank you for the courtesy of coming to testify before us.

If we could have the next panel, please? We have our next panel, and what I would like to do is to introduce each of you and then put on the five-minute light. Please try to abide by that light, because I'm going to try to keep the members up here to the five-minute light, also.

The first panelist is Terry Neese, who is the CEO at Terry Neese Personnel Service in Oklahoma City, Oklahoma, a corporate and public policy advisor for the National Association of Women Business Owners in Washington, D.C. She will be followed by Brian Reardon, who is Manager of Federal Public Policy for the NFIB, here in Washington. Then Bill Sinclair, Senior Tax Counsel and Director of Tax policy, Economic Policy Division, at the U.S. Cham-

ber of Commerce will testify, and then Dorothy Coleman, Director of Tax Policy for the National Association of Manufacturers in Washington, D.C.

Ms. Neese.

**STATEMENT OF TERRY NEESE, CHIEF EXECUTIVE OFFICER,
TERRY NEESE PERSONNEL SERVICES**

Ms. NEESE. Good morning, Mr. Chairman and Congresswoman Velazquez, and members of the Committee. I am Terry Neese. I own a business in Oklahoma City, and am past national president of the National Association of Women Business Owners, and currently serve as a consultant to NAWBO on corporate and public policy issues.

NAWBO represents this country's 9 million women business owners. We are employing about 27 million workers today, and generating \$3.2 trillion in annual revenues.

I want to discuss today the simple tax relief proposals for small business, what they mean, and why they're important, especially for women-owned businesses and minorities.

First, I want to talk about the increased small business expensing. Small businesses continue to invest in property and equipment in order to maintain growth and efficiency in the market place. Typically, small business owners will choose to pay for these assets in advance rather than finance the acquisition over time. This decision is based on the difficulty of obtaining term loans for small equipment acquisitions from lending institutions, as well as the business owners' desire to re-invest the profits back into the business for long-term growth, development, and stability.

The current expensing limit of \$19,000 is not allowing small business to keep up with the increasing costs of equipment and technology. An increase to \$35,000 would enable the small business owner to maintain their equipment acquisition needs by reinvesting profits. They would also not incur a tax burden on the difference between cash expended and tax deduction allowed. This provision will assist in maintaining the wherewithal-to-pay concept, whereby taxable income is essentially equal to cash flow.

Providing tax accounting relief to small business. Under current law, small businesses are required to use the accrual method of accounting for income tax reporting if they are involved in merchandise sales and maintain an inventory. Although this provision provides for a clear reflection of income earned, it does not necessarily result in a matching of taxable income to cash flow. Typically, the small business owner must maintain a material amount of inventory, as well as float a large amount of accounts receivable.

On the other side, the small business owner will acquire the inventory with COD or 30-day payment terms. This timing difference creates a need for flexible financing from lending institutions who are not particularly interested in writing up small business credit lines to finance inventory and accounts receivable.

In addition, funds must be borrowed in order to pay the respective income taxes on merchandise sold and included in taxable income, even though the proceeds from the sale have not been collected. This provision under the Small Employer Tax Relief Act will

again assist in maintaining the important wherewithal to pay concept for small business.

Repealing the Federal Unemployment Payroll Surtax. The 0.2 percent surtax was intended to be a temporary increase to repay government loans from the Federal Unemployment Trust Funds. These loans were paid 11 years later, in 1986; yet, the surtax has continued to be assessed and collected.

The fact that this surtax has continued 12 years past its original intended and represented purpose is truly an inequity that unfairly burdens the small business community. The Federal Unemployment Tax is assessed on the first \$7,000 of wages per employee per year. Thus, the turnover of employees and the hiring of temporary employees or seasonal employment further escalates the employment tax burden on the small business owner. This 0.2 percent surtax should be repealed now.

The 80 percent tax deduction for entertainment and meal expenses. Small minority and women-owned businesses typically rely on close personal relationships and customer service to compete for sales, rather than on expensive advertising campaigns. Expenditures for meals and entertainment are often an important part of this effort. Relationship marketing is key to women-owned businesses. Being able to sit down across the table from a client or prospective client is the best form of sales and marketing techniques available.

The prior changes in the tax laws that disallowed 50 percent down to 30 percent of these expenditures for tax purposes have disproportionately increased the selling costs for many small and women-owned businesses. Ten years ago, business and travel meals were 100 percent tax deductible, as ordinary and necessary expenses. Looking for revenue, Congress lowered the tax deduction to 80 percent in 1987, and 50 percent in 1994. This results in an unfair and disproportionate tax increase on the restaurant and entertainment industries and the business customers they serve.

This cutback has been particularly punitive for the small business community, and this is evidenced by the fact that the White House Caucus on Small Business cited its restoration as one of its top two priorities. So, reinstating the 80 percent, and ultimately 100 percent, tax deduction for meals and entertainment expenses is the right thing to do for this Congress, and the fair thing to do for women-owned business.

One hundred percent deductibility of health insurance for the self-employed. This is a no-brainer. The fact that the self-employed can not deduct 100 percent of healthcare premiums is a glaring inequity between large corporations and the self-employed. The 100 percent deductibility of health insurance for the self-employed is favored by large majorities of both parties in both houses of the Congress, spanning every region of the country and every political philosophy, including the White House. Now, we need a strong political will to find the formula that can make the change happen. Over 16 million Americans could benefit from this tax relief.

I would be remiss if I didn't also mention the onerous death tax issue in this testimony. Relief from the current death tax enables children to keep what they rightfully inherit, such as the farm that has been in their family for generations, or the small business that

has helped them live the American dream. Now, many have to sell their family legacy just to pay the taxes. This is an issue near and dear to my heart. My daughter recently joined my firm. I want her to carry on my legacy. She, in turn, may want her daughter, my granddaughter, to carry on my legacy. Will we be able to do that without selling the company to pay the death taxes? Only this Congress can answer that question, and that is a huge burden that you can eliminate this year. Thank you very much for allowing me the opportunity to present this testimony.

[Ms. Neese's statement may be found in the appendix.]

Mr. MANZULLO. Thank you very much.

Mr. REARDON, IF YOU COULD PLEASE FOLLOW THE LIGHTS ON THERE. I want to get the testimony in before we get a huge series of votes on the defense bill.

STATEMENT OF BRIAN REARDON, MANAGER, FEDERAL PUBLIC POLICY, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. REARDON. Okay, I will go very quickly. Good morning, my name is Brian Reardon. I am the Manager of Federal Public Policy at the National Federal of Independent Businesses. We represent 600,000 independent businesses nationwide, and I appreciate the opportunity to represent or present the views of small business owners on the legislation outlined by Chairman Talent today.

NFIB supports all of the provisions contained in this legislation, including the reduction in small business tax rates, 100 percent deductibility for the self-employed on their insurance costs, and increasing the business meal deduction.

Right now, though, I would just like to focus on two provisions within the bill. That is the repeal of the FUTA surtax, and increasing small business expensing.

NFIB supports comprehensive reform of the Federal unemployment system. Right now, the Federal Government collects payroll taxes to fund the administrative and extended benefits of the Nation's unemployment system, and the States collect payroll taxes to fund the regular benefits. There are four good reasons why this system should be reformed.

First, payroll taxes at the Federal level have never been cut. Since their enactment in 1937, they have only gone up, and while Congress, when it has a tax bill before it, tends to focus on the income tax side of the burden, for most small employers, for most workers, the payroll tax burden is significantly higher than income taxes.

The second reason is, Federal taxes collected by the Federal tax, the FUTA tax, are about twice as much as is necessary to finance the system. In 1997, FUTA collected \$6.1 billion from FUTA, but Congress only spent \$3.5 billion. FUTA taxes should be cut to reflect the costs of the system.

Third, the system is simply too complex. Right now, employers pay both a Federal unemployment tax and a State unemployment tax. That is twice the collection points, twice the complexity, twice the paperwork burden, and twice the opportunity for errors in fines from the IRS. There should only be one point of collection.

Finally, there is the FUTA surtax. As Terry mentioned, this temporary tax was enacted in 1976 to repay the borrowings from the unemployment trust funds. It was fully repaid back in 1987, and Congress has extended this surtax five times. Chairman Talent's bill would repeal this surtax, and we certainly support that. This temporary tax has survived the Carter Administration, the Cold War in the Soviet Union, and NIFB's hope is that it won't survive the millennium.

Expensing. Chairman Talent's bill would also raise the cap on small business expensing from \$19,000 to \$35,000. The purpose of small business expensing is two-fold. First, simplification, and second, cash flow.

Regarding cash flow, small business expensing encourages small businesses to invest by reducing tax liability and increasing their cash flow. Almost 70 percent of our members report having made a capital expenditure in the last three months. Expensing allows those members to recoup some of the cost in the first year that they make the expenditure.

For those members who report having a capital expenditure in the last three months, almost half of them report having a capital expenditure that exceeds the current cap of \$19,000 for small business expensing. By raising the cap, Chairman Talent's bill helps reduce the cost of investment for many of those small businesses.

The second reason is simplification. Deducting investments immediately is simply simpler than depreciating them over a number of years. For relatively small capital purchases, maintaining records and calculating depreciation schedules is perhaps the most complicated exercise a small business has to go through. They have to determine appropriate categories and schedules; they have to keep extensive records. By raising the cap on small business expensing, Congressman Talent's bill would allow our members to sidestep much of the unnecessary complexity, allowing them to focus more on their businesses.

In conclusion, taken as a whole, the Talent bill goes a long way towards creating a simpler, fair tax code for small business, and NFIB applauds the efforts of this Committee to move this forward.

If I can make just one final point, and that is today is June 9, and that is the 46th anniversary of what is perhaps the most onerous small business or small employer tax, which is employee tax withholding. Forty-six years ago, Congress enacted withholding in order to accelerate tax receipts to pay for World War II. We still have withholding with us, and I think that it is appropriate on this day that Chairman Talent and other members of this Committee are introducing this bill and attempting to simplify tax complexity for small employers. Thank you very much.

[Mr. Reardon's statement may be found in the appendix.]

Mr. MANZULLO. Thank you, Mr. Reardon.

Mr. Sinclair.

**STATEMENT OF WILLIAM SINCLAIRE, SENIOR TAX COUNSEL
AND DIRECTOR OF TAX POLICY, ECONOMIC POLICY DIVI-
SION, CHAMBER OF COMMERCE OF THE UNITED STATES**

Mr. SINCLAIRE. Good morning. I am Bill Sinclair, and I am with the U.S. Chamber of Commerce. The U.S. Chamber appreciates

this opportunity to express its views on the Small Employer Tax Relief Act of 1999, and we would like to thank Chairman Talent for introducing this legislation, and the co-sponsors for their endorsement.

The U.S. Chamber is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Accordingly, we are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community overall.

Simply stated, taxes should be levied in ways that minimize their negative impact on taxpayers, economic growth, and the international competitiveness of American business. The tax bias against work, savings, and investment should be minimized. The tax system should be made as simple and easy to comply with as is consistent with equitable administration of the tax laws. Particular emphasis should be placed on monitoring and reducing the administrative and paperwork burdens on small businesses.

Small business is the backbone of America's economy. They contribute almost one-half of all sales in this country and 50 percent of private gross domestic product. Small businesses also provide more than half of all employment and about two-thirds of all new jobs. In recent years, the number of new businesses has been at record levels, and the interest in starting and owning a small business has been dramatic. Nonetheless, parity with large businesses does not exist for small businesses under the tax law. It is time to remove inequities between small and large businesses and to provide small businesses with incentives to grow and create jobs.

The Small Employer Tax Relief Act of 1999 brings together several small business tax provisions and would provide substantial tax relief for America's small businesses. The bill would remove inequities between small businesses and large businesses, foster savings and investment, and bolster job growth. Specifically, this legislation would modify six areas of the Federal tax code. Namely, it would increase the deduction for health insurance costs for the self-employed. It would increase the expense deduction for meal and entertainment expenses. It would increase the expensing allowance for small businesses, the Section 179 expensing amount to \$35,000. It would repeal the FUTA surtax. It would create parity on the maximum tax rate at 34 percent between small businesses and corporations, and it would provide accounting relief to small businesses by allowing them to use the cash method of accounting without limitation.

Our long-term economic growth depends upon sound economic and tax policies. Today, we are critically shortchanging ourselves and, more importantly, our children, as we commit too many of our scarce resources into consumption and away from prudent investment. Our tax system encourages waste, retards savings, and punishes capital formation, all to the detriment of long-term economic growth. As we prepare for the economic challenges of the next century, we must orient our current fiscal policies in a way that encourages more savings, more investments, more productivity growth, and, ultimately, more economic growth.

The Chamber believes the tax reforms for small businesses specified in the Small Employer Tax Relief Act of 1999 would reduce the tax burden, create jobs, and increase the savings, investment, and productivity growth. The Chamber therefore wholeheartedly supports this legislation.

Mr. Chairman, members of the Committee, thank you for allowing me to testify today, and I would ask that my written comments be incorporated into the record. Thank you.

[Mr. Sinclair's statement may be found in the appendix.]

Mr. MANZULLO. We will incorporate all of the written comments from all of the witnesses unless there is any objection to it. Thank you, Mr. Sinclair.

Ms. Coleman.

STATEMENT OF DOROTHY COLEMAN, DIRECTOR OF TAX POLICY FOR THE NATIONAL ASSOCIATION OF MANUFACTURERS

Ms. COLEMAN. Thank you. My name is Dorothy Coleman. I am the Director of Tax Policy at the National Association of Manufacturers. Mr. Chairman, members of the Committee, thank you for the opportunity to come before you today to talk about tax rate relief for S corporations.

The NAM is the largest broad-based industry trade group in the United States. Our 14,000 members include over 10,000 small and medium manufacturers. About 41 percent of our small and medium manufacturers are organized as S corporations.

Mr. MANZULLO. If I could interject?

Ms. COLEMAN. Sure.

Mr. MANZULLO. The new president of the NAM is a small business person in suburban Chicago, is that correct?

Ms. COLEMAN. You're right. Tink Campbell.

Mr. MANZULLO. Tik.

Ms. COLEMAN. Tink.

Mr. MANZULLO. He does have under 50 employees at his manufacturing facility?

Ms. COLEMAN. Yes.

Mr. MANZULLO. Thank you.

Ms. COLEMAN. You are welcome.

The NAM's 1999 agenda includes a number of pro-growth tax incentives, including a reduction in S corp tax rates. For our small and medium manufacturers, S corporation tax rate relief is one of the top tax issues that would have the most positive impact on their company's ability to grow.

We applaud you for including S corp tax rate relief in the Small Employer Tax Relief Act of 1999. This morning I would like to briefly outline the history of S corps, discuss some recent tax law changes, and, finally, describe why S corp rate relief is so important to our members.

Congress created subchapter S corps more than 40 years ago to give owners of small and medium companies more flexibility in setting up and operating their businesses. This hybrid mix of a partnership and corporation was specifically designed to encourage the growth and stability of small and medium businesses by allowing owners to maintain control of their companies while benefiting from the liability protections afforded corporate shareholders.

