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SMALL BUSINESSES AND TAX REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

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SMALL BUSINESSES AND TAX REFORM

THURSDAY, MARCH 3, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to call, at 9:05 a.m., in Room 1100, Longworth House Office Building, the Honorable Pat Tiberi [chairman of the subcommittee] presiding.

[The advisory of the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
February 24, 2011
No. SRM-1

CONTACT: (202) 225-5522

Chairman Tiberi Announces Hearing on Small Businesses and Tax Reform

Congressman Pat Tiberi, (R-OH), Chairman of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on the special burdens that the tax code imposes on small businesses and pass-through entities and the need for comprehensive tax reform to address these problems. **The hearing will take place on Thursday, March 3, 2011, in Room 1100 of the Longworth House Office Building, immediately after a brief Subcommittee organizational meeting beginning at 9:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

Some advocates of tax reform have suggested limiting that effort solely to corporate tax reform while postponing consideration of reforming the individual income tax. Such an approach ignores three important facts: (1) more than half of active business income earned in the United States is earned by pass-through entities (sole proprietorships, partnerships, and S corporations) and is therefore subject to the individual income tax rates, not the corporate rate; (2) business tax preferences that presumably would be curtailed to offset the revenue loss caused by a reduction in the corporate rate generally are available to pass-through entities as well, meaning that such entities (most of which are small businesses) could end up paying higher taxes to finance a cut in corporate income taxes; and (3) small businesses face a tremendous administrative burden in complying with the tax code, as they must comply with rules designed for large corporations, even though they often have only a fraction of the resources.

On January 20, 2011, the full Ways and Means Committee held the first in a series of hearings on fundamental tax reform. At this hearing, the Committee received testimony outlining the importance of tax reform to small businesses. And according to a poll by the National

Federation of Independent Business, nearly 75 percent of small businesses are organized as pass-through entities, not C corporations.

In announcing the hearing, Chairman Tiberi said, **"Today, more than half of all business income earned in the United States is earned by pass-through entities, the vast majority of which are small businesses. While I applaud President Obama's interest in pursuing corporate tax reform, we cannot ignore the special problems faced by small businesses that must devote scarce resources to tax compliance and tax planning instead of to business expansion and job creation. This hearing will allow the Committee to better understand these issues."**

FOCUS OF THE HEARING:

The hearing will focus on the critical role small businesses and pass-through entities play in the U.S. economy and the importance of including small businesses in the ongoing discussion of fundamental tax reform. The hearing will also explore specific problems, such as complexity and administrative burdens, faced by small businesses.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, http://waysandmeans.house.gov, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, March 17, 2011**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at http://www.waysandmeans.house.gov/.

Chairman TIBERI. Now that we have finished our organizational meeting, I would like to call today's meeting to order. I want to welcome our witnesses to the hearing to discuss the taxation of small businesses and passthrough entities as part of a broader discussion on comprehensive tax reform.

I believe there is a window of opportunity to enact comprehensive tax reform, and we must take advantage of it. Last November, the American people sent a strong message to Washington. They told Washington to stop putting off tough decisions, start making the decisions that will ensure future generations of Americans will prosper.

Whether it will be reducing the national debt, ensuring entitlements will remain solvent, or reforming our Tax Code to encourage economic growth, saying it is too difficult isn't an excuse anymore. Our current system of taxation was written for an economy that was very different from the competitive global economy of today. It is time to enact a Tax Code that is competitive with the rest of the world, that is fairer, and that is simpler.

Small businesses must be included in comprehensive tax reform. Reforming corporate taxes means only reforming roughly 10 percent of Federal revenues. That is not comprehensive. Many small businesses pay taxes under the individual income tax rates as passthrough entities, which we will hear more about today.

The last thing we want to do as part of tax reform is create a situation where we are putting small businesses at a competitive disadvantage. I fear leaving them out of tax reform will do just that. Small businesses are the engine of economic growth in our economy. As we move forward with tax reform, the question we must ask ourselves is how we reform the code in a manner that empowers small businesses to grow and create jobs.

I look forward to hearing from our witnesses on those issues today.

With that, I will yield to the ranking member, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

And I want to thank you for calling this hearing this morning. I hope that it will be the first of many on the topic of tax reform.

Earlier, I commented on how this subcommittee always hears diverse points of view, and certainly this morning is no exception. We have one witness who is complaining that there are too many special provisions for small businesses and that the clutter is overwhelming. We have another saying that these special provisions make for a code that favors small businesses over large, and yet another tells us that we need to lower income taxes on the upper-income to save small businesses.

But one thing that we can agree on is that the U.S. offers some of the most flexible rules on structuring your business in the developed world, offering limited liability without the requirement of a corporate-level tax. As one witness tells us today, we are second only to Mexico in the size of the unincorporated businesses as a total share of business, and that this self-help integration is a step toward reform.

While this hearing is intended to explore special tax issues on passthrough entities, much of the discussion will involve small-business incentives. We should note that the two are not necessarily the same. As one witness tells us, less than 1 percent of all passthroughs are large businesses with more than $10 million in receipts but they accounted for almost 60 percent of the total revenues of all passthroughs.

Confucius noted that a journey of a thousand miles begins with a single step. I want to thank you, Mr. Tiberi, for taking that first step this morning on the road to tax reform. And we hope the journey does not take a thousand hearings.

Thank you.

Chairman TIBERI. Thank you, Mr. Neal.

I ask unanimous consent that all Members' written statements will be included in the record.

Without objection, so ordered.

Chairman TIBERI. We will now turn to our panel of witnesses, whose bios are in your packages. I will introduce them, and then we will begin after I have introduced them all.

Dr. Robert Carroll is from Ernst & Young. Ms. Patricia Thompson is a tax partner at Piccerelli, Gilstein & Company and chair of the AICPA Tax Executive Committee. Mr. Dennis Tarnay is the CFO of Lake Erie Electric and a former board member of the Ohio Society of CPAs and from the great Buckeye State. And Dr. Donald Marron is director of the Urban-Brookings Tax Policy Center.

Thank you all for joining us this morning.

Dr. Carroll, you may begin your testimony.

STATEMENT OF ROBERT CARROLL, PRINCIPAL, QUALITATIVE ECONOMICS AND STATISTICS, ERNST & YOUNG LLP, WASHINGTON, D.C.

Mr. CARROLL. Thank you, Chairman.

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, I thank you for the opportunity to testify today regarding the taxation of flow-through businesses and tax reform.

I have had the opportunity to consider the taxation of flow-through businesses from a number of different perspectives inside and outside of government in the context of broad reform of the

code and narrow reform of the business tax system. More recently, I have been analyzing the flow-through sector in the course of preparing a report on behalf of the S Corporation Association. Today I would like to share my perspectives and provide some preliminary results from the study on the flow-through sector we are preparing for release in the near future.

Flow-through businesses, S corporations, partnerships, limited liability companies, and sole proprietorships play an important role in the U.S. economy. The vast majority of businesses in the United States have chosen to organize as flow-through businesses.

Today, flow-through businesses comprise more than 90 percent of all business entities, employ more than 50 percent of the workforce, and report more than one-third of all business receipts. Individual owners of flow-through businesses report 40 percent of all business net income. These individual owners also pay 43 percent of business taxes when filing their individual tax returns.

The flow-through sector in the United States differs markedly from other developed nations. The business forms available in many other countries tend to push businesses toward the corporate form in pursuit of limited liability, whereas in the United States such limited liability is attainable through various organizational forms outside of the corporate sector.

This has resulted in a flow-through sector with considerable flexibility in how they organize and how they structure their operations. Businesses can choose between several different organizational forms which may provide a better match to their management needs and capital requirements.

The unincorporated business sector in the United States is also larger than in most other developed nations. Of the countries responding to a 2007 OECD survey, the unincorporated business sector was larger as a share of the total number of businesses in the U.S. in all but one country.

With the increasing prominence of flow-through businesses, it is important to carefully consider how the flow-through form fits into the U.S. tax system and how any particular reform might affect flow-through businesses.

Flow-through businesses are subject to a single level of tax on the income earned and allocated to their owners. Thus, it is the tax rates faced primarily by individual owners of flow-through businesses that affect decision-making and the economic health of these businesses.

In contrast, the income of C corporations is subject to two levels of tax: first when income is earned at the corporate level and again when the income is paid out to shareholders in the form of dividends or retained earnings and later realized by shareholders as capital gains, hence the phrase, "the double tax on corporate profits."

The double tax affects a number of important economic decisions: First, by increasing the cost of capital, it discourages investment and, thus, economic growth and job creation. Second, it leads to a bias in firms' financing decisions between the use of debt and equity. And, third, it distorts the allocation of capital within the economy. The flow-through form provides an important benefit to the

economy by reducing these economically harmful effects of the double tax.

Recent focus on the need to lower the corporate income tax has also drawn attention to how flow-through businesses might be affected by tax reform. With substantial evidence that the U.S. corporate tax rate is out of step internationally, corporate tax reform is an important component of an overall approach to improving the current tax system.

As with any such endeavor, however, it is important to keep in mind the potential for undesirable side effects. Corporate reform that eliminates business tax expenditures would have the unintended impact of raising the taxes of businesses organized using the flow-through form without offering the benefit of the lower corporate tax rate. Flow-through businesses would lose the benefit of widely used and longstanding provisions such as accelerated depreciation and the charitable-giving deduction. In total, flow-through businesses use about 22 percent of the roughly $100 billion in annual business tax expenditures.

Flow-through businesses are a large part of the U.S. business sector and important contributors to the economic vitality of the U.S. As reform progresses, it is important to understand and consider all of these issues with an eye toward bringing about the tax reform that is most conducive to increased growth and job creation.

The path toward tax reform will need to take into account many features of our tax system and strike a balance between a number of sometimes conflicting and competing objectives. This committee should be commended for holding this hearing to better understand the role that the flow-through sector plays in the U.S. economy.

I thank you, and I would be pleased to address any questions the subcommittee might have.

[The prepared statement of Mr. Carroll follows:]

Testimony before the

Committee on Ways and Means

Subcommittee on Select Revenue Measures

United States House of Representatives

Robert Carroll[1]

March 3, 2011

Chairman Tiberi, Ranking Member Neal, and distinguished members on the Committee, thank you for the opportunity to testify today regarding the taxation of flow-through businesses[2] and tax reform.

Flow-through businesses play an important role in the U.S. economy. The vast majority of businesses in the United States have chosen to organize as flow-through businesses. Today, flow-through businesses comprise more than 90 percent of all business entities, employ more than 50 percent of the work force and report more than one-third of all business receipts. Forty percent of business net income is reported by individual owners of flow-through businesses. These taxpayers pay 43 percent of business taxes when filing their individual tax returns.

With the increasing prominence of flow-through businesses, it is important to carefully consider how the flow-through form fits into the U.S. tax system and how any particular tax reform might affect flow-through businesses. President Obama recently called for tax reform that emphasizes the need to eliminate "special interest loopholes and to lower the corporate tax rate to restore competitiveness and encourage job creation."[3] While there is substantial evidence that the U.S. statutory corporate income tax rate is out-of-step internationally, elimination of business tax expenditures to finance a lower corporate rate can raise substantial issues for flow-through businesses. Flow-through businesses could potentially lose the benefit of widely used business tax provisions without the benefit of the lower corporate tax rate.