For more than four decades, American business owners, particularly small and medium companies, have recognized the value of this unique corporate structure. Presently, there are more than 2 million businesses in the United States operating as S corps.

Over the years, lawmakers have passed additional laws to encourage the creation of S corps. Legislation enacted in 1982, 1996, and 1997, simplified and eased many of the S corp rules, making it easier for companies to form S corps, and also more difficult for companies to inadvertently terminate their S corp status.

S corps received a real boost in 1986 when legislators lowered tax rates, and the individual rate ended up below the C corp rate. The rate differential provided an additional incentive for businesses to organize as S corps, since S corp income, which flows through to shareholders, was taxed at the lower individual rate.

By 1993, nearly half of all U.S. corporations were S corps. However, legislation enacted that same year dealt a major blow to S corporations. The 1993 Omnibus Budget Reconciliation Act raised the highest marginal tax rate for individuals from 31 percent to 39.6 percent, almost six percentage points higher than the comparable C corp rate, which remained at 34 percent.

Consequently, S corporations, as pass-through entities, now pay a higher tax rate than C corps on income that is reinvested in their businesses. The tax rate changes enacted in 1993 represent a stark departure from Congress' strong support for S corps, since they actually discourage small business owners from reinvesting earnings back to their corporations.

To put it simply, S corp owners now pay a higher tax than C corporations on money used to develop new products, enter new markets, and hire additional employees. The higher tax rate is particularly harmful to S corp manufacturers who have to make large capital investments to grow their business and improve their competitive position. These companies typically do not have access to capital markets that C corporations have, and have to finance capital investment from their cash flow. Increased investment translates into additional jobs. It is estimated that, for every \$100,000 that is reinvested, a small manufacturer can create three to four new jobs.

Recent surveys conducted by the NAM support these conclusions. In particular, the surveys show a dramatic decline in investment, R&D, and employee hiring among small manufacturer S corporations after enactment of the 1993 tax law. For many companies, changing from S corp to C corp status is not an option, in part because of administrative costs and planning problems.

There are ways to address the problem. One proposal advocated by the NAM would level the playing field for S corps by applying a maximum tax rate of 34 percent to the first \$5 million of S corp income that is reinvested in the business or used to pay taxes. Providing rate relief for S corps is an opportunity for Congress to continue the mission it began in 1958 when lawmakers first established S corporations. In fact, given the critical role of small and medium business in the United States economy, it is imperative that Congress correct the economic injustice of the 1993 tax increases. Now is the time to level the playing field for S corporations.

and encourage entrepreneurs who are trying to grow their business.

Thank you for your time.

[Ms. Coleman's statement may be found in the appendix.]

Mr. MANZULLO. Thank you very much. I have just a couple of questions.

Ms. NEESE, you mention that by increasing the deductibility of health insurance to 100 percent, there could be up to 16 million people added to the rolls of the insured. Was that in your statement?

Ms. NEESE. Actually, those figures came from a research firm in California. For me, personally, I have 12 employees and I pay 80 percent of their health insurance premiums today. If I had 100 percent deductibility of those insurance premiums, I would cover it 100 percent and I would also cover their spouses and their children. I don't cover spouses and children today.

Mr. MANZULLO. You can deduct the full cost of health insurance policy. If they were self-employed, they could only deduct a certain percentage of it. Isn't that correct? Did I get that right?

Ms. NEESE. I'm—

Mr. MANZULLO. For yourself? For your own policy?

Ms. NEESE. Right.

Mr. MANZULLO. Brian.

Mr. REARDON. If I could jump in, I think there are about 16 million self-employed individuals in the United States.

Mr. MANZULLO. That don't have insurance?

Mr. REARDON. No, just 16 million. There are about 3 million that do not have insurance. So, out of the 16 million people who would benefit from increasing the deduction for self-employed insurance costs, 3 million right now don't have any insurance at all. So, this provision would represent about a 10 or 15 percent health insurance cut for them, which is significant.

Mr. MANZULLO. Plus members of their family?

Mr. REARDON. Very much so.

Mr. MANZULLO. So, this figure could be—what?—10 million? Five to 10 million? Somewhere in there?

Ms. NEESE. And their children and spouses. If you look at the 16 million self-employed—and they're not all covered 100 percent—plus their spouses and children, you are looking at a huge number that we could take off of the uninsured rolls.

Mr. MANZULLO. I think it is very difficult to come up with the actual figure of self-employed people who don't have insurance. There is no reporting form from the government, at least on that one yet. The best figures I saw are based on some pretty rough estimates. Obviously, the more people who become insured, the lower the premiums become.

I have a question with regard to expensing of equipment. Obviously, those businesses that have a lot of equipment, such as restaurants, are in different positions. But those who don't have such a heavy investment, can anyone estimate the average costs of annual equipment purchases for the typical small business owner? Any real rough guesses out there? The purpose of the question, obviously, is with regard to increasing the amount that is expensed as opposed to amortized. Anybody want to take a stab at that?

Mr. REARDON. The best numbers I have are the survey I mentioned in my testimony. We have the whole range here, but, essentially, 48 percent of our members who had capital expenditures in the last three months, and that was 7 out of 10 of our members had capital expenditures exceeding \$20,000. So, I can provide these numbers.

[The information may be found in the appendix.]

Mr. MANZULLO. Exceeding by how much? Do you have an idea?

Mr. REARDON. Twenty-two percent were between \$20,000 and \$50,000. Twelve percent were between \$50,000 and \$100,000. Eleven percent between \$100,000 and \$500,000, and then 3 percent were above that.

Mr. MANZULLO. Thank you.

Ms. Neese, did you want to comment on that?

Ms. NEESE. In my business specifically, you look at the \$19,000 and you look at the Y2K problem, and replacing the computers and trying to get Y2k compliance, \$19,000 is minuscule. I just brought my company up to speed on the Y2K problem, and hopefully, I am Y2K okay at this point, but I am a small business and I spent close to \$40,000.

Mr. MANZULLO. The service industry is particularly being hit with the extreme cross of computers and computer technology. Mr. Sinclair, did you want to comment on the question?

Mr. SINCLAIRE. We do not have any specific numbers; however, on the issue, there are other aspects. Many of the small business people that I speak with, their largest asset—as was mentioned earlier, they don't have offices; they meet in restaurants; they are also very mobile—so, their biggest investment is in their motor vehicle, and under section 179, motor vehicles are excluded, and that is something that should be thought about being added for the small business person. That can be their largest investment.

Also, the Section 179 amount phases out at \$200,000. That \$200,000 cap has been there for a number of years, and we would submit that there should be some thought about changing that cap or indexing it, and they both would be helpful to small businesses.

Mr. MANZULLO. Mrs. Coleman.

Ms. COLEMAN. Since manufacturing is such a capital-intensive industry, the vast majority of our members, can't take advantage of the current expensing provisions, specifically, for what Mr. Sinclair mentioned, because it phases out after you invest \$200,000 a year.

Mr. MANZULLO. Okay. Ms. Velazquez.

Ms. VELAZQUEZ. Thank you.

Mr. Reardon, the bottom line in regards to assisting business through tax breaks is to enable them to expand. Increasing the expensing allowance will certainly allow a business to expand. Are you aware of any analysis that shows what type of job creation we can expect through the enactment of the increased expensing to \$35,000?

Mr. REARDON. I'm not, but I will search the records and see if I can come up with something.

[The information may be found in the appendix.]

Ms. VELAZQUEZ. Have any of you done any analysis? Do you have any numbers? Thank you.

Ms. Coleman, one of the bill's provisions would reduce the top individual income tax rate from 39.4 to 34 percent for productive income derived from small businesses. This means that individuals with the same income, but derived from different sources, will be taxed at different rates. My question is, isn't a proposal which would tax similarly-situated taxpayers at different rates potentially both confusing and unfair?

Ms. COLEMAN. Well, we are looking at it more from the business, the S corporation being taxed at the same rate that the C corporation is. Right now, if you are an S corporation and you are trying to buy a piece of equipment, and a C corporation is trying to buy the same piece of equipment, you are actually paying more, simply because the money that you are using to buy that equipment to make that investment is taxed at a much higher rate than the C corporation.

Ms. VELAZQUEZ. Isn't this proposal unduly complex in an era when many are seeking greater simplicity in the tax code? Could this go too far in the opposite direction?

Ms. COLEMAN. I don't think that I'm prepared to answer that right now.

Ms. VELAZQUEZ. When you are prepared, can you send it?

Ms. COLEMAN. I certainly will.

[The information may be found in the appendix.]

Ms. VELAZQUEZ. Does this change potentially give rise for conversion from C corporations to S status, or some other form of ownership, which will qualify for the next tax treatment?

Ms. COLEMAN. Pardon me?

Ms. VELAZQUEZ. Does this change potentially give rise to conversion from C corporation to S status or some other form of ownership, which would qualify for the next tax treatment?

Ms. COLEMAN. I don't know that that is necessarily true. I think businesses decide whether to become an S corp or a C corp for non-tax reasons. There are also State law ramifications. There are restrictions on S corps, restrictions on the number of shareholders, and who can be shareholders. So it is not a form of business that works for every company.

Ms. VELAZQUEZ. What specifically are the administrative costs and planning problems that make conversion from S to C status so difficult? Is this the real problem, or is it that profits that are through-in are taxed at both the corporate and individual levels?

Ms. COLEMAN. Well, as I mentioned in my testimony, Congress set up S corporations specifically for small businesses to give them the flexibility and the control of ownership, and also the limited liability protections. The C corporation can be publicly traded. There are less restrictions on shareholders. The tradeoff for becoming an S corp, there is a tradeoff in that you are limited on the number of shareholders, and there are also, again, some State law limitations on a state-by-state basis. I don't think you can really compare. It is not easy to move from one to the other. There are a lot of factors that go into that decision.

Ms. VELAZQUEZ. Your proposal to limit a rate reduction only to reinvested profits is interesting. This is quite a bit more targeted than the provision in the SETRA bill, isn't it?

Ms. COLEMAN. Yes, it is.

Ms. VELAZQUEZ. It also seems to me to be less complex and probably less costly.

Ms. COLEMAN. I believe so. Most of our members are S corporations. In fact, that is why I'm testifying specifically on their problem. Certainly, Mr. Talent's bill would address our concerns and provide the relief, but as far as the other types of entities, I can't comment on that.

Ms. VELAZQUEZ. Ms. Neese, other witnesses have suggested that the problem with regard to the cash-versus-accrual accounting method is a narrow issue centering on alleged stretching of the definition of inventory by the IRS. Yet, your testimony seems to say that small firms of all types, including those that do carry meaningful inventories, suffer from having to use the accrual method. Do this mean that the issue is a larger one than what people are saying here?

Ms. NEESE. I think it is a larger issue. Let me refer to my tax accountant here for a second because I want to be succinct to your question, so that I can get it right.

Ms. VELAZQUEZ. Ms. Neese? If you want, she could provide the explanation.

Ms. NEESE. We'll get you some information in writing.

Ms. VELAZQUEZ. Thank you.

[The information may be found in the appendix.]

Ms. NEESE. But if I could go back to the S corporation question just a moment that you were talking about, an S corporation is first a C corporation. So you can go back to it by giving up the election to be taxed as a C. It is complicated. We can also send you some things back in writing on that. I just wanted to put that in for the record.

[The information may be found in the appendix.]

Ms. VELAZQUEZ. I'm finished with my questions, Mr. Chairman.

Mr. MANZULLO. Well, that is pretty good timing. I pushed you along and then the bells went off for what I think will be a series of votes. We want to thank you for coming before us. 6

I do have a very short question. On this issue of the inventories, the actual amount of tax that is paid is really not any more, if you use the accrual versus the cash basis. It is just that there is more of an accounting function and more papers that have to be filed. Is that a correct statement?

Mr. SINCLAIRE. It is a timing question. If you boil the Federal Income Tax Code down to its basics, there are two parts: What is income, and when is it income? Going from cash to accrual, you determine when it is income. Generally, you would pay the same amount of tax, but it is spread over a different period of time or different tax years. In that sense, there is no difference. Now, you have the time value of money. You are giving your money to the government earlier and you don't have your money available, so it is a cash-flow problem also.

Ms. NEESE. The other issue is—and my inventory are people. I am in the human resource business.

Mr. MANZULLO. So you're on the cash basis?

Ms. NEESE. Yes. But, many times you have to pay taxes before you ever receive your money, based on what you think might come in.

Mr. MANZULLO. Based upon billing?

Ms. NEESE. Yes, and that is pretty tough.

Mr. MANZULLO. Mr. Reardon.

Mr. REARDON. I also think that, under the accrual method, there is the opportunity to overpay your taxes one year and then you have to go back and get a refund. You have to file a form, and it takes a long time to get your money back, which is what Bill referred to.

Ms. NEESE. If I could comment on that for just a second?

Mr. MANZULLO. Sure.

Ms. NEESE. I cannot tell you how many thousands of dollars that I have overpaid, and it takes sometimes two years to get the money back. It takes forever. And when you are talking thousands and thousands of dollars, you are talking thousands of dollars that I could have been using for advertising or other things in my business to continue to build my business when it is sitting at the IRS.

Mr. MANZULLO. Okay. Again, we want to thank you. I want to leave the record open for a week. Let's see, who is giving additional information? Are you, Ms. Neese? In a couple of weeks? Can you get that to us within a week? We will make that part of our permanent record. Again, thank you for coming. We appreciate it very much.

Ms. NEESE. Sure.

Ms. COLEMAN. Sure.

[Whereupon, at 12:10 p.m., the Committee was adjourned.]

**OPENING STATEMENT
OF
CHAIRMAN JIM TALENT
HOUSE SMALL BUSINESS COMMITTEE**

***“SETRA: FAIR AND SIMPLE TAX RELIEF FOR
SMALL BUSINESS”***

June 9, 1999

In opening this hearing today, I am thinking of the hard-working, small business owners, farmers, families, and self-employed taxpayers across our nation who, collectively, are the number one employer in America. Theirs is a heavy tax burden.

Congress made great strides in the last few years to provide tax relief to small business. Nevertheless, I welcome the testimony of each of our small business witnesses here today. It is my hope that the witnesses' call for fair and simple tax relief will continue to resonate in Congress.

Small entrepreneurs are the backbone of our economy. They run local, national, and international businesses. They provide the bulk of the services we need. They raise our children and care for our elderly. They grow our communities. They unambiguously need fair and simple tax relief under today's complicated tax code.

I am introducing a tax bill today, the *“Small Employer Tax Relief Act of 1999”* (SETRA), with my colleagues Mr. McCrery, Mr. English, Mrs. Bono, and Mr. DeMint, that squarely faces the constraints of small business under today's tax code. Accordingly, SETRA calls for:

- Deducting 100% of their health insurance costs;
- Restoring the meal deduction;
- Increasing expensing;
- Lowering taxes, including payroll taxes; and
- Simplifying complex tax accounting IRS rules.

SETRA tackles these important changes to complement, not to compete with, leading proposals by my colleagues to eliminate the death tax and to reduce taxes across the board for all Americans – proposals which I strongly support. In particular, I believe repealing the death tax immediately, or eliminating it as proposed by Reps. Dunn and

Tanner in H.R. 8, is essential. We must protect small farmers, family-owned businesses, and women business owners from having their lives' work confiscated by the Internal Revenue Service (IRS) after their demise.

In addition, there is no reasonable justification in my mind for denying small entrepreneurs legitimate health care, business meal, and other business expenses to run their businesses – so they can keep more of their hard-earned money and create jobs. High taxes, a complex tax code, and IRS tax traps, now penalize unnecessarily an otherwise vibrant small business economy. Small business Americans must be able to *afford* to save and invest in their children, in their communities, and in their future. It is my hope that SETRA or legislation like it will simplify and lower small business taxes and help small businesses continue to excel.

Small Business Committee**Statement on the "Small Employer Tax relief Act of 1999"*****By: Congresswoman Carolyn McCarthy (D-NY)*****June 9, 1999**

Thank you Mr. Chairman, and Congresswoman Velazquez, for scheduling this hearing to explore various tax relief provisions for small businesses. I would also like to thank our panel of witnesses for taking time out of their busy schedules to testify before this Committee as well.

As we all know, small businesses are vital to a prosperous economy. Yet they must overcome numerous financial inequities. Many of the provisions within Chairman Talent's bill addresses these concerns; particularly the immediate and complete deductibility of health insurance premiums.

Throughout Long Island, NY small businesses struggle to compete in an environment with an extremely high tax base. Many of these small businesses are your typical "mom and pop" stores who provide an important service to the surrounding community. Unfortunately, many can not provide health insurance to their employees because of the financial burden it imposes. Inability to deduct this expense is a serious deterrent and hinders a small business' ability to compete with larger companies when employing skilled labor. For those small business owners who try to provide health insurance for their employees, they are only allowed to deduct 60% of the premiums. Although current law would raise this deduction to 100% by 2003, why should small businesses have to wait?

Lastly, I would like to address a provision within Chairman Talent's bill that increases meal and entertainment expense deductions. Current law allows small businesses to deduct 50% of meal and entertainment expenses. Chairman Talent's bill would increase this deduction to 80%. Unlike larger companies which have the ability to advertise, and deduct this expense, smaller businesses rely on other means to promote their business. These include luncheons, dinners or other entertainment mediums in which to conduct business. Small businesses rely heavily on business meals to promote their business with potential customers. This is their way of advertising. Therefore, I support this increased meal deduction proposed under this legislation.

Allowing small businesses to compete on a level playing ground is important to their survivability. Many of the provisions discussed today are a step in the right direction to ensure this success rate.

Thank you Mr. Chairman.

Statement by Rep. John Sweeney
before the Small Business Committee
June 9, 1999

Mr. Chairman, thank you for giving me the opportunity to speak in support of the Small Employer Tax Relief Act (SETRA). I commend the Chairman for his work.

The Small Employer Tax Relief Act would give small businesses the economic relief to help ease their cash flow burdens. Increasing the meal deduction, reducing both individual and payroll taxes, and ensuring that small business have a legitimate choice in the method of accounting they employ will enable small business to achieve a more fluid cash flow.

In addition, the Small Employer Tax Relief Act allows for the immediate 100% health insurance deductibility for self-employed businesses. Currently there are over 40 million individuals that do not have access to health insurance. 100% deductibility will place small businesses on the same level playing field as larger businesses and will greatly increase access to health insurance in this country.

With small business accounting for 99% of the nation's employers, employing over 50% of the private workforce, it is essential that Congress eliminate unnecessary and cumbersome regulation and taxation on small businesses.

Forcing small businesses to use the accrual method of accounting when it hurts the business, as the IRS is now doing, only discourages small business growth.

Small businesses are high risk ventures with many proprietors putting their families' personal income and assets into the business. Over 90% of businesses in my district are small business. They are the engine of the local economy and the source of innovation throughout the country.

The Small Employer Tax Relief Act will provide much needed assistance to the 14,000 small business owners in my district. I support this legislation and urge the other members of the committee to do the same.

Chairman Talent, thank you for this opportunity to speak on behalf on the Small Employer Tax Relief Act.

STATEMENT
Of
JAMES M. WORDSWORTH
For the
NATIONAL RESTAURANT ASSOCIATION

At the
TAX RELIEF FOR SMALL BUSINESSES HEARING
Before the
HOUSE SMALL BUSINESS COMMITTEE
June 9, 1999

Mr. Chairman and members of the committee, thank you for the opportunity to testify before the Small Business Committee on legislation that would help thousands of restaurateurs across the country, the Small Employer Tax Relief Act. I am pleased to see the committee addressing such an extensive package of tax issues that have long been a burden on small businesses.

My name is Jim Wordsworth. I have been a small business "employer" in this area for a quarter of a century. In 1974, I started my own restaurant in Fairfax, Virginia, called J.R.'s Steak House. With a lot of hard work, we were successful. That enabled me to open another restaurant and a catering business shortly thereafter. I now employ 250 people, both part time and full time. Certainly, I am proud of the success of my business and throughout the years, I have learned many lessons.

One of those lessons is that you can do everything in your power to treat your employees well, serve quality meals to your customers and give back to your community, yet, you will never have total control over whether you succeed. There are barriers out there that can make or break your business -- regardless of your own efforts. One of those barriers is the heavy hand of the federal government. And to those of us in the business world, the Internal Revenue Code is probably the thing we fear the most. It's not just the rules that can't be deciphered without the aid of lawyers and accountants. It's the tax burden itself. It's substantial, and it's constantly changing.

Looking at the Small Employer Tax Relief Act, it is clear that Chairman Talent understands the barriers caused by the tax code. In fact, almost every provision in the bill will have a direct impact on my business. However, it will not surprise any of you to hear that I am going to focus my comments on the provision to increase the business meal deduction to 80 percent for small businesses and the self-employed.

As most of you may remember, in 1986 Congress lowered the business meal deduction from 100 percent to 80 percent. In 1993, it was lowered to 50 percent. As far as I can tell, the reason it was lowered, aside from bringing in a large amount of revenue to the

federal government, was that Congress considered it some type of "fat cat" tax loophole that people used in order to have three-martini lunches.

Well, Congress could not have been further from the mark.

When I walk around my restaurant at noon on a day like today, here's what I see. At one table I see a salesman up here from North Carolina trying to sell his outdoor signage to the guy who owns a shop in the strip mall down the street from my restaurant. At another I see a woman who's venturing out into her own human-resources consulting business, talking to a guy from a high-tech start-up in Tysons Corner about how they can work together.

In short, the businessmen and women having lunch in my restaurant are the same people you see testifying here today. They are the traveling sales representative pulling off the beltway, the start-up business working on new clients, or the self-employed entrepreneur who works at home and needs a meeting place. Each one of them considers my restaurant his or her conference room. And for many of these small businesspeople, this is the best (and sometimes only) way for them to do business. This is no less a legitimate business expense than any other form of marketing. But right now the tax code is telling them it's just 50% legitimate.

When Congress first reduced the business meal deduction, I, like restaurateurs throughout the country, saw an immediate impact on my restaurant. And while that's very important to those of us in the restaurant business, what's even more important to look at is the impact of Congress's decision on the business meal user. Since Congress first dropped the allowable business expense in 1986, our Association's research shows that the number of business meal users has declined by more than two million. A great majority of these were small businesses.

Let me take a minute to talk about who really uses the business meal, because it's important not to generalize or stereotype based on misconceptions. I think you'll be surprised.

- ◆ Two-thirds of the business meal users make less than \$60,000 a year, with almost 40 percent making less than \$40,000.
- ◆ One-fifth of the business meal users are self-employed.
- ◆ One-half of all business meal spending occurs in small towns and rural areas.
- ◆ And the average cost of a business meal, per person, is \$11.60.

For people in the business world, a business meal is just that -- business. They're not trying to scam the system for a tax break. They're not out to waste their hard-earned marketing budget on something that won't help them grow their business. And they're not out to eat a meal for their own personal enjoyment. They're businesspeople trying to drum up business.

Clearly, it was the small businesses that were hit hardest by the cut in the deduction. And that is why, on behalf of the National Restaurant Association, I applaud the inclusion of the business meal provision to increase deductibility to 80 percent for small businesses and the self-employed. This mirrors a stand-alone bill introduced by Congressmen Jim McCrery (R-LA) and John Tanner (D-TN), H.R. 1195, which has received strong bipartisan support.

Ideally, we would like to see the deduction go back to 100 percent for everyone, because we believe conducting business over a meal is a 100 percent legitimate cost of doing business. However, we realize that the revenue impact of such an increase would be very difficult to enact in one bite (if you'll excuse the pun).

Again, Mr. Chairman, I would like to thank you and all the members of the committee for the opportunity to tell my story and hopefully provide some insight into this tax issue.

Thank you.



National Association for the Self-Employed

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Testimony of

FRANK S. JOSEPH

Principal

*Key Communications Group, Inc.
Chevy Chase, Maryland*

on behalf of

The National Association for the Self-Employed

before the

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

9 June 1999

"Serving the Needs of Small-Business America"

Member Services: 2121 Precinct Line Road • Hurst, TX 76054 • 1-800-232-NASE • <http://www.nase.org>

Chairman Talent, members of the Committee, good morning. I am Frank Joseph, a publisher and publishing consultant in Chevy Chase, Maryland. My wife and I have been the self-employed owners of the Key Communications Group, Inc. for seventeen years. Key has been a home-based business for the last eight of those years.

I'm very happy to endorse your bill, the Small Employer Tax Relief Act of 1999, (SETRA) speaking both personally and on behalf of the National Association for the Self-Employed.

There are many good ideas in the bill.

- Increasing "direct expensing" for small businesses to \$35,000 would help many of us stay abreast of the information revolution.
- Reducing the maximum tax rate for income derived from small businesses would correct an anomaly in the tax code that penalizes many small businesses.
- The repeal of the 1976 "temporary" FUTA surtax is only fair, since the loans that this surtax was designed to repay were retired more than ten years ago.
- And raising the current 50% deduction for business meals is an especially good idea, since so many of us in home-based businesses use business meals to work with our clients.

But above all I commend this bill for keeping up the effort to immediately raise the health insurance deduction for the self-employed to 100%.

For millions of self-employed Americans, this deduction represents the difference between having no health insurance, being under-insured, and having real health insurance.

Almost 6 million self-employed people and their dependents are uninsured. And that includes nearly 2 million children.

This is a very real national problem. Thank you for fighting to get these people insured.

It's also a fundamental issue of tax fairness.

When I worked for a company -- a "C" corporation, under tax law -- my employer provided my health insurance. I had a policy that covered my family. A small premium was deducted each month from my gross pay. I barely noticed the cost.

My employer excluded his entire cost for that health insurance from his taxable income. One hundred percent.

Now I'm self-employed. My wife and I operate Key as an "S" corporation, under tax law. So, I can only deduct a fraction of my health insurance cost. It's the same thing for other self-employed people, like sole proprietors and partners.

(I should also note that I pay more for my health insurance than my former employer does, even before tax considerations. That's because I have to buy an individual health insurance policy that costs more than the large group health insurance policy he buys. Also, larger companies usually buy health insurance policies that are exempt from state "add-on's" under the federal ERISA law. Smaller companies rarely have access to these less expensive "ERISA plans". So even if I got the same deduction as the large company, I'd still pay more for my health insurance. Mr. Talent's bill H.R. 1496, the Small Business Access and Choice for Entrepreneurs Act of 1999, would help fix this problem. So thanks for that, too.)

Sometimes it seems like the smaller your company, the less the government wants you to have health insurance.

A mile or two away from me is Phillips Publishing International Incorporated. Like me, Phillips publishes newsletters. Last year, Phillips recorded revenues of about \$600 million. That's several orders of magnitude larger than my publishing business. Yet, when it come to health insurance, Congress has legislated an *advantage* for Phillips over me -- lower taxes.

But thanks to your past efforts, Congressman Talent, as well as those of a few other members of Congress, like Senator Bond, we self-employed are

finally on a schedule to deduct 100% of our health insurance costs by the year 2003.

Still, as the SETRA bill acknowledges, the people without health insurance shouldn't be asked to wait four years to get sick.

And the many people who struggling to get by with the 60% deduction now shouldn't have to wait four years to get a tax advantage that General Motors has enjoyed for half a century.

I'd like to add one other, personal note. When I came before you and this Committee two years ago, I said that if Congress increased the health insurance deduction for the self-employed, I could use the money to hire more part-time help for my company.

Well, you did and I did.

Today, I use more part-time help than I did then, thanks in part to the higher health insurance deduction.

I also have one full-time person working for me. And because I try to be a good employer, I provide her with 100% of her health insurance.

But think about this. Since she is an employee of my business, the insurance I offer her is fully excludable from my business' taxable income.

That's a better deal than I can get for my own family. The insurance I purchase for my own family -- because my wife and I are self-employed -- still is only 60% deductible.

Luckily, I can afford to buy health insurance for my family. But I'm sure there are many self-employed people who can't. The statistics show that somewhere between one fifth and one fourth of us don't have health insurance, and cost is by far the most important reason.

So the current tax law undoubtedly is creating situations where self-employed people with employees can afford to buy health insurance for their employees, *but not for themselves and their own families.*

Certainly some people will be selfless in such a situation. They will buy the health insurance for the employee but not for themselves. But other people will think: "How can I possibly explain it to my family that I'm buying health insurance for somebody else and not even for us?" And therefore not offer the health insurance to their employees.

Increasing the self-employed health insurance deduction to 100%, then, could help more than the self-employed. It may well result in more *employees* of small businesses getting employer-provided health insurance.

Thank you again for all your work to get this deduction up to 60%. I hope we can finish the job this year.

Statement required pursuant to Rule XI, clause 2(g)(4) of the House of Representatives: Neither Mr. Joseph nor the NASE has received any contract, subcontract or grant from any federal government source during the last three fiscal years.



Statement of Associated Builders and Contractors

On

The Small Employer Tax Relief Act of 1999

Presented to the House Small Business Committee

June 9, 1999

Speaking for the Merit Shop

**1300 North Seventeenth Street
Rosslyn, Virginia 22209
(703) 812-2000**

My name is Eric P. Wallace, CPA, and I speak today on behalf of Associated Builders and Contractors, Inc. ABC is a national trade association representing more than 20,000 firms in the construction industry. ABC's diverse membership is bound by a shared commitment to the philosophy of awarding work based on merit. With 80 percent of construction today performed by open shop contractors, ABC is proud to be their voice.

I am a practicing CPA with over 20 years of experience serving contractors and service providers from across the country in the fields of taxation, accounting, auditing, and consulting. I recently researched and authored an article titled "The IRS and Cash Basis Contractors" that appeared in publications of the Construction Financial Management Association as well as ABC. My extensive experience dealing with this issue enables me to provide to you specific expertise and insight concerning the proposal in SETRA to clarify that small business taxpayers are allowed to use the cash method of accounting without limitation.