The Internal Revenue Code (the "Code") provides businesses with considerable flexibility in how they organize and structure their business operations. Depending on their ownership and capital needs, businesses can choose between several different organizational forms. The flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double-taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment

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[1] Principal, Ernst & Young LLP. Formerly, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, November 2003 through January 2008. The views expressed do not necessarily reflect those of Ernst & Young LLP.

[2] "Flow-through" businesses refer to pass-through entities (S corporations, partnerships, and limited liability companies) and sole proprietorships whose income and expense is reported by the owners along with income received from other sources.

[3] President Obama's State of the Union address, January 25, 2011.

embodied in the income tax system leads to a bias in firms' financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation.

I have had the opportunity to consider the impact of taxation on flow-through businesses from a number of perspectives, inside and outside of government, in the context of broad reform of the Code and more particularly reform of the business tax system. More recently I have been analyzing the flow-through sector in the course of prepare a report on behalf of the S Corporation Association. Today I will share my perspectives and provide some preliminary results from the study on the flow-through sector we are preparing for release in the near future.

Current tax treatment of flow-through businesses and the double tax on corporate profits

Flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships – are subject to a single level of tax on the income earned. The income and expenses of flow-through businesses are reported by an entity's owners – hence the name "flow-through" or "pass-through" entities." An individual owner's flow-through income is combined with income they may receive from other sources and subject to individual income taxes. Losses, rather than accumulating within the business entity level, are also passed through to the owner where, subject to various limitations, they may, subject to various limitations, be used to offset income from other sources. Thus, it is the tax rates faced by individual owners of flow-through businesses that affect decision-making and the economic health of these businesses.

In contrast, the income of C corporations is subject to two levels of tax, first when income is earned at the corporate level, and again when the income is paid out to shareholders in the form of dividends or retained and later realized by shareholders as capital gains. These two levels of tax are often referred to as the double tax on corporate profits.

The differential taxation of business income earned by C corporations and flow-through businesses is an important consideration in a firm's choice of organizational form. The double tax is also economically important and can distort a number of business decisions.[4] One important such distortion arises because the double-tax mainly affects business income generated by activities financed through equity capital within the C corporation form. Interest expenses are generally deductible by businesses, leading to a tax bias in favor of financing with debt rather than equity. The double tax thus raises the cost of equity financed investment by C corporations relative to debt financed investment and provides an incentive for leverage and borrowing rather than for equity-financed investment. Accordingly, the double tax contributes to the tax bias for higher leverage. Greater leverage can make corporations more susceptible to financial distress during times of economic weakness.

The double tax also increases the cost of investment in the corporate sector relative to the rest of the economy. This tax bias against investment in the corporate sector leads to a misallocation

[4] For a discussion of these issues see Robert Carroll, "The Economic Effects of the Lower Tax Rate on Dividends," Tax Foundation Special Report No. 181, June 2010.

of capital within the economy whereby too little capital is allocated to the corporate sector because of the double tax. This in turn reduces the productive capacity of the capital stock and dampens economic growth. As noted before, the diversity of organizational forms can be seen as a useful choice for businesses to make in organizing themselves, but the impact of differential treatment should be recognized. Finally, the double tax raises the overall cost of capital in the economy, which reduces capital formation and, ultimately, living standards.

Overall, the flow-through form provides an important benefit to the economy by reducing the economically harmful effects of the double tax.

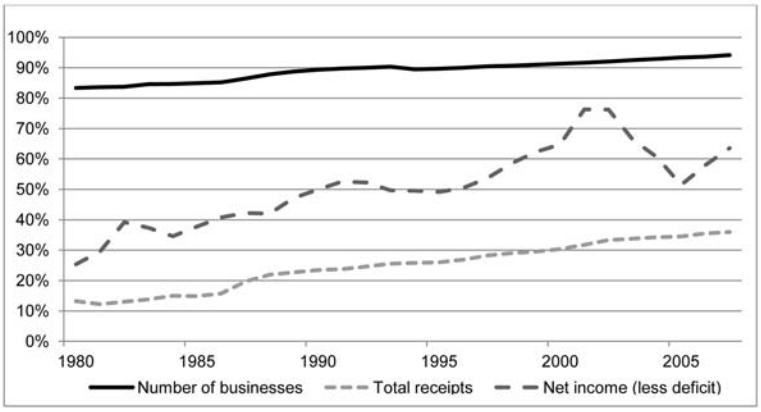
The growth and economic footprint of the flow-through sector

Flow though businesses have grown rapidly over the past several decades. Two changes contributed to this growth.[5] First, the individual tax rate was lowered relative to the corporate tax rate under the Tax Reform Act of 1986. The change in the relationship of the individual and corporate tax rates had the effect of making the flow-through form more attractive for many businesses. Second, actions by the Internal Revenue Service ("IRS") made limited liability companies (LLCs) offer flow-through treatment along with limited liability for their owners a more attractive organizational form in the late 1980s and 1990s than had previously been the case.[6] First, the IRS determined in 1988 that firms organized as LLCs would be taxed as flow-through businesses.[7] Next, the IRS simplified the classification of businesses as LLCs beginning in 1997 by allowing them to simply "check the box" on Form 1065-B to make an election to be treated as a corporation or partnership (or sole proprietorship) for tax purposes.[8]

The economic footprint of flow-through businesses has grown steadily by several different measures. The percentage of businesses choosing the flow-through form rose from 83 percent in 1980 to 94 percent in 2007.[9] The share of net income and total receipts generated by flow-through businesses has nearly tripled since the early 1980s with the flow-through share of net income growing from 25 percent in 1980 to 64 percent by 2007 and total receipts rising from 13 percent in 1980 to 36 percent by 2007 (see Chart 1).

[5] Limited partnerships, which offer limited liability to the limited partners, along with flow-through treatment, were available.
[6] S corporations, limited partnerships and limited liability companies (LLCs) all offer limited liability for their owners.
[7] In 1988 the IRS issued a revenue ruling indicating that it would treat LLCs established under Wyoming state law as partnerships for tax purposes. Other states subsequently enacted similar LLCs statutes.
[8] In 1995, there were 118,559 LLCs in the United States. By 2008 the number had grown to 1,898,178. Internal Revenue Service, *Partnership Returns, 2008*, Statistics of Income Bulletin, Fall 2010.
[9] Internal Revenue Service, Statistics of Income, computations from various historical data.

Chart 1. Flow-through shares of all business returns, receipts, and net income, 1980-2007

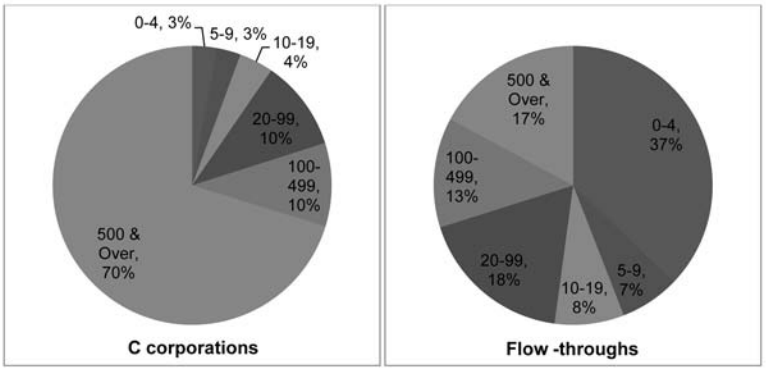


Note: These data include some flow-through entities, primarily partnerships, which are owned by C corporations. Data focusing on individual owners of flow-through businesses are presented below in Chart 4.
Source: Internal Revenue Service, Statistics of Income, Integrated Business Data.

The flow-through sector comprises a large fraction of business activity not only based on number of firms, and income/receipts, but also based on the number of workers it employs. In 2008, the flow-through sector employed 54.3 percent of the private sector work force, with C corporations employing the remaining 45.7 percent.[10] As shown in Chart 2, and as one might expect, private sector employment within the flow-through sector is highly concentrated among small firms. About 37 percent of workers within the flow-through sector were with firms with four or fewer employees. About 52 percent of workers in the flow-through sector held jobs in firms with fewer than 20 employees. In contrast, among C corporations 70 percent of workers held jobs in firms with more than 500 employees and 90 percent of workers held jobs in firms with more than 20 employees.

[10] This calculation excludes the non-profit and government sectors. U.S. Bureau of the Census, Center for Economic Studies, 2008.

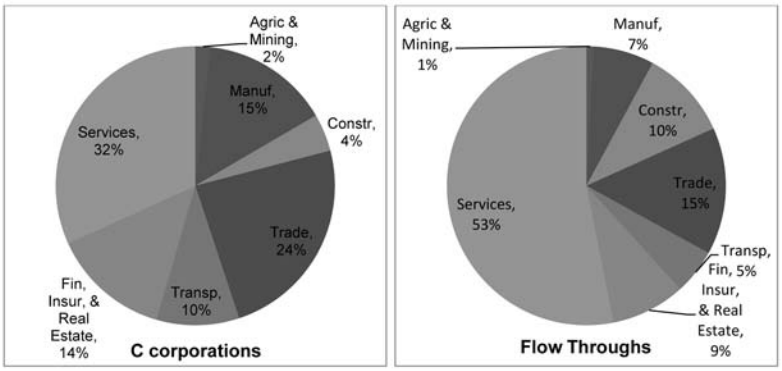
Chart 2. Employment by size of firm, C corporation and flow-through sectors, 2008



Source: U.S. Bureau of the Census, Center for Economic Studies.

There are also considerable differences in the employment within various industies for these two sectors, with significantly greater respresentation of flow-through employment in the services and construction industries (see Chart 3). In contrast, C corporation employment is more dominant in the manufacturing, wholesale and retail trade, and transportation industies. This likely reflects the scale of enterprises in these industries, with construction and services firms tending on average to be smaller than in those other industries.

Chart 3. Employment by industry, C corporation and flow-through sectors, 2008

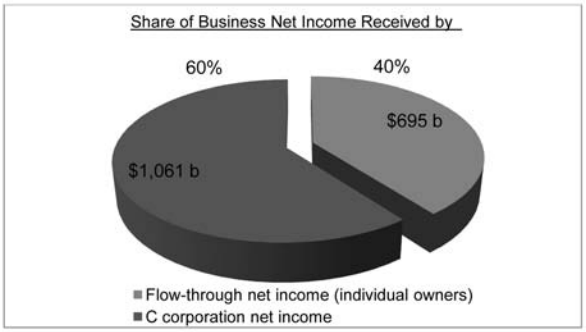


Source: U.S. Bureau of the Census, Center for Economic Studies.