The IRS is targeting just about all contractors and service providers who report their taxable income on the cash basis of accounting. One of the most onerous audit adjustments a contractor or service provider can face is an IRS initiated change in its tax accounting method from the cash to the accrual method. Such IRS proposed audit changes typically subject the taxpayer to six figure assessments, with a significant portion of this consisting of mandatory interest and penalties.

The difference between the cash method and the accrual method is not that the accrual method necessarily results in a greater taxable income. The only difference is one of timing of the reporting of income and expense. As an example, if a cash basis contractor or service provider collects its billings in advance and delays the payment of its payables, it will report income sooner under the cash method than it would under the accrual method.

Now, more than ever, the IRS is pushing their cash audit change position on a national level. The IRS spelled out its position on the cash basis when, in late 1997, it released its "Construction Audit Technique Guide" (ATG) as part of its Market Segment Specialization Program. In this ATG, it stated that IRS examiners should generally conclude that a contractor or service provider should be changed from the cash basis of accounting when their material cost, as a percentage of their gross receipts, is 15% or more, and depending on the facts and circumstances, can be changed when the ratio is less than 15%. This position is not based on any specific code section but is the result of several court cases successfully litigated by the Service.

This push is based upon a certain logic flow. The Service foundation logic is generally summarized as follows: materials are merchandise; if the cost of merchandise is over 15% of gross receipts, it is a significant income producing factor; if material is a significant income producing factor, the contractor or service provider must use inventories; if the taxpayer is required to use inventories, it is required to use an accrual method of accounting.

The result of this arbitrary national push by the Service would leave few, if any, contractors or service providers remaining on the cash basis of accounting. One of the IRS authors of the ATG stated to me that the only type of cash basis contractor that the Service is permitting to stay on the cash basis is an asphalt contractor who does not produce their own asphalt in a plant. (This is based upon the *Galedridge Construction, Inc. v. Commissioner*, T.C. Memo 1997-240 court case, though the IRS has still not agreed to the *Galedridge* decision.) All other contractors or service providers are "fair game."

The IRS denies that there is a national coordinated effort to focus on construction contractors and service providers and that they are merely enforcing the law as they interpret it. I, however, do believe that there is a national effort based upon the calls that I have received from contractors, service providers, and other practicing CPAs from across the country. For example, the IRS audited a carpet installer from Michigan doing \$1.2 million in revenue with material and supplies equaling 12% of his revenue. The only audit issue was to change him from the cash method to the accrual method. The cost to him of such a change was almost \$100,000. The IRS auditor had used as support the newly released IRS ATG. I advised an underground utility pipeline contractor from Pennsylvania to voluntarily change from the cash method to the accrual method because, if audited by the IRS, it would face over \$100,000 in interest and penalties. A window installer from Texas, with about 20% of revenues for materials as a cost of revenue, would be forced out of business if the IRS proposed a change from the cash method and assessed the mandatory interest and penalties.

The Service believes that, based upon a series of court decisions, their position to change all contractors and service providers from the cash method of accounting to the accrual method is justified. This is in conflict with past congressional intent on the use of the cash method. "The committee recognizes that the cash method generally is a simpler method of accounting and that simplicity justifies its continue use by certain types of taxpayers and for certain types of activities. Small businesses should be allowed to continue to use the cash method of accounting in order to avoid the higher cost of compliance which will result if they are forced to switch from the cash method." [House Report 99-426, at 605-606 (1985), 1986-3 C.B. (Vol.2) 1, 605- 606.]

A head IRS Construction Industry Specialist stated to me that, based upon the current IRS approach and court cases, cash basis contractors and most service providers will not be able to maintain their cash reporting position or have it supported in court. Their only hope is a congressional solution.

Sec.7 "Clarification of Cash Accounting Rules for Small Business" of the SETRA would provide such a needed congressional solution. The current ATG states that "Reg 1.446-1 (a)(4)(i) and 1.471-1 provide that the use of an inventory accounting method is required in every case in which the sale of merchandise is an income producing factor. The fact that the use of an inventory accounting method may result in inventory balances that are zero or minimal is irrelevant." It is clear that the Service position is inappropriate. SETRA Sec. 7 would stop the Service universal push against the cash basis contractors and service providers and enable these small businesses to utilize the simpler cash method without fear of severe IRS reprisal.

We would like to thank Chairman Talent and Representative Phil English for leading the effort to end the IRS's abuse of cash basis contractors, and for introducing this straightforward legislation to resolve the problem.

Thank you for allowing me to present ABC's views on this important issue, and I welcome any questions the Committee may have.

TESTIMONY OF

TERRY NEESE

CEO & FOUNDER, TERRY NEESE PERSONNEL SERVICES

ON BEHALF OF

THE NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS

BEFORE THE

U.S. HOUSE COMMITTEE ON SMALL BUSINESS

ON

THE SMALL EMPLOYER TAX RELIEF ACT OF 1999 (SETRA)

JUNE 9, 1999

SETRA

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Good morning, Mr Chairman and members of the committee. Thank you for the opportunity to appear before you today and discuss SETRA, the Small Employer Tax Relief Act of 1999.

My name is Terry Neese and I am the CEO & Founder of Terry Neese Personnel Services and Terry Neese Temporaries in Oklahoma, and GrassRoots Impact with offices in Washington, D.C., Detroit, Michigan, and Oklahoma City. I am also involved in farming and ranching in southern Oklahoma and own beach rentals on the Gulf Coast of Alabama.

In addition, I am a past national president of the National Association of Women Business Owners (NAWBO) and currently serve as a consultant to NAWBO on corporate and public policy issues. NAWBO represents this country's 9 million women business owners and advocates on their behalf from our city halls to international forums. Women business owners today are employing over 27 million workers (voters) and generating \$3.2 trillion in annual revenues. NAWBO's sister organization, the National Foundation for Women Business Owners tells us what our women-owned business community looks like with its ongoing, ground breaking research. NFWBO's statistics are quoted by the business and mainstream media, as well as government officials. NAWBO's other sister organization, the National Women Business Owners Corporation, has established the first national certification program for women business owners and created a national database of women-owned businesses for procurement opportunities with the Federal Government and the private sector.

Today, I want to discuss ways to explore fair and simple tax relief proposals for small business but especially for women-owned businesses.

Increase small business expensing.

Small business continues to invest in property and equipment in order to maintain growth and efficiency in the marketplace. Typically, small business owners will choose to pay for these assets in advance rather than finance the acquisition over time. This decision is based on the difficulty of obtaining term loans for small equipment acquisitions from lending institutions as well as the business owner's desire to re-invest the profits back into the business for long term growth, development and stability.

The current expensing limit of \$19,000 is not allowing small business to keep up with the increasing costs of equipment and technology. An increase to \$35,000 would enable the small business owner to maintain their equipment acquisition needs by re-investing profits. They would also not incur a tax burden on the difference between cash expended and tax deduction allowed. This provision will assist in maintaining the "wherewithal" to pay concept whereby taxable income is essentially equal to cash flow.

Provide tax accounting relief to small business.

Under current law, small businesses are required to use the accrual method of accounting for income tax reporting if they are involved in merchandise sales and maintain an inventory. Although this provision provides for a clear reflection of income earned, it does not necessarily result in a matching of taxable income to cash flow. Typically, the small business owner must maintain a material amount of inventory, as well as, float a large amount of accounts receivable.

On the other side, the small business owner will acquire the inventory with COD or 30 day payment terms. This timing difference creates a need for flexible financing from lending institutions who are not particularly interested in writing up small business credit lines to finance inventory and accounts receivable. In addition, funds must be borrowed in order to pay the respective income taxes on merchandise sold and included in taxable income even though the proceeds from the sale have not been collected. This provision under the Small Business Employer Tax Relief Act will again assist in maintaining the important "wherewithal" to pay concept for small business.

Repeal the Federal Unemployment Payroll Surtax.

Small employers create more than 90 percent of the jobs in America and incur an enormous payroll tax burden in doing so. The .2 percent surtax was intended to be a temporary increase to repay government loans from the federal unemployment trust funds. These loans were paid eleven years later in 1987, yet the surtax has continued to be assessed and collected. The fact that this surtax has continued 12 years past its original intended and represented purpose is truly an inequity that unfairly burdens the small business community. The federal unemployment tax is assessed on the first \$7,000 of wages per employee per year. Thus, the turnover of employees and the hiring of temporary employees or seasonal employment further escalate the employment tax burden on the small business owner. This .2 percent surtax should be repealed now.

80% Tax Deduction for Meals and Entertainment Expenses

Small and women-owned businesses typically rely on close personal relationships and customer service to compete for sales rather than on expensive advertising campaigns. Expenditures for meals and entertainment are often an important part of this effort. Relationship marketing is key to women-owned businesses. Being able to sit down across the table from a client or prospective client is the best form of sales and marketing techniques available.

The prior changes in the tax laws that disallowed 50 percent down to 30 percent of these expenditures for tax purposes have disproportionately increased the selling costs for many small and women-owned businesses. Ten years ago business and travel meals were 100 percent tax deductible as ordinary and necessary business expenses. Looking for revenue, Congress lowered the tax deduction to 80 percent in 1987 and 50 percent in 1994. This results in an unfair and disproportionate tax increase on the restaurant and entertainment industries and the business customers they serve. This cut back has been particularly punitive to the small business community. This is evidenced by the fact that the White House Conference on Small Business cited its restoration as one of its top two priorities. Reinstating the 80% and ultimately 100% tax deduction for meals and entertainment expenses is the right thing to do for this Congress and the fair thing to do for women-owned businesses.

100% Deductibility of Health Insurance for the Self-Employed.

This is a no-brainer!! The fact that the self-employed can not deduct 100% of health care premiums is a glaring inequity between large corporations and the self-employed. Why discriminate against the self-employed who are carrying the banner for this country's free enterprise system? Nearly a quarter of the self-employed still do not have health insurance because they simply cannot afford it. The 100% deductibility of health insurance for the self-employed is favored by large majorities of both parties in both houses of Congress, spanning every region of the country and every political philosophy, including the White House. Now we need a strong political will to find the formula that can make the change happen. Over 16 million Americans could benefit from this tax relief.

Capital gains.

84% of women use personal savings to start up their businesses. A lower capital gains tax leaves more essential capital in the hands of these businesswomen, investors, and entrepreneurs. A lower capital gains tax also means that a woman who is widowed will be able to keep more money from the sale of her home, oftentimes her largest asset during a difficult time.

These tax issues are important to women-owned businesses. We continue to grow our companies, expand into international arenas, and try to provide excellent benefit packages for our employees. I would be remised if I didn't also mention the onerous death tax issue in this testimony as well. Relief from the current death tax enables children to keep what they rightfully inherit; such as, the farm that has been in their family for generations or the small business that has helped them live the American

SETRA

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dream. Now, many have to sell their family legacy just to pay the taxes. This is an issue near and dear to my heart. My daughter recently joined my firm. I want her to carry on my legacy. She in turn may want her daughter to carry on her legacy. Will we be able to do that without selling the company to pay the death taxes? Only this Congress can answer that question. That is a huge burden you can eliminate this year!

Mr. Chairman, thank you and I will be happy to answer any questions from you and other Committee members.



Statement of
Brian Reardon
Manager, Federal Public Policy
National Federation of Independent Business

Subject: Small Employer Tax Relief
Before: House Committee on Small Business
Date: June 9, 1999

National Federation of Independent Business

600 Maryland Avenue S.W., Suite 700 • Washington, DC 20024 • 202-551-9000 • Fax 202-551-0496



Good morning. My name is Brian Reardon. I am a Manager of Federal Public Policy for the National Federation of Independent Business (NFIB). I appreciate the opportunity to present the views of small business owners on the subject of tax simplification.

NFIB is the nation's largest small business advocacy organization, representing 600,000 members in all fifty states and the District of Columbia. The typical NFIB member has five employees and grosses \$350,000 in annual sales. Our membership reflects the nation's commercial economy -- we have the same representation of retail, service, manufacturing and construction that makes up the nation's business community. NFIB sets its legislative positions and priorities based upon regular surveys of its membership.

Tax Simplification

Small business owners might best be described as the poster children of tax complexity. As tough as the IRS Code is on everyone else, it is doubly tough on America's small businessmen and women. It has been estimated that the tax-related paperwork costs are twice as high for a small business compared to a large business.

For that reason, NFIB strongly supports the tax provisions included in the Small Employer Tax Relief Act of 1999, as outlined by Chairman Talent. The portions of the IRS Code targeted by this legislation are particularly onerous to small business and by addressing them, the Talent bill would help move us towards the fairer, simpler tax code that we would all like to see.

Reform Payroll Taxes

First, the Talent bill would start us down the path towards payroll tax reform. One of the biggest disincentives to job creation for small businesses is the burden of payroll taxes on both employers and employees. Of five major tax burdens, payroll taxes were listed as the most costly tax in the NFIB survey, just ahead of personal income taxes.

One federal payroll tax that is ripe for reduction and simplification is the federal unemployment tax, or FUTA. For small business, FUTA presents two problems. First, the rate is too high. The FUTA tax currently collects about twice as much as is needed by the system. Second, employers are required to pay two unemployment taxes -- the federal tax and the state tax. That means twice the collection points, twice the payments, and twice the complexity.

NFIB supports making the following changes to our nation's unemployment system:

Eliminate the Surtax: The temporary FUTA surtax was put in place in 1976 in order to repay loans from the federal unemployment trust fund. Even though this

money was fully repaid in 1987. Congress has extended this temporary tax five times, imposing an annual \$1.4 billion tax burden on America's workers and employers. The surtax should be eliminated.

Cut FUTA Taxes: Even if the surtax is eliminated, FUTA still collects far more than it needs. FUTA raised \$6.1 billion last year, but only \$3.5 billion was spent on FUTA-related expenses. The rest was used to pay for non-related government programs. Permanent FUTA taxes should be cut to reflect the lower costs of the program.

Send the Program to the States: The current system is duplicative and inefficient, costing the federal government, state governments, and private employers hundreds of millions in unnecessary administrative costs annually. Unemployment taxes should be collected by the states alone to eliminate these unnecessary costs.

The Small Employer Tax Relief Act takes the all-important first step towards payroll tax reform by repealing the federal unemployment surtax of 0.2%. Federal payroll taxes have never been cut – they only go up. It is time to reverse history and cut payroll taxes.

Small Business Expensing

A positive step taken by Congress in 1996 was to increase the annual limit on business expensing to \$25,000 by the year 2003.

The purpose of small business expensing is twofold. First, it simplifies tax calculations – deducting investments immediately is simpler than depreciating them over a number of years. Second, it encourages small business to invest by reducing their tax liability and increasing their cash flow.

Expensing should be viewed as a win-win situation for both business owners and the government. When inflation is low, there is no real revenue loss from expensing. Any tax benefit gained one year is lost in the next. Meanwhile, this year's tax benefits are invested into the economy. Long and complex depreciation schedules don't just add up to complexity and cost -- they are also a tax on investments.

The Talent bill recognizes the importance of expensing by increasing the limit under Section 179 from the current \$19,000 to \$35,000 immediately. This provision would be extremely beneficial to thousands of small businesses and NFIB strongly supports it.

Another way to make Section 179 more effective, aside from increasing its limits, might be to expand the types of purchases that can be expensed. Right now, only tangible property like business equipment, office furniture, and computer hardware can

be expensed. Even auto purchases are subject to a limit. Expanding Section 179 to include purchases of computer software and other investments, like leasehold improvements, might make the section more effective.

100% Deductibility for the Self-Employed Health Care Costs

Another area where Congress could build on recent legislation would be to increase health care deductibility for the self-employed. Legislation enacted last fall would phase-in an increase in this deduction. The current allowable deduction is 60 percent.

Unfortunately, full deduction will not be realized by the self-employed until the year 2003. Small businessmen and women cannot put off all their health care needs until the year 2003. Congress should be applauded for putting the deduction on a glide path to 100 percent, but any tax bill adopted this year should provide immediate 100 percent deductibility.

The Talent bill recognizes this unfairness by providing immediate 100 percent deductibility for the health insurance costs of the self-employed.

Capital Gains

NFIB has long been an advocate for reducing the tax on capital gains to encourage investment and job creation.

The "Taxpayer Relief Act" reduced the long-term tax rate on capital gains from 28 to 20 percent, but it also increased the holding period necessary to claim a long-term gain from 12 months to 18 months. This increase effectively created three top rates for capital gains – 40 percent for gains on assets held less than 12 months, 28 percent for assets held between 12 and 18 months, and 20 percent for those held more than 18 months. Last year, Congress addressed this issue by reducing the holding period for long-term capital gains from 18 to 12 months.

Even with the increased complexity of the three-rate system, however, the capital gain tax cut has been wildly successful at stimulating economic activity. The latest revenue figures show that instead of losing revenue, as was previously estimated, the tax cut will actually increase federal collections significantly.

The Talent bill would continue this good news by reducing the rate on long-term capital gains to 15 percent. If history holds true, this should again result in more dynamic economic growth and higher revenues to the Treasury.

Cash vs. Accrual Accounting

Another area related to simplification has to do with shoring up Section 448 of the IRS Code. Section 448 permits businesses with less than \$5 million in annual revenues to use the cash method of accounting. Cash accounting simply allows a business to only recognize those revenues it has actually received.

There are two reforms that NFIB would like to see to this provision. First, the \$5 million cap has been in place for some time. It would be helpful to increase this cap.

Second, the IRS has begun to use other portions of the IRS Code to undermine Section 448. In some cases, the IRS has disallowed the use of the cash accounting system for businesses with annual revenues below \$5 million because the IRS claims inventory is a material factor in their business. It is my understanding that the IRS's definition of "material" is nebulous at best.

A bright line is needed to ensure that businesses below the threshold and without extensive inventories can use cash accounting if they so choose. The Small Employer Tax Relief Act would strengthen Section 448 by ensuring that all businesses with annual revenues below \$5 million have the option of using cash accounting, regardless of whether or not they use inventories.

Tax Rate Parity

Finally, the Talent bill addresses an issue that has long plagued small employers, tax rate parity.

Under current law, the top marginal tax rate for individuals is almost 40 percent (39.6) whereas the top marginal rate for corporations is 35 percent. For small business owners who pay taxes on their business income as individuals, this creates a situation where the marginal tax they pay is considerably higher than the tax rate paid by the largest corporations in America.

The Talent bill addresses this issue by reducing the marginal rate paid by business owners on their business income to the rate paid by medium corporate businesses – 34 percent. NFIB sees this issue as a matter of basic fairness and believes the Talent provision will stimulate investment, economic growth, and job creation in the future.

Conclusion

I would like to thank the Chairman for the opportunity to testify before the Small Business Committee on important tax relief for small employers. I would also like to thank him for taking on this issue with so much enthusiasm. Adoption of the reforms mentioned above would be a dramatic victory in the battle of tax simplification.



OFFICE
OF THE
U.S. CHAMBER
OF COMMERCE

ON: *SMALL EMPLOYER TAX RELIEF ACT OF 1999*
TO: HOUSE COMMITTEE ON SMALL BUSINESS
DATE: June 9, 1999
BY: WILLIAM T. SINCLAIRE

The Chamber's mission is to advance business progress through an environment
of free enterprise and based on individual freedom,
collective initiative, open competition, and respect for the

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – numbers more than 10,000 members. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 85 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on the
SMALL EMPLOYER TAX RELIEF ACT OF 1999
for submission to the
HOUSE COMMITTEE ON SMALL BUSINESS
on behalf of the
U.S. CHAMBER OF COMMERCE
by
William T. Sinclair
Senior Tax Counsel and Director of Tax Policy
June 9, 1999

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the *Small Employer Tax Relief Act of 1999*, and would like to thank Representative James M. Talent (R-MO), Chairman of the House Small Business Committee, for introducing this legislation, his pronounced advocacy of small business issues, as well as his outstanding leadership of the Small Business Committee. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

INTRODUCTION

Small business is the backbone of America's economy. They contribute almost one-half of all sales in this country and 50 percent of private gross domestic product. Small businesses also provide more than half of all employment and about two-thirds of all new jobs. In recent years, the number of new businesses has been at record levels, and the interest on starting and owning a small business has also been skyrocketing. Nonetheless, parity with large businesses does not exist for small businesses under the tax law. It is now time to remove inequities between small and large businesses and to provide small businesses with incentives to grow and create jobs.

SMALL EMPLOYER TAX RELIEF ACT OF 1999

The *Small Employer Tax Relief Act of 1999* ("SERTA") brings together several small business tax provisions and would provide substantial tax relief for America's small businesses. The bill would remove inequities between small and large businesses,

foster savings and investment, and bolster job growth. Specifically, this legislation would:

- **Increase Deduction For Health Insurance Costs Of Self-Employed.** The bill would increase the deduction for the health insurance costs of self-employed individuals to 100 percent, beginning on January 1, 1999. The self-employed currently can deduct only 60 percent of their health insurance costs. *The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998*, signed into law in October 1998, does not accelerate the deduction to 100 percent until the year 2003. SETRA would immediately place self-employed individuals on an equal footing with large businesses, which can deduct 100 percent of their health insurance costs.

The bill would also correct a disparity under current law that bars a self-employed individual from deducting his health insurance costs, if the individual is eligible to participate in another health insurance plan. This provision would only affect self-employed individuals who are eligible for, but do not participate in, a health insurance plan offered through a spouse's employer or second job. The insurance plan may not be adequate to meet the specific needs of the self-employed entrepreneur and his family. In addition, this limitation provides a significant disincentive for self-employed business owners to provide group health insurance for their employees. The bill would end this disparity by clarifying that a self-employed person loses the deduction for his health insurance costs, only if he actually participates in another health insurance plan.

- **Increase Meal And Entertainment Expense Deduction For Small Businesses.** The bill would increase the meal and entertainment expense deduction to 80 percent. Currently, small businesses and self-employed taxpayers can deduct only 50 percent of meal and entertainment expenses. Current law gradually increases the meal and entertainment expense deduction to 80 percent by 2008 for workers in the transportation industry with federally-mandated periods of rest, *i.e.*, airline pilots and long-distance truckers. SETRA would apply the same increase schedule to all small businesses – C corporation, S corporations, partnerships and sole proprietorships – averaging under \$5 million in annual gross receipts for the three preceding years.
- **Increase Expense Treatment For Small Businesses.** Currently, taxpayers can expense up to \$19,000 (in 1999) of the cost of certain tangible, depreciable personal property purchased for use in the active conduct of a trade or business. The expensing limit gradually increases over time to \$25,000 in 2003 (\$20,000 in 2000 and \$24,000 in 2001 and 2002). SETRA would increase expensing for small businesses to \$35,000 immediately.

- **Repeal Federal Unemployment Payroll Surtax.** SERTA would provide a 6 percent tax under the Federal Unemployment system instead of the 6.2 percent under current law. Congress added a “temporarily” 0.2 percent surtax in 1976 to repay government loans from the federal unemployment trust funds. While the loans were repaid in 1987, Congress continues to extend the temporary surtax. The bill would repeal the surtax and thereby reduce payroll taxes on small business taxpayers.
- **Reduce Maximum Income Tax Rate For Small Business Taxpayers.** SERTA would limit the maximum tax rate on net taxable income derived from a small business to 34 percent. For this purpose, qualified taxable small business income would mean taxable income of a small business to the extent such income does not exceed \$5 million. In addition, taxable small business income would mean for any tax year the taxable income of the taxpayer attributable to the active conduct of a trade or business. Generally, eligible small businesses under the bill would include S corporations, partnerships, limited liability companies, and sole proprietorships.
- **Provide tax accounting relief to small businesses.** SETRA would clarify that small businesses with annual gross receipts of \$5 million or less for the three preceding years would be entitled to use the cash method of accounting without limitation. This bill specifically allows small business taxpayers to use the cash method of accounting, and not be required to use the accrual method of accounting by reason of using merchandise or inventory.

CONCLUSION

Our long-term economic health depends upon sound economic and tax policies. Today, we are critically shortchanging ourselves and, more importantly, our children as we commit too many of our scarce resources into current consumption and away from prudent investment. Our tax system encourages waste, retards savings, and punishes capital formation – all to the detriment of long-term economic growth. As we prepare for the economic challenges of the next century, we must orient our current fiscal policies in a way that encourages more savings, more investments, more productivity growth, and ultimately, more economic growth.

The U.S. Chamber believes the tax reforms for small businesses specified in SETRA would reduce the tax burden, create jobs, and increase savings, investment, and productivity growth. The Chamber therefore wholeheartedly supports the *Small Employer Tax Relief Act of 1999*.



Testimony

of Dorothy Coleman
Director, Tax Policy

on behalf of the National Association of Manufacturers

before the Committee on Small Business
U.S. House of Representatives

on Proposed Tax Relief for Subchapter S Corporation Shareholders

June 9, 1999

**MANUFACTURING
MAKES AMERICA STRONG**





Manufacturing: The Key to Economic Growth

- The United States was rated number one in global competitiveness by the Switzerland-based Institute for Management Development by a wide margin — almost 20 percent above its closest competition, Singapore and nearly twice as high as traditional economic rivals, Germany and Japan.
- U.S. manufacturing productivity growth averaged more than 4 percent during 1996 and 1997 — roughly one-third higher than the trend since the early 1980s and nearly three times as great as the rest of the economy.
- U.S. manufacturing's direct share of the Gross Domestic Product (GDP) has remained remarkably stable at 20 percent to 23 percent since World War II. Manufacturing's share of total economic production (GDP plus intermediate activity) is nearly one-third.
- Manufacturing is responsible for two-thirds of the increase in U.S. exports, which have grown to 12.9 percent up from 11.4 percent in 1986.
- No sector of the economy, including the government, provides health care insurance coverage to a greater percentage of its employees. Average total compensation is almost 20 percent higher in manufacturing than in the rest of the economy.
- Technological advance accounts for as much as one-third of the growth in private-sector output, and as much as two-thirds of growth in productivity. The lion's share of this comes from the manufacturing sector, which accounts for more than 70 percent of the nation's total for research and development.

Testimony of

**Dorothy Coleman
Director, Tax Policy
National Association of Manufacturers**

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

**On the
Proposed Tax Relief for Subchapter S Corporation Shareholders**

June 9, 1999

Mr. Chairman, members of the Committee, thank you for the opportunity to testify before you today about proposed tax rate relief for S-corporation shareholders. I would also like to take this opportunity to express our appreciation for your interest in, and support of, America's small and medium businesses.

The NAM is the nation's largest national broad-based industry trade group. Its 14,000 member companies and subsidiaries, including approximately 10,000 small and medium manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. The NAM's member companies and affiliated associations represent every industrial sector and employ more than 18 million people. About 41 percent of our small and medium members operate as S corporations.

NAM members believe that federal taxes are too high and too complex, making the current federal tax code the single biggest obstacle to economic growth. The NAM's 1999 agenda includes a number of pro-growth tax law changes, including a reduction in S-corp tax rates. For our small members, S-corp tax rate relief is one of the top tax issues that would have the most positive impact on their companies' ability to grow.

A Special Type of Corporation

Congress created subchapter S-corporations (S-corps) more than 40 years ago to give owners of small and medium companies more flexibility in setting up and operating their businesses. This hybrid mix of a partnership and a corporation was specifically designed to encourage the growth and stability of small and medium businesses by allowing owners to maintain control of their companies while benefiting from the liability protections afforded corporate shareholders.

Like partnerships, S-corps are pass-through entities — all company profits and losses “pass through” to shareholders. At the same time, S-corp shareholders, like shareholders in traditional corporations (C-corps), have limited liability, *i.e.*, their liability is limited to the amount of their investment in the business. For more than four decades, American business owners — particularly owners of small and medium companies — have recognized the value of this unique corporate structure. The number of S-corps has increased more than 50-fold since 1958. Presently, there are more than 2 million businesses in the United States that are operating as S-corps.

In creating the S-corp structure, Congress recognized the economic importance of fostering and encouraging the growth of small and medium businesses. Over the years, lawmakers have passed additional laws to encourage the creation of S-corps. Legislation enacted in 1982, 1996 and 1997 simplified and eased many of the S-corp rules, making it easier for businesses to form S-corps and more difficult for them to inadvertently terminate their S-corp status.

S-corps received a real boost in 1986, when legislators lowered tax rates and the individual rate ended up below the C-corp rate. The rate differential provided an additional incentive for businesses to become S-corps since S-corp income, which flows through to shareholders, was taxed at the lower, individual rate.

Legislative support and the popularity of this special corporate structure, particularly among small and medium businesses, helped establish S-corps as a mainstay of the U.S. business community. By 1993, nearly half of all U.S. corporations were S-corps. However, legislation enacted that same year dealt a major blow to S-corps. The 1993 Omnibus Budget Reconciliation Act raised the highest marginal tax rate for individuals from 31 percent to 39.6 percent — almost six percentage points higher than the comparable C-corp rate, which remained at 34 percent. Consequently, S-corporations — as pass-through entities — now pay a higher tax rate than C-corps on income that is reinvested in their businesses.

A Step Backward for S-Corps

The tax law changes enacted in 1993 represents a stark departure from Congress’ strong support for S-corps, since they actually discourage small business owners from reinvesting earnings back in their companies. Income earned by similar sized C-corps that is retained and invested in the company is taxed at a maximum rate of 34 percent, while income reinvested in an S-corp is taxed at a maximum rate of 39.6 percent. To put it simply, S-corp owners now pay a higher tax than C-corps on money used to develop new products, enter new markets and hire additional employees.

The higher tax rate is particularly harmful to S corp manufacturers that have to make large capital investments to grow their business and improve their competitive position. These companies typically do not have access to capital markets and have to finance capital investment from their cash flow. Increased investment translates into additional jobs. It is estimated that, for every \$100,000 that is reinvested, a small manufacturer can create three to four new jobs.