While the foregoing data provides a picture of the growth and economic footprint of flow-through business entities, the owners of some flow-through businesses (primarily some partnerships[11]) are corporations, not individuals. This distinction is important because it is the individual owners of flow-through businesses who are taxed under the individual income tax. About one-half of partnership income flows through to corporate owners. This income is often associated with various types of joint ventures between corporations. The other half of partnership income flows through to individual owners.[12] This distinction explain the difference in the net income of flow-through business entities (64 percent shown in Chart 1) and individual owners (40 percent shown in Chart 4)

In 2007, $695 billion in flow-through income was reported on the roughly 30 million individual tax returns of individual flow-through owners who paid $176 billion in individual income taxes on this income (see Chart 4).[13] In comparison, C corporations reported $1,061 billion in net income and paid $229 billion in corporate income taxes in 2007.[14] That is, 40 percent of business net income and 43 percent of business taxes were paid by individual owners of flow-through businesses in 2007.[15]

Chart 4. Individual owners of flow-through entities receive 40% of business net income



Source: Internal Revenue Service, Statistics of Income, 2007 Corporate Source Book and Individual Tax Returns (publication 1304), 2007.

[11] Sole proprietorships are, by definition, owned by individuals and the ownership of S corporations is generally restricted to individual shareholders.
[12] Tim Wheeler and Nina Shumofsky, *Partnership Returns, 2008,* Statistics of Income Bulletin, Fall 2010.
[13] The $176 billion in individual income taxes paid on the $695 billion in flow-through income reported on individual income tax returns was estimated using the Ernst & Young LLP Individual Tax Micro-simulation Model. Tax was first calculated under current law and then compared to the tax the owners of flow-through entities would pay if they were assumed to have no flow-through income.
[14] Internal Revenue Services, Statistics of Income, 2007 Corporate Source Book, 2010.
[15] This calculation only accounts for the taxes paid on business net income. Taxes on dividends and capital gains are not included.

Moreover, research has found that individual income tax rates affect various economic decisions of flow-through businesses. For example, tax rates have been found to affect the entry and exit from flow-through form as individuals decide whether to open up their own business or work for another firm.[16] Tax rates have also been found to deter these businesses from hiring worker and investing and affect the rate at which flow-through businesses grow.[17] The effect of the individual tax rates on these types of economic decisions is one reason the tax treatment of flow-through businesses have figured prominently in recent discussions of changes to these tax rates.

How does the flow-through sector in the United States compare to other countries?

The flow-through sector in the United States differs markedly from many other developed nations. In the United States, non-publicly traded businesses can organize themselves in ways that allow them to receive limited liability protection and avoid the double tax on corporate profits. This provides highly flexible ownership structures and legal forms that help meet the specific organizational and capital requirements of businesses. Of 17 countries responding to a question from the OECD, 7 reported having no form of business organization that provides limited liability without an obligation for the corporate income tax. The business forms available in other countries appear to push businesses towards the corporate form in pursuit of limited liability, whereas in the United States, such limited liability is attainable through various organizational forms outside of the corporate sector.

This has resulted in a non-corporate sector in the United States that is larger than in most other developed nations. Of the countries responding to a 2007 OECD survey, as shown in Chart 5, only in Mexico was the unincorporated sector larger share of the total number of businesses (88 percent) than in the United States (82 percent).[18] Another difference between the United States and other nations was that businesses with taxable profits greater than $1 million have greater representation in the flow-through sector in the United States than in the other countries responding to the OECD survey.[19] From an economic policy perspective, this self-help integration is beneficial in that it helps reduce the harmful effects of the double tax.

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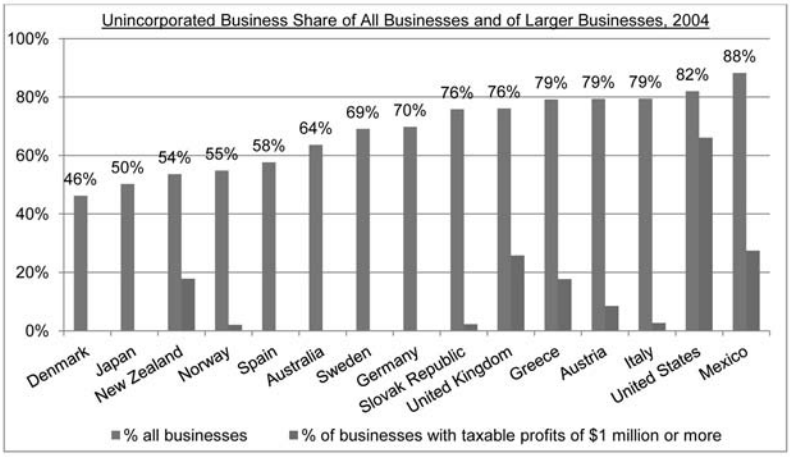
[16] Donald Bruce and Tami Gurley-Calvez, "Federal Tax Policy and Small Business," In Overcoming Barriers to Entrepreneurship, Rowan and Littlefield Publishers, forthcoming; William M. Gentry and R. Glenn Hubbard, "'Success Taxes, Entrepreneurial Entry, and Innovation," Working Paper No. 10551, National Bureau of Economic Research, June 2004.

[17] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351; Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147; and Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.

[18] Although they are flow-through businesses, S corporations were included by the OECD with other corporations because they are incorporated. Thus, the size of the flow-through sector in the United States is understated in Chart 5 below.

[19] Organisation for Economic Co-operation and Development, Center for Tax Policy and Administration, "Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire," revised 25 July 2007; Table 1.

Chart 5. The United States has among the largest unincorporated business sectors within the OECD



Source: OECD, Center for Tax Policy and Administration, "Survey on the Taxation of Small and Medium-Sized Enterprises: Draft Report on Responses to the Questionnaire," revised September 2007; Tables 1-3.

Tax reform can have significant consequences for flow-through businesses

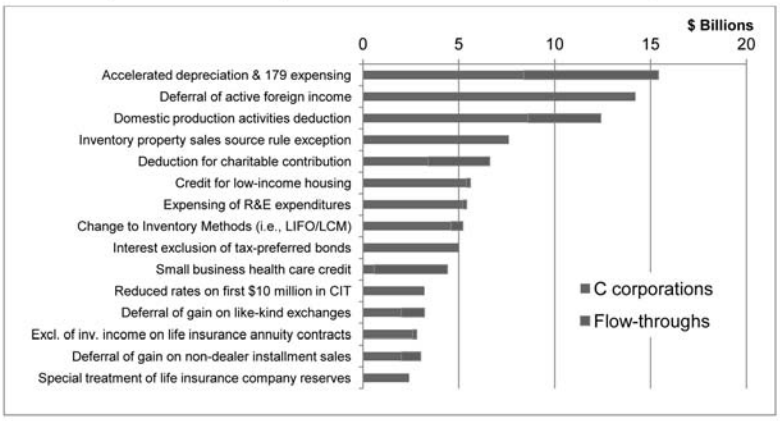
Some have suggested that tax reform focus first on reform of the corporate income tax before focusing on reform of the individual income tax. With the flow-through sector representing more than half of all business activity, as measured by employment, and paying 43 percent of total business taxes, it is difficult to see how significant reform of the corporate income tax system can be achieved without also addressing the taxation of the flow-through sector.

One approach to tax reform that has been suggested, for example, is lowering the corporate tax rate and paying for this change by eliminating or limiting business tax expenditures, such as accelerated depreciation and expensing, deferral of foreign source income, the production activities deduction, and other (Chart 6 provides a list of major business tax expenditures). Many of these expenditures are long-standing provisions that are available to and widely used by both C corporations and flow-through businesses. Curtailing business tax expenditures would thus raise the taxes paid by the flow-through businesses, even though these businesses would receive no tax benefit from the lower corporate tax rate.

As shown in Chart 6, flow-through businesses make extensive use of a number of broadly available business tax expenditures such as accelerated depreciation, the deduction for production activities, and the deduction for charitable giving. In total, flow-through businesses used 22 percent of the roughly $100 billion annual average business tax expenditures between

2011 and 2015. Repeal of any of these provisions would entail substantial tax increases for flow-through businesses. On the other hand, a corporate tax reform that lowered the corporate tax rate paid for by eliminating or limiting business tax expenditures only for C corporations would also add substantial complexity to the Code and create additional differences in the tax treatment of C corporations and flow-through businesses. Differences in tax treatment have caused shifting between the C corporation and flow-through business forms in the past,[20] but in this case the shift would be the result of the various tax expenditures being available only to businesses in the flow-through sector.

Chart 6. Largest business tax expenditures in US, Annual 2011-2015 average*



* Includes only permanent, positive tax expenditures. The value of the tax expenditure for tax-exempt bonds includes only the benefit to the corporate investors, not the benefit of lower interest rates to the issuers.
Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), December 15, 2010, and Ernst & Young LLP calculations.

Conclusion

Recent focus on the need to lower the corporate income tax rate has also drawn attention to how flow-through businesses might be affected by tax reform. Corporate tax reform is an important component of an overall approach to improving the current tax system. As with any such endeavor, however, policy makers should keep in mind the potential for undesirable side effects. Corporate reform that eliminates business tax expenditures would have the unintended impact of raising the cost of capital for businesses organized using the flow through form. Such

[20] See, for example, Robert Carroll and David Joulfaian, "Do Taxes Affect Corporate Financial Decisions? -- The Choice of Organizational Form," U.S. Treasury Department, Office of Tax Analysis, Working Paper 73, October 1997; and Austan Goolsbee, "Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax," *Journal of Public Economics*, 69(1), 1998, pp. 143-152.

firms are a large part of the U.S. business sector and important contributors to the economic vitality of the United States.

This sector has grown rapidly over the past several decades to the point where flow-through businesses now employ 54 percent of all private sector workers and pay more than 40 percent of all business taxes. The expansion of the flow-through sector provides the important benefit of reducing the scope of the double tax on corporate profits, as well is providing additional flexibility in the ownership structure of businesses that may provide a better match to their management needs and capital requirements.

The path towards tax reform will need to take into account many features of our tax system and strike a balance between a number of sometimes conflicting and competing objectives. This Committee should be commended for holding this hearing to better understand the role that the flow-through sector plays in the U.S. economy.

Thank you and I would be pleased to address any questions you may have.

Chairman TIBERI. Five seconds to spare. Impressive.
Ms. Thompson.

STATEMENT OF PATRICIA A. THOMPSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, TAX PARTNER, PICCERELLI, GILSTEIN & CO. LLP, PROVIDENCE, RHODE ISLAND

Ms. THOMPSON. Good morning, Chairman Tiberi, Ranking Member Neal, and Members of the Subcommittee. My name is Patricia Thompson. I am a CPA and chair of the AICPA Tax Executive Committee. My testimony today is based on my experiences with working with many small business clients. I am tax partner at Piccerelli, Gilstein & Company LLP, a CPA firm in Providence, Rhode Island, and have been with the firm for over 32 years. I would like to thank this subcommittee for the opportunity to appear today.

Chairman Tiberi, I would like to start by thanking you for your work in trying to repeal the two 1099 provisions. As noted in our written testimony, these are significant burdens on small businesses.

Today's hearing focuses on the special burdens that the tax law imposes on small businesses. Business tax reform cannot merely change the corporate tax rates or other corporate provisions if the desired impact is to help small businesses, since many of them are not organized as corporations. I understand the challenges inherent in drafting tax legislation and appreciate your diligence in trying to do the right thing for taxpayers.

My full written testimony discusses several burdens and complexities facing small businesses. In my brief time with you today, I would like to highlight just a few.

The first is tax simplification—depreciation is the best example. Methods to compute depreciation are different for tax and financial accounting purposes. Depreciation rates can vary depending on the method. There are special types of depreciation, such as bonus, special straight line, and Section 179. Plus, there is a different method for AMT. So businesses have to maintain several different books of depreciation and update them annually for each individual asset.

Let's say a client places several pieces of equipment in service throughout the year. To determine the best depreciation method, they need to run a complex analysis: When was it purchased? Was it new? Was it used? What was the total amount purchased? Depending on the purchase date, they may be entitled to 50 percent depreciation; maybe it is 100 percent. If they purchase too much equipment, Section 179 isn't available. If they don't earn enough money, Section 179 is limited. The best depreciation method may not be clear without extensive analysis.

My second point is uncertainty in the tax law. Many of the changes passed last year were designed to help employ more workers, help small businesses improve cash flow, and improve the economy. For example, the HIRE Act that passed last March provided an incentive to hire unemployed workers. This legislation was time-sensitive. If taxpayers did not know of the new incentive, the tax-saving opportunity was permanently lost.

The increased use of temporary provisions has also created some uncertainty. While some measures may be appropriate for the short term, temporary tax provisions and incentives have become far too common. Often they are allowed to expire, then they are revived

after much debate, but only for another temporary period. It is inefficient and ineffective to make longstanding tax policy utilizing temporary provisions.

Additionally, when changes occur late in the year, small-business owners have little time to evaluate the impact of those changes on their businesses. It is even harder to plan when the new tax law takes effect in the same year that it is issued. In that case, a small-business owner can't do long-term planning for growth, business development, or new hiring. It can be difficult to change course in response to a new, short-term expiring tax provision.

The third issue I would like to highlight is the need to consider expansion of corporate provisions to help noncorporate entities.

The Small Business Jobs Act passed last September expanded an existing provision to allow 100 percent gain exclusion on the sale of small-business stock if certain conditions were met. There are several requirements to qualify for this exclusion. It must be a C corporation of a qualifying business. The stock cannot exceed a certain value and must be held for more than 5 years.

The key here is that this provision only benefits C corporations, so it excludes many small businesses that are conducted as sole proprietors or passthrough entities. This is an excellent example of a provision that was intended to help small business that will likely not have the desired impact.

One final note: I would encourage you to review two of our recent publications, one on alternatives for tax reform, and the other is our report on penalty reform. Both are available online, and links are provided in our written testimony.

Thank you again for the opportunity to testify, and I will be happy to answer any of your questions.

[The prepared statement of Ms. Thompson follows:]

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WRITTEN TESTIMONY OF PATRICIA THOMPSON, CPA

ON BEHALF OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

HEARING ON

SMALL BUSINESSES AND TAX REFORM

MARCH 3, 2011

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HEARING ON SMALL BUSINESSES AND TAX REFORM

MARCH 3, 2011

Good morning Chairman Tiberi, Ranking Member Neal and Members of the subcommittee. My name is Patricia Thompson. I am a CPA and I am the Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants ("AICPA"). My testimony today is based on my experiences working with small business clients. I am the Tax Partner at Piccerelli, Gilstein & Company, LLP, a CPA firm in Providence, Rhode Island, and have been with the firm for over 32 years. I would like to thank this Subcommittee for the opportunity to appear at today's hearing on Small Businesses and Tax Reform.

Today's hearing focuses on the special burdens that the Internal Revenue Code (Code) imposes on small businesses and those small businesses operating as pass-through entities. I understand the challenges Congress faces as it tackles the complex issues inherent in drafting tax legislation and appreciate your diligence in trying to do the right thing for taxpayers. The Code imposes many compliance and filing burdens on small businesses and tax reform should encompass simplification proposals designed to alleviate the burdens placed on small businesses. Many small businesses are organized as entities other than corporations. Accordingly, tax reform cannot merely involve changes to corporate tax rates or other tax provisions targeting corporations if the desired impact is to help all small businesses overcome the burdens and complexities of tax compliance.

There are a number of areas in the tax Code that impose burdens on small businesses including those operating as pass-through entities. Simplification is needed in areas such as depreciation, Alternative Minimum Tax ("AMT"), partnerships, and retirement plans. Minimizing overall uncertainty throughout the Code and expanding provisions intended to help small business to include non-corporate entities should also be considered. Finally, while momentum is building to repeal section 9006 of the *Patient Protection and Affordable Care Act* ("PPACA"), any reform should include repeal of section 2101 of the *Small Business Jobs Act of 2010* ("SBJA") which imposes significant compliance burdens on rental property owners by requiring them to file Forms 1099-MISC for the first time.

Depreciation

Depreciation is an example of an area of the tax law where simplification is sorely needed. The depreciation methods required by the Code are different than those used for financial accounting. There are differences in

depreciation rates depending on the depreciation method, and different rules may apply depending on when an asset is purchased. There are special rules for "bonus" depreciation, options to compute depreciation under special "straight line" rules and different rules for depreciation allowed under code section 179. Different types of property qualify for different types and levels of depreciation, and states often require different depreciation methods or have different section 179 and bonus depreciation limits. Finally, there is an entirely different depreciation method used for AMT. As a result, businesses often have to maintain several different "books" of depreciation (i.e., tax, book, state, and AMT depreciation) which are maintained and updated annually for each asset. I'd like to share three client examples to illustrate the complexity of these depreciation rules.

Client #1 purchased equipment totaling approximately $145,000. She expected to write-off the entire purchase price as depreciation under section 179. However, when the tax return was completed and all the tax adjustments made, the amount of her section 179 depreciation deduction was limited because of her taxable income. Some portion of the section 179 was disallowed but is available for carryover to the future years.

She could have recalculated the depreciation but that would have meant more time to redo her books and records as well as the tax return. These assets were purchased before September 8, 2010. If they had been purchased after that date, she would have been entitled to a 100% bonus depreciation deduction that would not have been limited to her taxable income. The analysis for Federal purposes is further complicated by the required state analyses.

Client #2 provides an illustration of how the rules affect a taxpayer who, prior to bonus depreciation, was not eligible for the additional depreciation under section 179. The taxpayer would have to calculate depreciation using two different methods. One is based on MACRS using accelerated methods and another is based on MACRS recovery lives using a less accelerated method for AMT purposes. When any of the assets are sold, two different gain or loss calculations have to be done to take into consideration based on the different tax depreciation methods.

It is easy for a small business owner to be subject to AMT with the result that any tax benefit of the accelerated depreciation is non-existent.

Client #3 places various types of manufacturing equipment in service throughout the year. Some is new and some is used. Before the taxpayer can calculate depreciation, an analysis of the equipment is needed. When was it purchased? Was it new or used? What was the total amount of equipment purchased? Depending on the timing of the purchase, the taxpayer may be eligible for 50% bonus depreciation or 100% bonus depreciation. If the equipment is used, bonus is not available. If the taxpayer purchased more than $2 million, the section 179 deduction is not available. The dollar limit changes from time to time depending on the tax incentives provided by tax legislation. In 2007, the limit was $500,000 with a maximum section 179 deduction of $125,000. In 2008 and 2009, it was $800,000 with a maximum section 179 deduction of $250,000.

Another consideration is the taxpayer's taxable income, because section 179 is limited to the taxpayer's taxable income. The taxpayer may not have the sophistication to know that they need to calculate their taxable income as part of a process of evaluating the different depreciation methods available.

Overall, taking the section 179 deduction and bonus depreciation currently helps cash flow for a small business taxpayer. But there is uncertainty about whether or not taking advantage of these tax incentives is most beneficial in the long term. For example, if manufacturing equipment is written off completely in the first year when the highest individual income tax rate is 35%, the taxpayer may pay more in taxes in future years when the equipment is sold if the highest maximum tax rate in the year of sale is then 39.6%. There would be a need for a time value of money analysis to determine which depreciation method to use.

Alternative Minimum Tax

Small businesses, including those operating through pass-through entities, have become increasingly at risk of being subject to AMT. The AMT was created to ensure that all taxpayers pay a minimum amount of tax on their economic income. The AMT is one of the tax law's most complex components.

In fact, the AMT is a separate and distinct tax regime from the "regular" income tax. Code sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions and credits under the AMT system. This separate calculation must be done on all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations.

Small businesses must maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. Including adjustments and preferences from pass-through entities contributes to AMT complexity. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity affects the IRS's ability to meaningfully track compliance with the AMT.

Although most sophisticated taxpayers are aware of the AMT and that they may be subject to its provisions, the majority of middle-class taxpayers has never heard of the AMT and are unaware that it may apply to them. Unfortunately, the number of taxpayers facing potential AMT liability is expanding exponentially due to: (1) "bracket creep;" (2) classifying as "tax preferences" the commonly used personal and dependency exemptions, standard deductions, and itemized deductions for taxes paid, some medical costs, and miscellaneous expenses; and (3) the inability to use many tax credits to offset AMT.

Due to the increasing AMT complexity, the AMT's impact on unintended taxpayers, and AMT compliance problems, the AICPA supports repealing the individual AMT altogether. However, we recognize that simply eliminating the AMT would generate a new set of problems given the large loss of tax revenue that would accompany such a move. Consequently, the AICPA urges Congress to consider alternative solutions that would reduce or eliminate most of the complexity and unfair impact of the AMT as currently imposed.

Uncertainty of Tax Law

Despite IRS efforts to educate the public regarding new legislative provision and stimulus activity, small employers are too busy keeping their businesses afloat in difficult economic times to stay apprised of changes in the income tax laws. Many small businesses must rely on their tax professionals to inform them of the changes. Unfortunately, many small businesses cannot afford to retain tax professionals throughout the year.

Many of the legislative provisions enacted in 2010 were designed to help small business taxpayers put more money into their business, employ more workers and to improve the economy. Most small business taxpayers, however, find it challenging to plan their cash flow and business needs especially when the federal income tax laws change frequently, are sometimes temporary or are passed late in the year.

During 2010 there was a spate of tax legislation designed to stimulate the economy. Small businesses can be overwhelmed by the barrage of late-year tax law changes and do not have the time or the ability to evaluate properly the impact of the changes on their businesses. During 2010, for example, a taxpayer, depending on when equipment was purchased, needed to choose the correct and most beneficial depreciation method from a menu of choices, which necessitated cumbersome alternative computations.

There was also legislation that was intended to spur the economy and benefit businesses and employees. This legislation, however, was time sensitive and only provided tax benefits for a short period of time. For example, there were incentives for employers that hired certain unemployed workers after February 3, 2010, and before December 31, 2010. If the taxpayer is not aware of such time sensitive legislation immediately upon enactment, the tax saving opportunity is permanently lost. Not having taxpayers avail themselves of such tax saving opportunities is contrary to the intent of the legislation and nullifies the good intentions of our lawmakers.

Actions regarding the use of temporary provisions have also created uncertainty. While some measures, such as those designed for economic stimulus, are appropriate for temporary and sporadic use, temporary tax provisions, including many incentive provisions, have become far too common. Many are routinely allowed to expire for a period of time, with subsequent debate and legislative action to extend them for some additional temporary period, thus causing disruption and costs to thousands of businesses, individuals, and the Internal Revenue Service ("IRS"). From a pure tax policy perspective, it is both inefficient and ineffective to utilize temporary provisions.

In reality, the temporary nature of some provisions has not led to rigorous review of the related incentives before their renewal. Further, the temporary nature of the incentives may have served to blunt their effectiveness in motivating taxpayer behavior. This is particularly true for small business owners.