A study¹ by the Congressional Joint Economic Committee confirms that the 1993 tax law changes hit small businesses harder than other taxpayers. Based on statistics from the IRS, the study estimates that two-thirds of all small businesses feel the negative repercussions of the 1993 tax-rate increase.

Recent surveys conducted by the National Association of Manufacturers support these conclusions. In particular, the surveys showed a dramatic decline in investment, R&D and employee hiring among small manufacturer S corporations since enactment of the 1993 tax law. In contrast, C-corps surveyed did not report a similar decline.

For many companies, changing from S-corp to C-corp status is not an option, in part because of administrative costs and planning problems. Moreover, companies that do make the transition forfeit the right to flow through income so that income distributed to shareholders would be taxed twice. In addition, S-corps that do switch to C-corp status cannot re-elect S-corp status for a five-year period. Finally, there is no guarantee that tax rates will remain at current levels.

Possible Solutions to the Problem

There are ways to address this problem. The proposal advocated by the NAM would "level the playing field" for S-corps by applying a maximum tax rate of 34 percent to the first \$5 million of S-corp income that is reinvested in the business or used to pay taxes.

This proposal represents an opportunity for Congress to continue the mission it began in 1958, when lawmakers first established S-corps. In fact, given the critical role of small and medium business in the U.S. economy, it is imperative that Congress corrects the economic injustices of the 1993 tax increases.

Congress originally created S-corps to offer small and medium size business owners an efficient and cost-effective way of doing business. Up until recently, lawmakers' efforts were extremely successful. For almost 40 years, S-corps have contributed significantly to the country's economic growth. However, this positive trend was derailed in 1993, when the top *individual* tax rate was increased. Now is the time to restore the benefits of S-corps and encourage entrepreneurs who are trying to grow their businesses. In fact, President Clinton has admitted that the 1993 tax increases went too far. Speaking to a group of businessmen in 1995, the President commented that "there are people in this room still mad at me because you think I raised your taxes too much." He added, "It might surprise you to know that I think I raised them too much, too."

¹ *Taxing Small Business and Innovation (1996)*



June 10, 1999

Submitted to House Small Business Committee:

Here is some information on small business capital expenditures. This data is from the National Federation of Independent Business Education Foundation publication *Small Business Economic Trends* from the Month of May 1999. The survey on which this report is based was conducted during the month of April 1999. A sample of 7,200 small business owners was drawn from the membership files of the National Federation of Independent Business. Each was mailed a questionnaire and one reminder. Fifteen hundred and forty-eight usable responses were received--a response rate of 22 percent.

Net percent of firm owners reporting capital expenditures in the last three months

Overall:	69%
Vehicle purchase	27%
Equipment	54%
Fixtures/Furniture	21%
New buildings/land	8%
Improved buildings	16%

Total amount spent on these capital expenditures

Under \$1,000	8%
\$1,000-\$4,999	18%
\$5,000-\$9,999	12%
\$10,000-\$19,999	14%
\$20,000-\$49,999	22%
\$50,000-\$99,999	12%
\$100,000-\$499,999	11%
\$500,000-\$999,999	2%
\$1 million or more	1%

The following is the breakdown of businesses by form of business organization

Proprietorship	26%
Partnership	6%
Corporation	45%
Sub s corp	20%
No reply	3%

Elliot Steinberg
Research Associate
NFIB Education Foundation

National Federation of Independent Business

600 Maryland Avenue S.W., Suite 700 • Washington, DC 20024 • 202-554-9000 • Fax 202-554-0496



bcc: Ligia McWilliams



Dorothy B. Coleman
Director, Tax Policy
Economic Policy Department

June 10, 1999

The Honorable Nydia Velazquez
 United States House of Representatives
 Washington, D.C. 20515

Dear Representative Velazquez:

Thank you again for the opportunity to appear before the House Small Business Committee June 9 to present the NAM's view on tax rate relief for subchapter S corporations. As I mentioned in my statement, about 41 percent of NAM's small and medium members are organized as S corporations. In a recent survey, these companies identified S-corp tax rate relief as one of the top tax policy issues that would have a positive impact on their ability to grow.

During the question and answer segment, you graciously agreed to allow me to respond in writing to your question about whether the proposed tax rate relief in the Small Employer Tax Relief Act of 1999 would make the tax code more complex. I'd like to take this opportunity to respond to your question.

NAM members believe that federal taxes are too high and too complex, making the current federal tax code the single biggest obstacle to economic growth. The long-term solution calls for a new tax system that is simpler and encourages, rather than penalizes, work, investment and entrepreneurial activity. In the meantime, however, the NAM supports a number of pro-growth tax law changes to insure the nation's continued economic growth. Tax rate relief for S-corp shareholders is one of these proposed changes. So, while the change we are advocating would make the system more complex, we are willing to put up with this complexity to fix a real inequity in the system.

As I noted in my testimony, income earned by a similar sized C corporation that is retained and invested in the company is taxed at a maximum rate of 34 percent, while income reinvested in an S corporation is taxed at a maximum rate of 39.6 percent. To put it simply, S-corp owners now pay a higher tax than C corporations on money used to develop new products, enter new markets and hire additional employees. This is the inequity we would like to see corrected.

I hope this response adequately addresses your concerns. Several colleagues of mine at the NAM, Dean Garritson, Elwyn Darden and Jo-Anne Prokopowicz enjoyed meeting with you and talking about this issue earlier this year. If you would like further information about the plight of the small manufacturer S corporation, I can arrange for you to meet with an NAM member who operates as an S corporation. Please contact me at the number below if you are interested in meeting with one of our members.

Sincerely,

Manufacturing Makes America Strong

1331 Pennsylvania Avenue, NW • Washington, DC 20004-1790 • (202) 637-3077 • Fax (202) 637-3182 • www.nam.org

**WRITTEN STATEMENT
OF
THE NATIONAL ALLIANCE OF SALES REPRESENTATIVES ASSOCIATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
ON
"SETRA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS"
WASHINGTON, DC
JUNE 9, 1999**

Chairman Talent and Members of the House Small Business Committee:

On behalf of the nearly 10,000 members of the National Alliance of Sales Representatives Association (NASRA), we would like to submit the following statement in support of the Small Employer Tax Relief Act of 1999.

The membership of NASRA includes the membership of the following fourteen organizations:

Bureau of Wholesale Sales Representatives
International Home Furnishings Representatives Association
National Golf Sales Agents
Ski & Outdoor Sales Representatives Associations
Western Winter Sports Sales Representatives Associations
New England Ski Sales Representatives Association
Eastern Ski Sales Representatives Association
Mid West Ski Sales Representatives Association
Southeast Winter Sports Association
Western Shoe Association
Boot & Shoe Travelers of New York
National Association of Selling Agents
Professional Representatives Organization
Independent Sales Association

The members of these organizations are an integral part of the economy providing knowledge and expertise in their industries crucial to the manufacturing and retail sector. It is safe to say that in their individual industries, sales reps are the eyes and ears of both retailers and manufacturers when it comes to identifying and moving new and innovative products from the manufacturer to the retailer, and ultimately to the consumer.

The 10,000 members of these 14 organizations are independent business owners, often working from their homes as a base, but spending up to 200 days per year on the road. They are impacted by most of the tax code provisions that make daily life increasingly difficult for a small business owner impeding their ability to remain competitive in today's rapidly changing markets.

The Small Employer Tax Relief Act of 1999, introduced by Chairman Talent, would if enacted, eliminate several of these impediments. The provisions of SETRA that NASRA members are particularly interested in are:

Accelerating the 100% Deduction for Health Insurance for the Self-Employed Business Owner.

As self-employed business owners the combined effect of high health care costs along with the inability to fully deduct these costs has been a strong impediment to many NASRA members being able to afford health insurance plans. The discriminatory nature of the existing rules that allow full deductibility for some business owners is patently unfair. The same tax deduction should apply without regards to the form of business chosen.

Increasing the Meal Deduction from 50% to 80%.

Spending up to 200 days on the road, sales representatives use the opportunity to take the buyer or manufacturer away from the environment of interruptions and telephones ringing to build the necessary relationship for doing business. These representatives do not have access to large advertising budgets or other gimmicks to attract a buyers attention.

A meal at a local restaurant usually of modest price, typically averaging less than \$12, is an important part of the sales process. These meals are not personal; they are valid business expenditures and should be fully deductible so long as the business owner satisfies the substantiation rules of the Internal Revenue Code.

Page 3

Increasing the Expensing Allowance to \$35,000 for Small Business.

Computers, fax machines, cell phones, lap tops, palm tops, have become important parts of the rep's tool bag, as much as his samples or order forms. The current depreciation rules are too limited and do not represent the true cost of maintaining up-to-date technology.

CONCLUSION

On behalf of the membership of NASRA, we wanted to lend our strong support for this legislation and look forward to working with the members of this committee to work towards its enactment.

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**WRITTEN STATEMENT
OF
ROGER HARRIS, PRESIDENT
PADGETT BUSINESS SERVICES
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
ON
“SETRA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS”
WASHINGTON, D.C. JUNE 9, 1999**

**Padgett Business Services
160 Hawthorne Park
Athens, GA 30606
Tel: 706-548-1040**

Padgett Business Services is pleased to offer this statement in support of "SETRA: Fair and Simple Tax Relief for Small Business." We have been providing accounting and tax services to small business clients for over 30 years, and currently have over 300 franchise and company owned locations serving over 13,000 clients. Padgett believes the enactment of this legislation would be of great benefit to small business. Further, because of the importance small business plays in our economy, we also feel its enactment would benefit the economy as a whole.

Small business has been described as the engine that drives our economy. Yet the provisions of the law SETRA proposes to modify impose financial hardships and inequities on taxpayers least able to afford them and create disincentives to the prospering of the small business community. The provisions of the proposed legislative measures overturn many of these downsides of the current law. We encourage their prompt enactment.

INCREASE DEDUCTION FOR HEALTH INSURANCE

SETRA would permit small business to increase the deduction for health insurance costs to 100% as of January 1, 1999. This full deduction has been a priority of small business for some time. Small business owners have felt they were being discriminated against with the existing limit placed on their health insurance deduction. Congress already has recognized this when it agreed to allow a 100% deduction to be phased in by the year 2003. While that was a good start, there is no sound reason to make small businesses wait for their equal treatment. Therefore, the ability of small businesses to deduct 100% of their health insurance cost immediately is needed and would justifiably be viewed by them as well-deserved and long overdue. Of significance, it also would overcome some of the cost barrier that has precluded health care coverage to millions of small business owners, their employees, and the children of those persons.

We also are pleased the bill corrects the disparity that currently is in place regarding eligibility for any deduction of health insurance costs. This provision should be made law even if the deduction were to remain where it stands today. To penalize a person only because he or she is eligible to participate in another health plan is without justification. Only those who actually participate in another plan should be subject to the limitation.

INCREASE MEAL AND ENTERTAINMENT EXPENSE

The gradual increase in the meal and entertainment deduction is a needed incentive to the prospering of small business. Entertaining is a normal activity in most businesses. Large companies have the funds to engage in this activity without close scrutiny of its tax consequences. Small business does not have this luxury; yet its need is as great as that of big business. Small businesses must consider every aspect of any activity since they do

not have the financial depth of most large companies. Consequently, the increased deduction would allow small businesses to compete with large companies in this area. The limit on the size of the business that can benefit from the increased deduction insures that only those small businesses needing the help will garner the benefits of the bill. As an added benefit, the restaurant industry should see a potential increase in the business entertaining that takes place in their places of business. Since many restaurants are also small businesses, this provision may have an additional positive impact on them.

INCREASE EXPENSE TREATMENT FOR SMALL BUSINESS

Expanding and modernizing one's business is required in today's competitive environment. Small business always has faced difficulty in keeping pace with the vast improvements made in capital assets over the last decade. Part of the problem has been the inability of small businesses to finance the purchase of the (improved) new equipment. By increasing the deduction for capital improvements, a small business owner would be able to allocate money that otherwise would go to income tax and invest it back in the business. This provision of the legislation also would ease some of the record-keeping burdens small businesses face. In this respect, keeping up with depreciable assets can require a great deal of work for a number of years. The ability to expense the item or items in one year would eliminate the need to keep records on the asset for many subsequent years.

REDUCE THE MAXIMUM TAX RATE FOR SMALL BUSINESS

It seems self-evident that all taxpayers favor the reduction or limitation of income tax applicable to them. This includes small business. Consequently, this provision of the bill would be welcomed by small business owners across the nation. A small business owner who pays less in income taxes is able to spend more on and in the business. For example, tax savings would allow the business owner to upgrade plant or equipment, give employees additional benefits, and/or expand their workforce by hiring another employee. Even if the saved tax money goes directly to the business owner, it still benefits the economy by having the funds spent with other businesses, invested, or saved. It also is an incentive to a prospective small business owner to enter the marketplace, thereby being supportive of our free enterprise system.

A possible concern with respect to this provision is potential difficulty in the implementing regulations. Questions may arise in this regard relative to the definition of small business income. A simple example is the treatment to be accorded the interest earned on a business checking account reported under the social security number of the sole proprietor. Care must be taken that the maximum tax rate be made law without the creation of undue additional paperwork and record keeping.

REPEAL FEDERAL UNEMPLOYMENT SURTAX

This law change is long overdue. The current surtax is an example of where a temporary solution to a problem has become a permanent tax on small business. As has been

acknowledged, the surtax was imposed to pay back loans that were repaid in 1987. There is no valid reason to continue to collect this surtax. We also must recognize that any time there is an added cost to hiring an employee, money is taken away from that employee or, worse yet, postpone or eliminate the hiring of an employee. Small business owners feel strongly that payroll taxes are much too high. Anything that can be done to lower these taxes would be a great benefit to them. While the reduction may not be a large saving to a small employer, it does send the right message that Congress understands what small business owners face when hiring people.

CASH ACCOUNTING RULES FOR SMALL BUSINESS

This provision of SETRA may constitute the biggest benefit to small business; yet it is the benefit they may least recognize. It is very common for Padgett Business Services to learn a new client is using the wrong accounting method. In most cases, this is due to a lack of knowledge of the current law rather than an intentional disregard of it. Most small business owners think in terms of cash in and cash out as opposed to accrual accounting. Cash accounting for most small business owners is a more accurate picture of the manner in which their businesses operate. Tax reporting by them should be consistent their "real world." Hence, they should be permitted to use the cash accounting method for tax purposes.

As indicated, many small business owners currently are reporting under the wrong accounting method. To correct this problem mean a small business owner could be faced with large professional fees, high IRS user fees, IRS penalties and interest, and/or high tax bills. SETRA not only would make things better for small business in the future, it would eliminate a big problem many of them have today, a problem of which they are not even aware.

In summary, Padgett Business Services, on behalf of our small business clients, thanks Congressman Talent and the entire committee for offering this legislation. While no single legislative effort can solve every problem facing small business today, SETRA does fix many of the problems that small business sees as important. We urge SETRA's enactment and offer our support and help in way the committee may desire.