These ever-changing, oft expiring, short-term changes to the tax laws make it increasingly difficult for a small business owner to do any long-term planning, including strategic planning for growth, new business development and hiring. These planning challenges are further compounded when regulatory or administrative guidance is not timely or tax laws are changed after the year has already begun but are slated to take effect that same tax year. It can be difficult to change course, alter buying plans, secure new or different funding or change their hiring policies in response to a new, short-term, expiring tax provision. When tax laws, new regulations or Treasury guidance are issued late in the year or at the last minute, business owners do their best to comply with no ability to plan for such last-minute provisions, no matter how well-intentioned.

Partnership Taxation

Partnership tax rules are among the most complex in the Internal Revenue Code. Many small businesses are organized as partnerships. Individual partners cannot determine their personal tax liability until the partnership has computed and allocated the income, expenses, deductions and credits for the partnership. There are several issues that must be addressed at the partnership level and individual partner level, including determining basis (both inside basis and outside basis), application of the at-risk rules, and properly allocating liabilities and losses. Items, such as the maximum section 179 depreciation expense, are determined at the partnership level before passing through to the individual partner. Other items, such as charitable contributions, pass through to the individual partner before rules limiting the deduction apply.

The tax implications for various transactions for partners in a partnership are often very different from shareholders in C corporations or S corporations, or even sole proprietorships. The result is that there is an inequality in treatment between the different entity types. For example, a partner does not receive a W-2 for the services he or she may provide to a partnership but they would have received a W-2 if the entity was either an S or C corporation. Small business owners may have formed new business entities as a partnership rather than an S corporation and become confused when the tax practitioner informs them that they will not be receiving a W-2. Many small business owners would prefer to receive a W-2 so that the partnership can withhold the appropriate taxes and reduce or eliminate the need to make estimated tax payments.

Numerous Retirement Plans

When a small business grows and begins to explore options for establishing a retirement plan, the rules are immediately overwhelming. There are almost too many options for retirement plans that businesses need to consider before deciding which is appropriate for them. These options include a SEP, SIMPLE, 401(k), profit sharing plan, defined benefit plan, SIMPLE 401(k), among others. Some plans are only available to employers with a certain number of employees while other plans require mandatory contributions and higher administrative burdens. Some of the administrative burdens would include annual return filing, discrimination testing, etc. To determine which plan is right for the business, owners must consider their

cash flows, projected profitability, anticipated growth of the work force, and expectations by their employees and co-owners.

The diversity of plans came about because of Congress' intent to create plans for small business owners that were easier to manage, allowed for more flexibility in funding, and creates choices for different size entities. Over the years, however, the plans have been modified, adjusted, expanded and limited. We are now at a point where the choices can be overwhelming and many are too complex or costly for the small business owner to be able to benefit.

Small Business Provisions that Exclude Non-Corporate Entities

A provision in the Code that was intended to help small business will likely not have the desired impact. The SBJA expanded an existing provision to allow gain on the sale of small business stock purchased after September 27, 2010, and before January 1, 2012, to be excluded from income if certain conditions are met. Prior to the expansion of this provision, the gain exclusion was based on when the stock was purchased. If the stock was purchased before February 18, 2009, the gain exclusion is 50%. Stock purchased after February 17, 2009 and before September 27, 2010 is eligible for a 75% exclusion. After December 31, 2011, the exclusion reduces to 50%. The stock must be held more than 5 years, be C corporation stock whose value at all times after August 10, 1993, and before issuance and immediately after issuance does not exceed $50 million. The corporation must conduct a qualified trade or business. Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset is the reputation or skill of one or more of its employees, farming, hotels, motels, restaurants, or certain other specified industries are excluded from eligibility.

The problem is that the majority of small businesses are not conducted as C corporations. They are operated as pass-through entities. In addition, many buyers prefer to purchase the assets of a company rather than the stock. If the assets of the company are sold, any portion of the gain relating to capital assets would be taxed at ordinary income tax rates which would be a maximum of 35%. The corporation would be liquidated and no additional tax would be due if the conditions relating to this provision were met. If those same assets were sold by a pass-through entity, the gain relating to capital assets would be taxed to the individual using capital gain tax rates, currently 15%. The result of the sale of the assets would increase the tax liability by 20% by taking advantage of the gain exclusion provision.

Different Definitions Used Throughout the Code

Many provisions in the Code and certain IRS guidance use similar terms but not similar definitions. These different definitions create more complexity to understand and apply tax law to small business. A recent example is a provision in the Health Care bill passed in 2010 allowing a health insurance tax credit for "small businesses". Many small businesses are offering health insurance and believed this credit would be available to them. However, "small business" is defined in various ways throughout the Code. A "small business" may be defined based on average annual gross receipts or it may be on the number of employees. Using average annual gross receipts still does not result in consistency. Sometimes gross receipts are defined

for "small business" purposes as "$5 million or less," while other times it may be "$10 million or less." Using the number of employees to define a small business also varies. In some cases it is fewer than 20, other times fewer than 100, and yet other times it can range from 50 to 500. The definition used by the Health Care bill was 25 full-time equivalents. Based on this definition, the benefit may not be available to as many small businesses as expected or intended. Small business owners would appreciate having one definition of a small business and have it apply to all provisions of the Code.

Concerns Regarding Form 1099 Reporting Requirements

A current example of the need for simplification of our tax law relates to recent changes that significantly increase the administrative burden on many small businesses and individual taxpayers – the revisions to the Form 1099 requirements made by section 9006 of the PPACA and the new Form 1099 reporting requirements placed on rental property owners by section 2101 of the SBJA.

Code section 6041 currently requires "persons engaged in a trade or business" to satisfy reporting requirements upon the purchase of $600 or more in services in a year from another entity. PPACA made two significant changes to the law that will take effect in 2012. First, the act overturns a longstanding tax regulation providing that corporations were generally exempt recipients for Code section 6041 reporting purposes. Second, the provision expands information reporting requirements to business payments for property (which is in addition to business payments for services, as required by current law). Thus, beginning in 2012, if a business generally purchases $600 or more in property or services from another entity (including a corporation), it must provide the vendor and the Internal Revenue Service with a Form 1099-MISC, Miscellaneous Income. The AICPA strongly supports repeal of section 9006 of the PPACA to avoid what will otherwise be an overwhelming compliance burden on the nation's small businesses beginning in 2012.

The SBJA further expands the information reporting requirements to include, with only limited exceptions, payments for rental property expenses paid by all persons receiving rental income, whether or not they were previously considered engaged in a trade or business. Similar to other "persons engaged in a trade or business," the reporting requirements are triggered upon the purchase of $600 or more in services from another entity. The information reporting requirements applicable to rental property expense payments are effective beginning January 1, 2011, but will be expanded in 2012 to include payments for property and payments to corporations as described above with regard to the PPACA changes.

The AICPA urges repeal of the expanded information reporting requirements on individuals receiving rental income. This requirement would be the first time that individual taxpayers owning rental property who are not "engaged in a trade or business," would be required to provide Forms 1099-MISC. For example, many individuals, who own a vacation property that is rented part of the year, or who rent a room in their home, to help defray costs, would be subject to the provisions of the SBJA. In order to comply with these onerous requirements, taxpayers will incur a significant increase in costs and/or time with respect to the accumulation of relevant information and the preparation and mailing of Forms 1099-MISC.

The administrative burden reaches far beyond the completion of an additional tax return. Many CPAs and advisors are recommending that individuals begin taking action as soon as possible if they think the new reporting requirements might apply to them.

First, these individuals should obtain their own Employer Identification Number (EIN) to report on a Form 1099-MISC. Although an EIN is not required by the IRS, we strongly recommend obtaining one to reduce identity theft risk associated with using a Social Security Number. Individuals must complete Form SS-4, Application for Employer Identification Number, to obtain an EIN or apply online at IRS.gov. An individual who already has an EIN will need to contact the IRS or research whether to apply for a separate EIN for the rental activity.

Next, these individuals should begin collecting information from their regular vendors if they anticipate making payments of at least $600 to them during the year. Each vendor should complete a Form W-9, Request for Taxpayer Identification Number and Certification, to provide its name, address, EIN or Social Security Number and type of business (sole proprietor, partnership, corporation, etc.). The vendors must also certify that information provided is accurate, they are not subject to backup withholding and they are United States citizens (or other eligible persons). Since the "vendor" is the business to whom individuals issue payment, not necessarily the individual rendering the service, we anticipate that additional time and effort may be required to gather the vendor's information. For individuals who own rental property out of state, it may be even more difficult to obtain this information.
It is important to note that the administrative burden does not merely occur during "tax time." We are recommending that individuals who receive rental income keep detailed accounting records throughout the year. In order to track which vendors are paid $600 or more in a year, individuals will need to keep more detailed records than in prior years. For example, individuals should record how much of a payment to a vendor is related to services as opposed to the purchase of goods. In addition, individuals should only note the amount paid to a service provider in connection with the rental activity.

By January of next year, not a time when most individuals have received their own tax information or began thinking about their personal income tax returns, individuals receiving rental income will need to complete Forms 1099-MISC. A separate Form 1099-MISC will be required for each vendor to whom the individual engaged in rental activity paid at least $600 during the year. Generally, an individual will need to provide "Copy B" of the Form 1099-MISC to the service provider by January 31, 2012 and file "Copy A" with the IRS by February 29, 2012. Unlike most tax forms which taxpayers can download from the IRS website and use, Form 1099-MISC must be obtained in hard copy from the IRS (or office supply store) to file as it is a special type of scannable form.

Finally, if an individual uses a vendor who is subject to backup withholding or obtains a wrong or incomplete EIN from the vendor, the individual's administrative burden significantly increases. There is an additional tax return that must be completed, a requirement to withhold a certain percentage from each payment to the vendor, various notices which individuals are required to send to the vendor, and a requirement to submit backup withholding amounts to the IRS. Beginning January 1, 2011, individuals are generally required to deposit these funds electronically using the Electronic Federal Tax Payment System

("EFTPS"). Individuals will need to spend additional time, at least the initial year, to enroll in EFTPS and learn how to use the system.

Although the AICPA generally supports information reporting, we think the extraordinary burden this approach imposes far outweighs any potential benefit. Accordingly, the AICPA urges Congress to take action to repeal section 2101 of the SBJA in addition to the more widely known expansion of the Form 1099 reporting requirements under section 9006 of the PPACA.

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The AICPA is the national professional organization of certified public accountants comprised of approximately 370,000 members. Our members advise clients on federal, state and international tax matters, and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, tax-exempt organizations, small and medium-sized businesses, as well as America's largest businesses.

Thank you, again, for the opportunity to testify. In addition to this testimony, I encourage you review our recent publications on alternatives for tax reform and our report on penalty reform, both of which are available online, as follows:

Tax Reform Alternatives for the 21st Century, is available at:
http://www.aicpa.org/InterestAreas/Tax/Resources/TaxLegislationPolicy/TaxReformStudies/DownloadableDocuments/Tax%20Reform%20Alternatives%202009.pdf

Report on Civil Tax Penalties: The Need for Reform, is available at:
http://www.aicpa.org/InterestAreas/Tax/Resources/IRSPracticeProcedure/Advocacy/DownloadableDocuments/AICPA_report_civiltax_penalty_reform1.pdf

I hope you will find this testimony and additional publications useful in your continued work on tax reform for small businesses. We welcome the opportunity to discuss this information with you informally or in any future public hearing.

Chairman TIBERI. Thank you. Thank you, Ms. Thompson. And you came in under time, as well.

Mr. Tarnay, welcome.

STATEMENT OF DENNIS TARNAY, CHIEF FINANCIAL OFFICER, LAKE ERIE ELECTRIC, INC., CLEVELAND, OHIO

Mr. TARNAY. Chairman Tiberi, Ranking Member Neal, and Members of the Subcommittee, thank you for inviting me to appear before you today to discuss the issue of fundamental tax reform, particularly as it relates to small businesses.

I am the chief financial officer and a minority owner of Lake Erie Electric, a position I have held since 1987, and a former board member of the Ohio Society of Certified Public Accountants. I am speaking today on behalf of both Lake Erie Electric and the OSCPA.

Lake Erie Electric, based in Cleveland, Ohio, is an electrical contracting company that was first formed as a C corporation in the 1950s to primarily serve industrial customers in the automotive and steel sectors of the Midwest.

My company has seen many changes since its inception, both in terms of its corporate structure and business strategies. In 1987, we modified the corporate structure of the company to a pass-through Subchapter S corporation through the Federal tax law

changes that occurred at that time and because it was a better fit for us. When Cleveland's industrial base contracted, we transitioned our customer base to be more heavily weighted to commercial businesses and the health-care sector.

The main message I want to deliver to you today, gentlemen, is that simplifying the Tax Code for small businesses means creating jobs in places like Cleveland, Ohio. Predictability and stability within the Tax Code provides businesses, particularly small businesses, which typically have tighter profit margins, the necessary lens with which to make decisions regarding growth, investment or reinvestment of capital, and expanding new employee job opportunities.

Further, a simpler Tax Code means small-business owners can spend less time on costly and burdensome compliance activities and invest more of their time on innovation and growing their businesses. Simplicity also helps to minimize taxpayer confusion over exactly what liability is owed and helps with financial planning for the future.

Tax reform for small business is about one thing in America: jobs for all business sectors.

Subchapter S corporations are structured so that net income or losses to the business are distributed to the shareholders of the company and are reflected on the individual's Federal, State, and even local income tax returns. The tax is assessed at their individual income tax rates, meaning legislators should be conscious that discussions of assessing higher tax rates on individuals at the $200,000 level and families at the $250,000 level will have a direct impact on the ability of many small-business owners to reinvest in their businesses and keep or grow their workforce.

In addition to Subchapter S corporations, other forms of passthrough entities that will be similarly impacted are limited-liability companies, partnerships, limited-liability partnerships, and sole proprietorships. Roughly 75 percent of small businesses are passthrough entities. As we know, the primary reason there are so many passthrough entities is because double taxation is eliminated, first at the entity level as earnings and then again at the individual level as dividend payments to shareholders.

This data leaves little doubt that, in order for a significant economic recovery to take place, there must be a tax structure in place that will give small businesses the incentive to hire and thrive.

Tax law does matter to small-business passthrough entities because they modify business practices to adjust for law changes. In recent years, tax-law changes have become a political tool, with revisions occurring far too often, sometimes more than once a year and sometimes so late in the year that it is retroactive in impact, causing business owners to be confused and uncertain on how to proceed.

The frequency of tax-law changes affects small businesses in particular because the unpredictability often slows or discourages the hiring or rehiring of employees or investing in new capital or other products and services. While certainly businesses of all sizes are impacted by the frequency of tax-law changes, they have a far greater impact on small-business decisions because so many of them operate on very tight profit margins.

Predictability helps to keep costs down, as fewer changes equate to fewer compliance costs associated with changing practices and procedures that, in many cases, are longstanding and successful from a cost-benefit standpoint. Lower cost equals greater ability to reinvest in company and future growth.

The current structure of passthrough entities, such as Subchapter S corporations, provides flexibility and control to small-business owners and should be maintained in any tax reform proposal. Going forward, tax reform should help small business by reforming issues such as: simplifying compliance rules regarding E-Filing and E-Verify; shifting the burden away from being the watchdog for various government entities on its employees; reforming the timing requirements for S-corporation formations; increasing the amount a small businesses may expense on the Federal tax returns; reasonable independent contractor rules.

Gentlemen, the alternative minimum tax should be eliminated. If it can't be eliminated, enact a more reasonable and consistent threshold for the alternative minimum tax.

In a related matter, I do applaud your efforts to address the expanded 1099 requirements currently on schedule to become effective January in 2012. From a small-business perspective, this is the classic example of a compliance cost on both businesses and the Internal Revenue Service outweighing the benefits derived.

Chairman TIBERI. Mr. Tarnay, if you can wrap up——

Mr. TARNAY. I am right now.

Chairman TIBERI. Thank you.

Mr. TARNAY. Meaningful tax reform that focuses on simplicity, predictability, and fairness that includes an emphasis on the related cost and compliance burden to small businesses is critically important so that we, as small-business owners, do our part to grow the economy.

On behalf of both Lake Erie and the Ohio Society of CPAs, I appreciate the opportunity to share my concerns and would welcome any questions you have.

[The prepared statement of Mr. Tarnay follows:]

Testimony of Mr. Dennis Tarnay, CPA

Chief Financial Officer
Lake Erie Electric
Before the Subcommittee on Select Revenue Measures
Washington, D.C.

March 3, 2011

Chairman Tiberi, Ranking Member Neal and members of the Subcommittee, thank you for inviting me to appear before you today to discuss the issue of fundamental tax reform, particularly as it relates to small businesses. I am the Chief Financial Officer and a Minority Owner of Lake Erie Electric, a position I have held since 1987 and a former board member of The Ohio Society of Certified Public Accountants (OSCPA). I'm speaking today on behalf of both Lake Erie Electric and OSCPA. Lake Erie Electric, based in Cleveland, Ohio, is an electrical contracting company that was first formed as a C Corporation in the 1950's to primarily serve industrial customers in the automotive and steel industries in the Midwest.

My company has seen many changes since its inception, both in terms of its corporate structure and business strategy. In 1987, we modified the corporate structure of the company to a pass-through Subchapter S-Corporation due to federal tax law changes that occurred at that time and because it was a better fit for us. When Cleveland's industrial base contracted, we transitioned our customer base to be more heavily weighted to commercial businesses and the health care sector. Both of these business decisions allowed Lake Erie Electric to continue to grow and to expand our workforce, even as other small businesses in the greater Cleveland area took the brunt of the current and prior recessions.

As you may know, Cleveland has one of the highest unemployment rates in the country. Small businesses in my area are working hard to find creative ways to reinvent and reinvest in themselves so that they may begin to hire workers again. Having a tax environment that doesn't punish higher income taxpayers – and therefore many, many small business owners -- is critical to not only survival in recessionary times, but having the ability to expand our workforce when times are better. That's the main message I want to deliver to you today: that simplifying the tax code for small businesses means creating jobs in places like Cleveland, Ohio.

Predictability and stability within the tax code provide businesses, particularly small businesses which typically have tighter profit margins, the necessary lens with which to make decisions regarding growth, investment or reinvestment of capital and expanding new employee job opportunities. Lower tax rates on small businesses mean that the money we do not have to pay in additional taxes instead can be reinvested in our businesses and workforce, spurring an

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economic recovery that in Ohio is slow at best. Further, a simpler tax code means small business owners can spend less time on costly and burdensome compliance activity and invest more of their time on innovation and growing their businesses. Simplicity also helps to minimize taxpayer confusion over exactly what liability is owed, and help with financial planning for the future. That simplicity could also prove beneficial to government as they seek to close the tax gap. Tax reform for small businesses is about one thing in America: JOBS for all business sectors.

Small Business and Tax Reform: You Can't Separate the Business Owners from the Business

Subchapter S Corporations are structured so that net income of or losses to the business are distributed to the shareholders of the company and are reflected on an individual's federal, state and even local income tax returns. The tax is assessed at their individual income tax rates, meaning legislators should be conscious that discussions of assessing the higher tax rates on individuals at $200,000 and families at $250,000 will have a direct impact on the ability of many small business owners to reinvest in their businesses, and to keep or grow their workforce.

In addition to Subchapter S corporations like mine, other forms of pass-through entities that will be similarly impacted are Limited Liability Companies, partnerships, Limited Liability Partnerships and sole proprietorships. Roughly 75% of small businesses are pass-through entitles.[1] The primary reason there are so many pass-through entities is because double taxation is eliminated (first at the entity level as earnings, and then again at the individual level as dividend payments to shareholders) unlike businesses that operate as C Corporations. The largest percentage of small businesses are Subchapter S-Corporations like Lake Erie Electric.[2] This data leaves little doubt that in order for a robust economic recovery to take place, there must be a tax structure in place that incentivizes small businesses to hire and thrive.

Tax law does matter to small business pass-through entities, because they modify their business practices to adjust for law changes. In recent years, tax law changes have become a type of political tool, with revisions occurring far too often: sometimes more than once a year, and sometimes so late in the year that it is retroactive in impact, causing business owners to be confused and uncertain on how to proceed. . The frequency of tax law changes affect small businesses in particular because the unpredictability often slows or discourages the hiring or rehiring of employees, or investing in new equipment or other products and services . While certainly businesses of all sizes are impacted by the frequency of tax law changes, they have a far greater impact on small business decisions because so many of them operate on very tight profit margins. Predictability helps to keep costs down as fewer changes equate to fewer compliance costs associated to changing practices and procedures that in many cases are longstanding and

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

[2] Id. Subchapter S Corporations make up 31% of small businesses. Id.

successful from a cost/benefit standpoint. Lower costs equal greater ability to reinvest in the company and future growth.

Why pass-through entities should be maintained
The current structure of pass-through entities such as Subchapter S-Corporations provide flexibility and control to small business owners and should be maintained in any tax reform proposal.

Going forward, tax reform should help small businesses by reforming issues such as:

- Simplifying compliance rules regarding E-filing and E-verify
- Shifting the burden away to be the watchdog for the government on the small business's employees -
- Reforming the timing requirements for S-Corporation formation
- Increasing the amount a small business may expense on the federal tax return
- Reasonable independent contractor rules
- The alternative minimum tax should be eliminated. If it can't be eliminated, enact a more reasonable and consistent threshold for the alternative minimum tax

- In a related matter, I applaud your efforts to address the expanded 1099 requirement currently on schedule to become effective Jan. 1, 2012. From a small business perspective, this is the classic example of a compliance cost on both business and the Internal Revenue Service outweighing the benefit derived.

The Bottom Line for Small Business and Tax Reform

In Ohio, in 2008 small firms made up 98.1% of the state's employers[3], and nationally have generated 64% of net new jobs over the past 15 years[4]. To truly spur economic growth, rates should be set at a level that incentivize business owners to create the opportunity to hire additional workers, not punish them for being successful.

Meaningful tax reform that focuses on simplicity, predictability and fairness, and that includes an emphasis on the related cost and compliance burden to small businesses, is critically important so that we as small business owners, seek to do our part to grow the economy. On behalf of both Lake Erie Electric and OSCPA, I appreciate the opportunity to share my concerns and would welcome any questions you might have.