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WRITTEN STATEMENT

OF

DAVID GOODREAU

QUANTUM MANUFACTURING

906 SOUTH SAN FERNANDO BLVD.

BURBANK, CA 91502

BEFORE THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

ON

"SETRA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS"

WASHINGTON, DC

JUNE 9, 1999

Good morning Chairman Talent and members of the Small Business Committee. My name is David Goodreau and I am the general manager of Quantum Manufacturing in Burbank, California -- a small business with only 14 employees. I am a member of the National Tooling and Machining Association, the only national voice of the precision tooling and machining industry representing 2,600 companies who manufacture precision machined parts, molds, dies, tools and special machines. I am also the Chairman and co-founder of the Small Manufacturers Association of California (SMAC). The SMAC is a statewide organization of 1,000 companies dedicated to uniting the small and middle-sized manufacturers to improve their business environment.

I appreciate the opportunity to discuss the Small Employers Tax Relief Act (SETRA) today. SETRA offers not only small business relief but is a family relief act as well. In a nation where the vast majority of small businesses are "family" owned and operated, SETRA would be a catalyst to assist these small, family business owners in playing their diverse leadership roles in a more effective way. It can't be stressed enough how much sacrifice and passion is put into the small enterprise where the principle owner often makes less than minimum wage when considering hours worked versus return on investment. The stakes are high. In my area of manufacturing, small family-owned firms are as much a fabric of our American heritage as the small family farmer.

I applaud Chairman Talent and the other cosponsors of the Small Employer Tax Relief Act. The provisions in SETRA will benefit all small firms in some way. As a small businessman, I especially see the immense value in raising the meal deduction from 50 percent to 80 percent. Many of us attempt to squeeze twenty hours of tasks into a 10 to 12 hour workday. Lunch meetings are a vital and strategic part of that workday. Limiting options, such as working

lunches, is a barrier for the small entrepreneur to succeed in today's global business environment. However, we shouldn't stop at 80 percent. The meal deduction should be a full 100 percent deductible if it is a legitimate business expense. As an entrepreneur I would like the IRS to treat me the same as an executive from a big company.

I am very pleased with the cash versus accrual method of accounting provision in this package. The NTMA has been trying to get relief from the IRS and prevent them from using inventory tests to switch our members from cash to accrual accounting. This bill will certainly help those companies with revenues under \$5 million annually by forcing the IRS to follow the law that is already in place. Small entrepreneurs are generally not CPAs; allowing a more simplistic approach to accounting and inventory will provide many more hours of productive time for the businessperson to expand their business or spend time with their family.

An increase in expensing would be very helpful to all small firms. The tax code currently allows taxpayers to expense up to \$19,000 of the cost of certain tangible, depreciable personal property purchased for use in the active conduct of business. We are on a track to increase the expensing limit to \$25,000 by the year 2003. SETRA would make the expensing level \$35,000 immediately. As we need more equipment to keep up with the changing times it helps any business to be able to take more of an immediate tax write-off than to capitalize the expenses over a three year period. As America created and encouraged the evolution of global trade, our government failed to assist our own small companies in preparing for the competition that was to develop. We have failed to invest in the technologies and education that would allow us to use those strategic tools to combat low wage economic infrastructures of developing nations. We must continue to invest and invest quickly to maintain a competitive edge in the high value-added services and manufacturing that is a core competency of the American enterprise.

SETRA will lower the top individual income tax rate from 39.4 percent to 34 percent on the active business income of small businesses. This will result in a lower tax on the entrepreneurs who are simply middle-class people trying to live out the American dream. Small business owners ride the rough seas of economic trends in a buoy rather than the Ocean Liner of Global Corporations. Reducing the tax rates allows the business owner to ride those ever changing conditions in a more secure manner for both the business and the family. Tax reduction on these people is also an investment stimulus package. Job creation, family security, technology investment, and family education expenditures will be the legacy of this Tax Relief Act.

SETRA also repeals the Federal Unemployment Payroll Surtax (FUTA). This “temporary” tax was added in 1976 to repay government loans from the federal unemployment trust funds. While the loans have been paid off since 1987, Congress continues to collect this miniscule tax of .2 percent. I consider this tax to be a nuisance. New entrepreneurs struggle just to refine their products and services. Additional and unnecessary taxation requirements and regulations hasten their ability to stay in business during the first critical months of their business venture.

An immediate increase in the deductibility for health insurance costs for the self-employed would place small business on a level playing field with the big firms. Currently, the self-employed can deduct only 60 percent of their costs while big businesses can deduct 100 percent. I view this discrepancy as nothing less than discrimination against the American small business entrepreneur.

The Small Employer Tax Relief Act is great legislation that will help small business people get a fair shake against the big companies. We are all willing to work hard, pay our fair

share of taxes, grow our businesses, hire new employees and help the economy, but a level playing field would make our lives that much easier. Simplifying the Tax Code for entrepreneurs who can't always afford to keep a professional accountant on staff, or even the ones that can, is a common-sense approach to helping those of us in the tooling and machining industry remain the backbone of American manufacturing.

Statement of the National Society of Accountants
Offered for the Congressional Record
Small Employer Tax Relief Act of 1999 Hearings
House Small Business Committee

June 9, 1999

The National Society of Accountants (NSA) is pleased to offer this statement in support of the Small Employer Tax Relief Act of 1999 (SETRA). NSA commends Chairman Talent and the other members of the Committee for their attention to the small business tax issues raised by this proposed legislation. SETRA represents significant tax relief for the nation's 23 million small businesses. SETRA proposes simple and fair tax relief that would promote economic growth by creating incentive for small businesses to invest in new employees and equipment. The legislation provides these benefits while not adding to the complexity of the tax law, and once implemented, will create a new level of growth and prosperity in our nation's small business community.

Through our national organization, and affiliates in 54 jurisdictions, the National Society of Accountants represents the interests of approximately 30,000 practicing accountants and tax practitioners. NSA members, as sole practitioners or partners in small to medium-sized accounting firms, are often times themselves small businesses. Secondly, the majority of our member's clients are small businesses. Our members provide accounting, tax preparations, representation before the Internal Revenue Service (IRS), tax planning, financial planning and managerial advisory services to approximately six million individuals and small businesses. The members of NSA are pledged to a strict code of professional ethics and rules of professional conduct.

1. SETRA is Simple and Fair Tax Relief.

The Small Employer Tax Relief Act of 1999 is a set of six miscellaneous amendments of the nation's tax laws drawn together by the common thread of bringing tax relief to small businesses. The six proposed amendments, in abbreviated form include,

- 1) Immediate increase in the self-employed business expense deduction for health insurance costs to 100%.
- 2) Gradually increase the small business meal and entertainment expense deduction from its current 50% to 80% by the year 2008.
- 3) Increase the expense treatment limit for small businesses to \$35,000 per year.
- 4) Repeal of the Federal unemployment surtax.
- 5) Reduce the maximum small business income tax rate from 39.4% to 34%.
- 6) Expand the allowable small business use of the cash method of accounting.

Chairman Talent hit upon the primary goal of any tax legislation when he said, “[t]he Small Employer Tax Relief Act provides a *simple, fair* solution to one of small businesses greatest impediments – a tax system that overburdens small business.” The National Society of Accountants agrees that SETRA meets the simple and fair standard. SETRA is simple, in that it merely amends existing code sections by substituting rates or numerical limits without amending how those numbers are applied, and in the case of increasing the use of current tax year expensing and the cash method of accounting SETRA offers simplification. SETRA is fair, both to the public and to small businesses, because it serves to provide equitable treatment for small businesses and large businesses alike.

2. SETRA does not Add Complexity to the Tax Law.

Proposals to amend the tax laws should first be analyzed in terms of any added complexity. Complexity is an ever-present trend in tax law. Although, complexity is warranted in taxing complex transactions, it is a double-edged sword. By leading to increasingly difficult compliance standards being applied to honest taxpayers, complexity has furthered the negative public perception of the IRS. Given the present complexity of the tax laws, inevitable and understandable errors can nonetheless result in penalties and interest costs for imprecise compliance. Complexity puts the taxpayer on the defensive - creating a climate of distrust between the taxpayer and tax collector, and between the professional tax preparer and tax collector.

We recognize and appreciate the strides this Committee and the IRS have made in this regard, but in promoting the public interest, our members still believe more could and should be done to simplify our tax code. NSA suggests that a complexity analysis should be a prerequisite to enacting any amendment to the tax law. Proposed amendments that are found to add complexity must show a substantial economic, social or equitable good that overcomes the burdens of added complexity.

Such an analysis of SETRA leads to the conclusion that the six amendments are simple substitutes for existing provisions. The substitutes are simply drafted and address well understood and longstanding tax code sections. The simplicity of the amendments themselves and the fact that the laws being amended is well established provides the necessary assurance that SETRA will not prompt complex regulatory interpretation. The Act would not add to the growth in tax law complexity, but it does offer substantial economic, social and equitable tax benefits.

3. SETRA Offers Tax Fairness and Would Promote the Public Good.

SETRA is a good example of amendment to the tax laws that is fair to both those directly and indirectly affected. SETRA would benefit the public in many ways. The legislation would further the growth of small business in the nation’s economy by lowering small business costs and providing investment incentive. Small business growth translates into increased competition between large and small enterprises, and the public benefits both in terms of product quality and

cost. Further, a growing small business sector is critical to job creation and individual opportunities to work, save and provide for one's family.

- a. SETRA corrects a significant tax inequity and furthers the public good by making health insurance more affordable to small business.

Few services promote the public good more than affordable health insurance. Health insurance is a fundamental human service. SETRA's health insurance deduction provision, the immediate increase of the self-employed business deduction for health insurance costs to 100%, provides incentive for millions of small business owners to purchase health insurance for themselves and their families. It has been estimated that there are 5 million uninsured Americans who are self-employed. It is further estimated that increasing the health insurance deduction to 100% would induce half of these 5 million to purchase insurance for themselves, their spouses and children. The direct public benefit is substantial, and further, by causing an increase in the percentage of insured Americans, SETRA may also marginally lower individual health insurance costs for all Americans.

In the past, self-employed health insurance costs have been treated, at least partially, as a non-deductible personal expense. At the same time, large enterprises have always deducted the same expense as a legitimate business deduction. SETRA eliminates this inequity. There is no justification for permitting large businesses to fully deduct employee health insurance cost, while not allowing the self-employed to fully deduct cost of insuring themselves and their families. SETRA would promote the viability of small businesses, and meet the important social concern of making health insurance more affordable for the self-employed and their families.

- b. Fairness in tax policy supports treating small and large businesses differently under the meal and entertainment business expense deduction.

An important policy distinction should be made between small and large business use of the meal and entertainment expense deduction. Entertaining clients and customers is a normal activity in for most businesses. But, as a practical matter, small businesses are less likely to have the facility or the financial means necessary to entertain a client at their own site. Small businesses often do not possess any place of their own at which they can entertain, clients or customers.

Restaurants serve as the offices and conference rooms for millions of small businesses. Entertaining is thus necessary and indispensable for small business, not a luxury. Further, small businesses are often start-up businesses. Getting a new business off the ground involves scrutinizing every expense. Raising the small business meal and entertainment expense deduction from 50% to 80% will provide incentive for small businesses to seek out new clients and customers, to grow and prosper.

- c. Increasing the expense limit and providing tax accounting relief lessens the regulatory tax burden facing small businesses.

Increasing the annual small business expensing limit to \$35,000 and providing tax accounting relief by allowing more liberal use of the cost accounting method are two excellent examples of fair tax policy. Arguably, complying with Federal regulations of all kinds falls disproportionately on small businesses. Disproportionate in the sense that when measured by an objective standard, such as the cost of regulatory compliance as a percent of gross receipts, small businesses pay a higher price for their good faith effort to comply with the myriad of complicated agency regulations, especially tax laws. The issue is primarily one of equity in the ability of businesses of relative sizes to comply with the tax law. Small enterprises are less likely to staff for expertise in tax law and thus are often times completely reliant on consulting professionals to achieve compliance.

Increasing the business expense limit to \$35,000 allows small businesses to simplify their compliance with the tax law by closing out deductions in a single tax year, versus have to administratively track depreciation deductions over many years. The increased expense limit also provides important incentives for small business to make capital improvements, again providing for growth and the creation of jobs.

The cost burden of tax law compliance is also an argument that supports more liberal small business use of the cash accounting method. The accrual accounting method is considered to be more complex, and certainly the cash method is more intuitive. As a practical matter, cash in and cash out is how most small businesses will analyze their activity. In this context it makes good policy to match the application of the tax law up to the actual business practices.

- d. Any tax revenue lost due to the enactment of SETRA is relatively modest in comparison to the expected economic growth such changes will achieve.

The cost of SETRA is estimated to be \$30 billion over five years. But whatever revenue is lost will undoubtedly be offset to some extent by growth in small business activity that will produce new tax revenue. The amendments are not only fair to the public, but benefit the public by promoting growth in the small business sector. Further public benefit is foreseen by providing incentive for the self-employed to purchase health insurance for themselves and their families. Reducing the ranks of the uninsured is a public good in itself that may also cause a marginal reduction in individual health insurance costs for all Americans.

The National Society of Accountants would like to conclude by thanking the Committee and Chairman Talent for their leadership and attention to these small business tax issues. NSA strongly supports the Small Employer Tax Relief Act of 1999. Through simple and fair tax law amendments, SETRA will simultaneously advance the public good and the interests of our nation's estimated 23 million small businesses. NSA, for its part, is pleased to remain an active part of the process in assisting lawmakers and tax regulators in any way possible. Thank you.



Statement of the American Farm Bureau Federation

**BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
ON
“SERTA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS”
June 9, 1999**

As the national voice of agriculture, AFBF's mission is to work cooperatively with the member state Farm Bureaus to promote the image, political influence, quality of life and profitability of the nation's farm and ranch families.

FARM BUREAU represents more than 4,800,000 member families in 50 states and Puerto Rico with organizations in approximately 2,800 counties.

FARM BUREAU is an independent, non-governmental, voluntary organization of families united for the purpose of analyzing their problems and formulating action to achieve educational improvement, economic opportunity and social advancement and, thereby, to promote the national well-being.

FARM BUREAU is local, county, state, national and international in its scope and influence and works with both major political parties to achieve the policy objectives outlined by its members.

FARM BUREAU is people in action. Its activities are based on policies decided by voting delegates at the county, state and national levels. The American Farm Bureau Federation policies are decided each year by voting delegates at an annual meeting in January.

**WRITTEN STATEMENT
 OF
 THE AMERICAN FARM BUREAU FEDERATION
 BEFORE THE
 COMMITTEE ON SMALL BUSINESS
 U.S. HOUSE OF REPRESENTATIVES
 ON
 “SERTA: FAIR AND SIMPLE TAX RELIEF FOR SMALL BUSINESS”**

June 9, 1999

The American Farm Bureau Federation appreciates the opportunity to express its views on the Small Employer Tax Relief Act of 1999. The American Farm Bureau is the nation's largest general agriculture organization representing 4.8 million member families. Our membership represents virtually every commodity grown or raised in the United States.