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[3] Small Business Administration Office of Advocacy, Small Business Profile; Ohio. www.sba.gov. Published Feb. 2011.
[4] U.S. Small Business Administration,, "How important are small businesses to the U.S. economy?" , www.sba.gov.

Chairman TIBERI. Thank you.
Mr. Marron.

STATEMENT OF DONALD B. MARRON, DIRECTOR, URBAN–BROOKINGS TAX POLICY CENTER, WASHINGTON, D.C.

Mr. MARRON. Chairman Tiberi, Ranking Member Neal, Members of the Subcommittee, thank you for inviting me to appear today to discuss the tax system and small business.

America's tax system is needlessly complex, economically harmful, and often unfair. Because of a plethora of temporary tax cuts, it is increasingly unpredictable. And it fails at its most basic task, which is raising enough money to pay our government's bills. For all those reasons, the time has come for fundamental tax reform.

Such reform could have far-reaching effects on every participant in the economy, including small businesses. To provide a foundation for thinking about these effects, my testimony discusses basic facts about the relationships between tax policy and small business.

I make six main points.

First, today's Tax Code generally favors small businesses over larger ones. Provisions such as Section 179 expensing, graduated corporate tax rates, and special low capital gains taxes benefit businesses that are small in terms of investment, income, or assets.

Second, many small businesses also benefit from the opportunity to organize as passthrough entities. S corporations, limited-liability companies, partnerships, and sole proprietorships all avoid the double taxation that applies to income earned by C corporations.

Third, the benefits of organizing as a passthrough are not limited to small businesses. Some large businesses adopt these forms, as well. Although these large firms account for a tiny share of passthrough entities, they represent a substantial fraction of passthrough economic activity. For example, only 0.3 percent of S corporations had revenues above $50 million in 2005, but they accounted for more than a quarter of S-corporation income. The situation is even more extreme with partnerships. Only 0.2 percent of partnerships had revenues above $50 million, but they accounted for 57 percent of partnership income. Lawmakers should therefore take care not to assume that all passthroughs are small businesses.

Fourth, small businesses face disproportionately high costs in complying with the Tax Code. They are also more likely to understate their income and underpay their taxes. High compliance costs thus disadvantage responsible small businesses, while the greater opportunity to evade taxes can advantage less responsible ones.

Fifth, an ideal tax system would collect enough revenue to pay for government services while minimizing distortions to economic activity. To the extent possible, economic fundamentals, not tax considerations, should drive business decisions about organizational structure. By treating passthroughs and C corporations differently, our current tax system deviates from that ideal.

Sixth, and finally, in discussing reform proposals, it is important to distinguish between businesses—a broad category that includes passthroughs—and corporations, which generally means C corporations. Many tax reform proposals would reduce business tax preferences and use the resulting revenue to cut corporate income tax rates. Such revenue-neutral reforms could lessen the disparity in tax treatment between passthroughs and C corporations. Passthroughs would see their tax burden increase since they would lose some tax preferences but not benefit from the rate reduction, while C corporations would, on average, see their taxes decline.

Thank you. I look forward to any questions.

[The prepared statement of Mr. Marron follows:]

Tax Policy and Small Business

Donald B. Marron*
Director,
Urban-Brookings Tax Policy Center
www.taxpolicycenter.org

Testimony before the Subcommittee on Select Revenue Measures,
Committee on Ways and Means,
United States House of Representatives
March 3, 2011

Chairman Tiberi, Ranking Member Neal, and Members of the Subcommittee, thank you for inviting me to appear today to discuss the tax system and small business.

America's tax system is needlessly complex, economically harmful, and often unfair. Because of a plethora of temporary tax cuts, it's increasingly unpredictable. And it fails at its most basic task, raising enough money to pay our government's bills. For these reasons, the time has come for fundamental tax reform.

Such reform could have far-reaching effects on every participant in the economy, including small businesses. To provide a foundation for thinking about these effects, my testimony discusses basic facts about the relationship between tax policy and small business. I make six main points:

- Today's tax code generally favors small businesses over larger ones. Provisions such as Section 179 expensing, graduated corporate tax rates, and special, low capital gains taxes benefit businesses that are small in terms of investment, income, or assets.

- Many small businesses also benefit from the opportunity to organize as pass-through entities. S corporations, limited liability companies, partnerships, and sole proprietorships all avoid the double taxation that applies to income earned by C corporations.

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* The views expressed here are my own; they do not necessarily reflect the views of the Urban Institute, its funders, or its trustees. Joe Rosenberg, Eric Toder, and Roberton Williams provided helpful comments, but all errors are my own.

- However, the benefits of organizing as a pass through are not limited to small businesses. Some large businesses adopt these forms as well. Although these large firms account for a tiny share of pass-through entities, they represent a substantial fraction of pass-through economic activity. For example, only 0.2 percent of partnerships had revenues above $50 million in 2005, but they accounted for 57 percent of partnership income. For that reason, lawmakers should take care not to assume that all pass throughs are small businesses.

- Small businesses face disproportionately high costs in complying with the tax code. They are also more likely to understate their income and underpay their taxes. High compliance costs thus disadvantage responsible small businesses, while the greater opportunity to evade taxes can advantage less responsible ones.

- An ideal tax system would collect enough revenue to pay for government services while minimizing distortions to economic activity. To the extent possible, economic fundamentals, not tax considerations, should drive business decisions about organizational structure. By treating pass throughs and C corporations differently, our current tax system deviates from that ideal.

- Many tax reform proposals would reduce business tax preferences and use the resulting revenue to cut corporate income tax rates. Such revenue-neutral reforms could lessen the disparity in tax treatment between pass throughs and C corporations. Pass throughs would see their tax burden increase (since they would lose tax preferences but not benefit from the rate reduction), while C corporations would, on average, see their taxes decline.

I elaborate on these points in the remainder of my testimony.

1. The tax code generally favors small businesses over larger ones.

The tax code favors businesses that are small in terms of investment, income, or assets. The most important such preferences include Section 179 expensing, graduated corporate tax rates, and low capital gains taxes.

Section 179 expensing

Under Section 179, businesses can deduct from their taxable income the full cost of qualifying investments (machinery and equipment) up to a specified limit; those

investments would otherwise need to be capitalized and written off over time. Such expensing benefits firms by reducing their tax liabilities immediately and eliminating the record-keeping burden of tracking capitalization and depreciation.

Under permanent law, firms can immediately expense their first $25,000 in qualifying investments; this benefit is then taken back dollar for dollar for investments in excess of $200,000. Thus, only firms that make less than $225,000 in qualifying investments benefit.

Since 2003, however, Congress has repeatedly extended Section 179 expensing on a temporary basis. Most recently, the Small Business Jobs Act of 2010 and the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 set the maximum amount for expensing at $500,000 and the start of the phase-out at $2 million.[1] For taxable years starting in 2012, those amounts are scheduled to decline to $125,000 and $500,000, respectively. In 2013, they are scheduled to return to permanent law levels of $25,000 and $200,000.

Graduated corporate tax rates

Corporate income tax rates are 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and 34 percent up to $10 million.[2] These rates are lower than the 35 percent that applies to larger, profitable corporations. The tax code thus favors corporations with small profits over those with higher profits.

Lower capital gains taxes

The tax code also offers favorable treatment to some capital gains from individual investments in small businesses. For investments made in 2011, for example, capital gains (up to the larger of $10 million or ten times the taxpayer's basis in the stock) resulting from new equity investments in qualifying small businesses (C corporations with less than $50 million in assets) will be exempt from income taxes

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[1] The 2010 tax act also extended and expanded certain bonus depreciation provisions for all businesses. As a result, businesses can fully expense the cost of qualified investments through the end of 2011. Leaving aside some differences in the investments covered, this provision means that small and large businesses have the same opportunity to expense investments in 2011. The relative preference for small businesses will reemerge in 2012 and beyond.

[2] A 5 percent additional tax between $100,000 and $335,000 recaptures the benefits of the 15 and 25 percent brackets. A 3 percent additional tax between $15 million and $18.3 million recaptures the benefits of the 34 percent bracket.

if the stock is held for more than five years. In his recent budget, President Obama proposed to extend this provision permanently, while tightening reporting requirements to avoid misuse.

2. The tax system favors pass-through entities over C corporations.

The tax system also distinguishes among businesses based on how they are organized. Businesses that organize as S corporations, partnerships, limited liability companies (LLC), and sole proprietorships do not pay the corporate income tax. Instead, their profits are reported and taxed on the returns of their owners. The earnings from pass-through entities thus escape the double taxation that otherwise can apply to the income of C corporations.

To illustrate, consider a small business owner in the top personal income tax bracket, currently 35 percent. If she structures her business as an LLC, she will pay 35 cents in personal taxes on each additional dollar that her business earns.

If she structures her business as a C corporation, however, the income will face two layers of tax. The business will pay a 35 percent corporate income tax on each additional dollar of earnings. The 65 cents in after-tax income is then subject to personal income taxes when it gets distributed to the owner. Any earnings distributed as dividends, for example, would be taxed at a top personal rate of 15 percent. If the company paid out all 65 cents in after-corporate-tax income as dividends, the resulting personal taxes would be about 10 cents. The owner's after-tax income would thus be only 55 cents from a C corporation versus 65 cents from an LLC. The difference between a 45 percent effective tax rate and a 35 percent rate is a powerful incentive to structure as a pass through.[3]

3. The benefits of organizing as a pass through are not limited to small businesses; in fact, much pass-through activity happens in large enterprises.

Most small businesses organize themselves as pass throughs. For example, the Census Bureau reports that in 2008 more than three-quarters of small businesses were pass throughs.[4] But that doesn't mean that all pass throughs are small

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[3] The owner might keep some of her earnings in the company rather than paying them out as dividends. That would reduce, but not eliminate, the difference in effective tax rates.

[4] This is true for businesses with fewer than 100 employees and for businesses with fewer than 500 (http://www2.census.gov/econ/susb/data/2008/us_naicssector_lfo_2008.xls).

businesses. Some large, closely held businesses also organize themselves as partnerships, S corporations, LLCs, and even sole proprietorships.

Those large pass throughs are few in number but account for a large fraction of the economic activity pass throughs undertake. Data from the Joint Committee on Taxation (Table 1) show that in 2005 less than 1 percent of S corporations and partnerships[5] had more than $50 million in assets.[6] Large partnerships and S corporations were thus extremely rare. But they accounted for the majority of partnership assets (76 percent) and a substantial share of S corporation assets (37 percent).

Table 1. Distribution of S Corporations and Partnerships by Assets, 2005

	Total Assets		
	< $50 million	$50 million +	Total
S Corporations			
Returns	99.8%	0.2%	100%
Assets	62.7%	37.3%	100%
Partnerships			
Returns	99.2%	0.8%	100%
Assets	24.1%	75.9%	100%
S Corporations + Partnerships			
Returns	99.6%	0.4%	100%
Assets	30.6%	69.4%	100%

Source: Author's calculations based on Joint Committee on Taxation (2008)

A similar pattern emerges when we look at receipts. Among all partnerships, S corporations, and sole proprietorships, only 0.1 percent had receipts greater than $50 million and only 0.4 percent had receipts greater than $10 million (Table 2).[7] But those large firms account for a disproportionate share of pass-through revenues. Firms with receipts over $50 million accounted for more than 40 percent

[5] Almost all LLCs choose to be treated as partnerships for tax purposes; they are included in the partnership data.