Increases Deduction for Health Insurance Costs of Self-Employed

The majority of farmers and ranchers are self-employed individuals who pay for their own health insurance. Because of the high cost of health insurance, many cannot afford high quality coverage or must go without health insurance. Even though corporations that provided health insurance for their employees can deduct premium costs, only 60 percent of the self-employed person's health insurance premiums are tax deductible in 1999. The deduction is scheduled to increase over time until it reaches 100 percent in 2003.

According to data from the Current Populations Survey (CPS), the agricultural industry has the highest percentage of uninsured individuals among all industries reported. Thirty-five percent of individuals in the farm sector do not have health insurance compared with 18 percent for the population as a whole. Farm Bureau supports the immediate full deductibility of health insurance premiums paid by the self-employed.

Increase Expense Treatment for Small Businesses

Farmer and ranchers are affected daily by business expenses that are necessary to keep their operations in order and functioning. Currently, taxpayers can expense up to \$19,000 (in 1999) of the cost of certain tangible, depreciable personal property purchased for use in the active conduct of a trade or business. The expensing limit gradually increases over time to \$25,000 in 2003. This legislation would immediately increase expensing for small businesses to \$35,000. This provision would be extremely beneficial to farmers and ranchers. Farm Bureau supports the immediate increase in expensing for small businesses.

Repeals Federal Unemployment Payroll Surtax

FUTA taxes finance the administration of the federal unemployment compensation system and half of the federal state extended benefits program. In 1976, Congress passed a temporary surtax

of 0.2 percent to repay loans to the federal unemployment trust fund. This temporary tax has been extended five times even though the loan was fully repaid in 1987.

The 0.2 percent FUTA surtax imposes \$1.4 billion of taxes annually on business. With the trust fund loan repaid, the surtax is no longer needed but has been extended to raise revenue for other purposes. The bill would repeal the surtax and thereby reduce payroll taxes on small business taxpayers. Farm Bureau supports the repeal of the 0.2 percent Federal Unemployment Tax Act (FUTA) surtax.

Conclusion

Farmers and ranchers need relief from the federal burdens of being in business. The long-term economic health of agriculture depends upon sound economic and tax policies. Farm Bureau supports those efforts that would reduce the tax burden, increase savings and investment and productivity growth.

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H.L.C.

.....
(Original Signature of Member)

106TH CONGRESS
1ST SESSION

H. R. _____

IN THE HOUSE OF REPRESENTATIVES

Mr. TALENT (for himself, Mr. MCCRERY, Mr. ENGLISH, Mrs. BONO, and Mr. DEMINT) introduced the following bill; which was referred to the Committee on _____

A BILL

To amend the Internal Revenue Code of 1986 to provide tax relief for small businesses, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE.**

4 This Act may be cited as the “Small Employer Tax
5 Relief Act of 1999”.

1 **SEC. 2. DEDUCTION FOR HEALTH INSURANCE COSTS OF**
2 **SELF-EMPLOYED INDIVIDUALS INCREASED.**

3 (a) IN GENERAL.—Paragraph (1) of section 162(l)
4 of the Internal Revenue Code of 1986 (relating to special
5 rules for health insurance costs of self-employed individ-
6 uals) is amended to read as follows:

7 “(1) ALLOWANCE OF DEDUCTION.—In the case
8 of an individual who is an employee within the
9 meaning of section 401(c)(1), there shall be allowed
10 as a deduction under this section an amount equal
11 to the amount paid during the taxable year for in-
12 surance which constitutes medical care for the tax-
13 payer, the taxpayer’s spouse, and dependents.”.

14 (b) CLARIFICATION OF LIMITATIONS ON OTHER COV-
15 ERAGE.—The first sentence of section 162(l)(2)(B) of the
16 Internal Revenue Code of 1986 is amended to read as fol-
17 lows: “Paragraph (1) shall not apply to any taxpayer for
18 any calendar month for which the taxpayer participates
19 in any subsidized health plan maintained by any employer
20 (other than an employer described in section 401(c)(4))
21 of the taxpayer or the spouse of the taxpayer.”.

22 **SEC. 3. SMALL BUSINESSES ALLOWED INCREASED DEDUC-**
23 **TION FOR MEAL AND ENTERTAINMENT EX-**
24 **PENSES.**

25 Subsection (n) of section 274 of the Internal Revenue
26 Code of 1986 (relating to only 50 percent of meal and

1 entertainment expenses allowed as deduction) is amended
 2 by adding at the end the following new paragraph:

3 “(4) SPECIAL RULE FOR SMALL BUSINESSES.—

4 “(A) IN GENERAL.—In the case of any
 5 taxpayer which is a small business, paragraph
 6 (1) shall be applied by substituting ‘the applica-
 7 ble percentage (as defined in paragraph
 8 (3)(B))’ for ‘50 percent’.

9 “(B) SMALL BUSINESS.—For purposes of
 10 this paragraph, the term ‘small business’
 11 means, with respect to expenses paid or in-
 12 curred during any taxable year—

13 “(i) any C corporation which meets
 14 the requirements of section 55(e)(1) for
 15 such year, and

16 “(ii) any S corporation, partnership,
 17 or sole proprietorship which would meet
 18 such requirements if it were a C corpora-
 19 tion.”.

20 **SEC. 4. INCREASE IN EXPENSE TREATMENT FOR SMALL**
 21 **BUSINESSES.**

22 Paragraph (1) of section 179(b) of the Internal Reve-
 23 nue Code of 1986 (relating to dollar limitation) is amend-
 24 ed to read as follows:

1 “(1) DOLLAR LIMITATION.—The aggregate cost
2 which may be taken into account under subsection
3 (a) for any taxable year shall not exceed \$35,000.”.

4 **SEC. 5. REDUCTION OF MAXIMUM INCOME TAX RATE FOR**
5 **SMALL BUSINESS TAXPAYERS.**

6 Section 1 of the Internal Revenue Code of 1986 (re-
7 lating to tax imposed) is amended by adding at the end
8 the following new subsection:

9 “(i) TAX RATE ON CERTAIN SMALL BUSINESS IN-
10 COME.—

11 “(1) IN GENERAL.—Except as provided in para-
12 graph (4), if a small business taxpayer has taxable
13 income for any taxable year to which this subsection
14 applies, then the tax imposed by this section shall
15 not exceed the sum of—

16 “(A) a tax computed at the rates and in
17 the same manner as if this subsection had not
18 been enacted on the greater of—

19 “(i) taxable income reduced by quali-
20 fied small business income, or

21 “(ii) the amount of taxable income
22 taxed at a rate below 34 percent, plus

23 “(B) a tax of 34 percent of qualified small
24 business income in excess of the taxable income
25 that is subject to tax under subparagraph (A).

1 “(2) TAXABLE SMALL BUSINESS INCOME.—For
2 purposes of this subsection—

3 “(A) QUALIFIED SMALL BUSINESS IN-
4 COME.—The term ‘qualified small business in-
5 come’ means taxable income of a small business
6 to the extent such income does not exceed
7 \$5,000,000.

8 “(B) TAXABLE SMALL BUSINESS IN-
9 COME.—The term ‘taxable small business in-
10 come’ means, with respect to any taxable year,
11 the taxable income of the taxpayer for such
12 year attributable to the active conduct of any
13 trade or business of an eligible small business.

14 “(D) ELIGIBLE SMALL BUSINESS.—The
15 term ‘eligible small business’ means an S cor-
16 poration, partnership, limited liability company
17 or sole proprietorship, except that such term
18 does not include a personal service corporation
19 (as defined in section 469(j)(2)) unless such
20 corporation is a qualified personal service cor-
21 poration (as defined in section 448(d)(2)).

22 “(3) REGULATIONS.—The Secretary shall pre-
23 scribe such regulations as may be necessary or ap-
24 propriate to carry out the purposes of this section,
25 including regulations preventing the characterization

1 of income for purposes of compensation or personal
 2 use as qualified small business income.”.

3 **SEC. 6. REPEAL OF FEDERAL UNEMPLOYMENT SURTAX.**

4 (a) IN GENERAL.—The text of section 3301 of the
 5 Internal Revenue Code of 1986 is amended to read as fol-
 6 lows:

7 “There is hereby imposed on every employer (as de-
 8 fined in section 3306(a)) for each calendar year an excise
 9 tax, with respect to having individuals in his employ, equal
 10 to 6.0 percent of the total wages (as defined in section
 11 3306(b)) paid by him during the calendar year with re-
 12 spect to employment (as defined in section 3306(c)).”

13 (b) EFFECTIVE DATE.—The amendment made by
 14 subsection (a) shall apply to calendar years beginning
 15 after the date of the enactment of this Act.

16 **SEC. 7. CLARIFICATION OF CASH ACCOUNTING RULES FOR**
 17 **SMALL BUSINESS.**

18 Section 446 of the Internal Revenue Code of 1986
 19 (relating to general rule for methods of accounting) is
 20 amended by adding at the end the following new sub-
 21 section:

22 “(g) SMALL TAXPAYERS PERMITTED TO USE CASH
 23 ACCOUNTING METHOD WITHOUT LIMITATION.—A tax-
 24 payer shall not be required to use an accrual method of
 25 accounting for any taxable year by reason of using mer-

1 chandise or inventory, if the average annual gross receipts
2 of such taxpayer (or any predecessor) for the 3-year-period
3 ending with such prior taxable year does not exceed
4 \$5,000,000. The rules of paragraphs (2) and (3) of section
5 448(c) shall apply for purposes of the preceding sentence.
6 In the case of a C corporation or a partnership which has
7 a C corporation as a partner, the first sentence of this
8 subsection shall apply only if such C corporation or part-
9 nership meets the requirements of section 448(b)(3).”

10 **SEC. 8. EFFECTIVE DATE.**

11 Except as otherwise provided in this Act, the amend-
12 ments made by this Act shall apply to taxable years begin-
13 ning after the date of the enactment of this Act.

Small Employer Tax Relief Act of 1999 (SETRA)

Section-by-Section Analysis

SECTION 1. TITLE.

The title of the bill is the “*Small Employer Tax Relief Act of 1999.*”

SECTION 2. INCREASES DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED¹

The bill amends section 162(l)(1) of the Internal Revenue Code to increase the deduction for the health insurance costs of self-employed individuals to 100 percent, beginning on January 1, 1999. The self-employed currently can deduct only 60 percent of these costs. The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998, signed into law in October 1998, does not accelerate the deduction to 100 percent until the year 2003. The bill would place self-employed individuals on an equal footing with large businesses, which can deduct 100% of their health insurance costs.

The bill also corrects a disparity under current law that bars a self-employed individual from deducting any of his or her health insurance costs, if the individual is *eligible* to participate in another health insurance plan. This provision affects only self-employed individuals who are eligible for, but do not participate in, a health insurance plan offered through a second job or through a spouse's employer. The insurance plan may not be adequate to meet the specific needs of the self-employed entrepreneur and his or her family. Nonetheless, current law prevents him or her from deducting the costs of insurance coverage to meet those needs. In addition, this limitation provides a significant disincentive for self-employed business owners to provide group health insurance for their employees. The bill would end this disparity by clarifying that a self-employed person loses the deduction for his or her health insurance costs, only if he or she *actually participates* in another health insurance plan.

SECTION 3. INCREASES DEDUCTION FOR MEAL AND ENTERTAINMENT EXPENSES FOR SMALL BUSINESSES²

The bill amends Section 274(n) of the Internal Revenue Code of 1986 to increase the meal and entertainment expenses for small business taxpayers to 80 percent. The Internal Revenue Code of 1986 reduced the meal and entertainment expenses for all businesses from 80 percent to 50 percent. Under current law, small businesses and self-employed taxpayers can deduct only 50 percent of meal and entertainment expenses.

¹ This section of the bill is identical to Chairman Jim Talent's stand alone bill, H.R. 980.

² This section of the bill is identical to Representatives' McCrery, Tanner, Farr and Talent stand alone bill, H.R. 1195.

Current law increases the meal and entertainment expense deduction to 80 percent by the year 2008 for workers in the transportation industry with federally-mandated periods of rest (i.e., airline pilots and long-distance truckers). The deduction increases gradually for these workers by 5 percent annually to 80 percent beginning after December 31, 2005, as follows:

55%	1999
60%	2000 or 2001
65%	2002 or 2003
70%	2004 or 2005
75%	2006 or 2007
80%	2008 or thereafter

The bill applies these increases in the meal and entertainment deduction to all small businesses (including C corporations, S corporations, partnerships and sole proprietorships) averaging under \$5,000,000 in annual gross receipts for the three preceding years.

SECTION 4. INCREASES EXPENSE TREATMENT FOR SMALL BUSINESSES

The bill amends Section 179(b) of the Internal Revenue Code of 1986 to increase expensing for small businesses. Current law allows taxpayers to expense (or deduct as a current business cost) up to \$19,000 (in 1999) of the cost of certain tangible, depreciable personal property purchased for use in the active conduct of a trade or business. Under current law, the expensing limit gradually increases over time to \$20,000 in 2000; \$24,000 in 2001 and 2002; and \$25,000 in 2003.

The bill increases expensing for small businesses to \$35,000 immediately.

SECTION 5. REDUCES MAXIMUM INCOME TAX RATE FOR SMALL BUSINESS TAXPAYERS

The bill amends Section 1 of the Internal Revenue Code of 1986, relating to tax imposed, by adding a provision limiting the tax on certain small business income if a small business taxpayer has taxable income for any taxable year. The bill limits the tax on the taxable income of a small business taxpayer to no greater than 34 percent on the net taxable income currently taxed above that rate. For this purpose, qualified taxable small business income means taxable income of a small business to the extent such income does not exceed \$5,000,000. In addition, taxable small business income means for any tax year the taxable income of the taxpayer attributable to the active conduct of a trade or business. Generally, eligible small businesses under the bill include S corporations, partnerships, limited liability companies, and sole proprietorships.

The bill grants the Secretary of the Treasury authority to issue regulations to carry out the purpose of this section, including regulations to prevent the characterization of income for purposes of compensation or personal use as qualified small business income.

SECTION 6. REPEALS FEDERAL UNEMPLOYMENT PAYROLL SURTAX

The bill repeals the Federal Unemployment surtax of 0.2% under current law. Specifically, the bill amends Section 3301 of the Internal Revenue Code of 1986 to provide a 6.0 percent excise tax under the Federal Unemployment system instead of a 6.2 percent tax under current law. Congress added the 0.2% surtax temporarily in 1976 to repay government loans from the federal unemployment trust funds. While Congress fully repaid the loans in 1987, it continues to extend the temporary surtax. The bill repeals the surtax and thereby reduces payroll taxes on small business taxpayers without affecting Social Security.

SECTION 7. CLARIFIES CASH ACCOUNTING RULES FOR SMALL BUSINESS

The bill amends Sections 446 of the Internal Revenue Code of 1986 to clarify that small business taxpayers with average annual gross receipts for the prior three preceding years of \$5,000,000 or less are entitled to use the cash method of accounting without limitation. Specifically, the bill provides that small business taxpayers (including taxpayers allowed to use cash accounting under Section 448 (b) (3)), shall not be required to use the accrual method of accounting by reason of using merchandise or inventory.