[6] I use $50 million as the cutoff because that's the asset level the tax law uses to distinguish small C corporations that qualify for favorable capital gains rates.

[7] The Small Business Administration uses a range of revenue cutoffs to identify small businesses; they generally fall in the $7 million to $35.5 million range, but some are smaller (http://www.sba.gov/sites/default/files/Size_Standards_Table.pdf). The closest divisions in the JCT data are at $10 million and $50 million.

of pass-through revenues, and those with receipts over $10 million accounted for almost 60 percent of pass-through revenues.

Table 2. Distribution of Pass-Through Entities and Net Income by Receipts, 2005

	Total Receipts			
	< $10 million	$10-50 million	$50 million +	Total
S Corporations				
Returns	97.9%	1.7%	0.3%	100%
Receipts	41.0%	25.0%	34.0%	100%
Net Income	51.0%	22.2%	26.8%	100%
Partnerships				
Returns	99.0%	0.8%	0.2%	100%
Receipts	19.4%	13.9%	66.7%	100%
Net Income	28.7%	14.0%	57.4%	100%
Nonfarm Sole Proprietorships				
Returns	100.0%	0.0%	0.0%	100%
Receipts	94.2%	3.6%	2.2%	100%
Net Income	98.9%	0.8%	0.3%	100%
Total				
Returns	99.6%	0.3%	0.1%	100%
Receipts	40.2%	18.5%	41.3%	100%
Net Income	58.0%	12.5%	29.5%	100%

Source: Author's calculations based on Joint Committee on Taxation (2008)

Large pass throughs also accounted for a disproportionate share of net profits. Firms with revenues of $50 million or more accounted for nearly 30 percent of pass-through net income, and firms larger than $10 million accounted for 42 percent of net income (Table 2).

Large businesses thus account for a large share of the economic activity pass-through entities undertake. Policymakers should therefore take care not to equate pass throughs with small business.

4. **Small businesses face relatively high costs in complying with the tax system; they are also more likely to underpay their taxes.**

Although the tax law often favors small businesses over large ones, complying with that law can be disproportionately burdensome. A few years ago, researchers at the Internal Revenue Service (DeLuca et al. 2007) estimated the total costs of complying with the income tax, including out-of-pocket expenses and the estimated value of employee and management time devoted to compliance. They found that there are

substantial economies of scale in tax compliance. The cost of compliance amounted to 15 to 18 percent of revenues for very small businesses—those with receipts of $50,000 to $100,000. For businesses with receipts between $100,000 and $500,000, that ratio fell to about 5 percent. For businesses with receipts between $500,000 and $1 million, it was about 2 percent. And for businesses with receipts greater than $1 million, it was only 0.5 percent.[8] Tax compliance thus imposes much less relative burden on larger organizations.

On the other hand, smaller firms are more likely to underreport their income and thus underpay their taxes. Some small businesses, for example, rely heavily on cash transactions, which are relatively difficult for the tax authorities to monitor. Small businesses willing to engage in tax evasion may thus have an advantage over larger firms that have more transparent systems for monitoring and reporting income. As Toder (2008, p. 6) notes,

> The IRS reports that large percentages of income not subject to withholding or document matching go unreported—57 percent for nonfarm proprietor income, 72 percent for farm income, and 51 percent for rents and royalties. In contrast, income sources that make up a majority of income originating in large corporate businesses have very low underreporting rates—1 percent for wages and 4 percent for dividends and interest. IRS estimates of underreporting of corporate profits tax by large and small corporations are based on extrapolations from earlier studies and are less reliable, but the order of magnitude estimates reinforce the conclusion that large businesses are more compliant.

5. An ideal tax system would neither favor nor disfavor particular organizational choices.

In a world without taxes, businesses would choose their organizational structures based solely on economic fundamentals. Partnerships and corporations, both small and large, would compete on a level playing field, and an efficient mix of organizations would tend to emerge over time.

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[8] These estimates rely on several important assumptions, including (a) an average cost of $45.40 per employee hour devoted to tax compliance and (b) tax record-keeping costs would not otherwise have been incurred for internal management purposes. Alternative assumptions would affect the estimated compliance burden, but would not change the qualitative result that smaller businesses bear a larger burden, as a share of receipts.

Taxes can interfere with that process. An ideal system would raise enough revenue to pay for government services but not distort business decisions, including those about organizational form and size. By treating pass throughs and C corporations differently, our current system deviates from that ideal. As a result, some businesses may choose less efficient organizational forms to reduce their tax burdens.

6. Tax reform could change the relative attractiveness of pass throughs and C corporations.

Both the corporate and personal income taxes are riddled with tax preferences (Marron 2011). These preferences narrow the tax base, reduce revenues, distort economic activity, complicate the tax system, force rates higher than they would otherwise be, and are often unfair. Many analysts and policymakers thus believe that reducing tax preferences should be the core of any new tax reform. Doing so could make the system simpler, fairer, and more conducive to America's future prosperity and raise revenues to finance a combination of tax rate cuts and deficit reduction.

Recently, several policymakers—including President Obama—have proposed narrow tax reforms that would reduce business tax preferences and use the resulting revenue to lower corporate tax rates. Such revenue-neutral reforms could increase the tax burden on pass throughs, since they would lose the tax preferences, but not benefit from the rate reduction. On the other hand, such reforms would reduce the tax burden on corporations, since the benefit of the rate reduction would be larger than the loss of corporate tax preferences. Such changes raise important questions about the distribution of the tax burden among different types of businesses. One potential benefit of such reform is that it would reduce the disparity in tax treatment between pass throughs and C corporations.

Thank you again for inviting me to appear today. I look forward to your questions.

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Chairman TIBERI. Thank you.

Mr. Tarnay, in your written testimony and briefly in your verbal testimony, you mentioned a couple of things I would like you to ex-

pand on, if you could. You mentioned simplifying compliance rules regarding E-Filing and E-Verify. And you also mentioned shifting the burden away from small businesses to be the watchdog for government on their employees.

Can you expand on both of those issues?

Mr. TARNAY. E-Verify—in our business sector, since our labor force comes from the unions, we have employees that come and go during the course of the year. And every time they come on, we have to E-Verify.

So you can have an employee, an electrician, for example, that comes on the payroll for, let's say, 3 weeks, 4 weeks, 3 months, and then goes back to the labor force because we don't need that employee anymore. Well, the next time he comes on, we once again have to go through the E-Verify process, and we have to do that within 3 days of him being on the payroll. But when we do that, and since we have roughly 400 or 500 electricians and they rotate, we could have that same employee being E-Verified 3 or 4 times a year.

It is time-consuming, and it takes away from other opportunities.

Chairman TIBERI. And the other issue?

Mr. TARNAY. E-Filing? We haven't had much to do with E-Filing. But I know for small businesses it can be very difficult, simply because many of the small businesses are not that, I am going to call it, technologically—have those technological abilities.

Chairman TIBERI. And your point about being a watchdog, small businesses being a——

Mr. TARNAY. Well, that isn't just at the Federal level. That is at all levels of government. Garnishments, withholdings——

Chairman TIBERI. 1099s.

Mr. TARNAY [continuing]. Child support. It goes throughout. It is a tremendous burden.

Chairman TIBERI. Thank you.

Dr. Carroll, if Congress decides to reduce business tax expenditures and cut the corporate tax rate, what are some ways that we could mimic a corporate tax rate cut for noncorporate businesses?

I would note, and I know you are aware, for example, that the House Republican Pledge to America proposes a 20 percent deduction for small-business income, which would, I believe, be a similar rate cut from 35 percent to 28 percent for small businesses.

Can you give us some thoughts on that?

Mr. CARROLL. Yeah, sure. I think there are a couple of ways that that could be accommodated in our current tax system. One approach would be to put in place a separate rate schedule, similar to dividends and capital gains. Another approach would be to put in a deduction for a certain fraction of flow-through income.

One of the complexities in extending a deduction or a lower rate to flow-through income might be trying to split up the return to labor and return to capital associated with that income.

For S corporations, it is fairly—it is more straightforward, I would say. S corporations are required to pay the owners a reasonable level of compensation. But for other organizational forms, such as, you know—one would have to address that issue. Some of the Nordic countries have tried to split up the return to labor and re-

turn to capital, but they have come up with very, very complicated approaches for that.

Chairman TIBERI. Last question, if you could all just comment on this. Some have said that if we can lower the rate and broaden the base and get rid of some of the other stuff within the Tax Code to simplify it—Ms. Thompson, starting with you—what would be a ballpark figure that you think you could lower rates for passthrough entities and get rid of some of the things that might benefit some passthrough entities but not all?

Ms. THOMPSON. The AICPA actually doesn't take a position on the best alternative to come up with. But what they have is the report talks about reform alternatives for the 21st century.

And what they think about when evaluating the tax reform proposals, they would want to look for simplicity within the measure; whether it is fair; whether it has economic growth and efficiency; its neutrality; whether it is transparent to everybody; whether or not it is minimizing the noncompliance, because we all know that that is a significant issue, and the easier you make something, the more compliant people will be; whether it has the ability to have cost-effective collection and the impact on the government revenues; whether there is certainty in it; and whether there is payment convenience.

So the AICPA really, at this point, doesn't have a position, to answer your question, on it. But as proposals come up, we could take a look at them and see what——

Chairman TIBERI. We could probably move your bill right now, actually. I think everyone agrees with what you have said.

Mr. Tarnay.

Mr. TARNAY. Simplicity and predictability for a small business is essential so that they know what to do, moving forward. As we all know, in small businesses, it is usually the owner that leads it, and he is not necessarily the key in financial decision-making. That is why, many times, the CFO is known as an "OFO," the "only financial officer."

If you make it simple and predictable, a small-business owner begins to understand it, and he can make decisions in his structure, in his decision-making, so that he can expand his business. It is as simple as that.

Chairman TIBERI. Mr. Marron.

Mr. MARRON. I was quite impressed with where the President's fiscal commission came out. I served on the parallel Domenici-Rivlin commission.

Both of those did full-scale tax reform, individual and corporate at the same time. And in both of those, they came out in roughly the same place, saying that we should aspire to a system where both the top corporate rate and the top individual rate are the same and begin with a "2," and it is 27, 28, somewhere in there.

Chairman TIBERI. Thank you.

And, finally, Dr. Carroll?

Mr. CARROLL. Just following on Mr. Marron's comments, both the fiscal commission and the Rivlin commission got down to about a 27, 28 percent. They would eliminate most, if not all, business tax expenditures, depending on the plan. They kept a few things.

If you go back to the 2007 Treasury competitiveness report, we were able to get the rate, at that time, down to about the same. If you eliminated all business tax expenditures, you could get the rate down to about 27, 28 percent. And that includes getting rid of provisions like accelerated depreciation, and so some provisions that are longstanding and, certainly, widely used.

And one of the things I think you need to also consider is, when you add in the State rates, even if you got the business rate down to 28 percent for corporations and for flow-throughs, when you add in State rates you would still have a rate on the order of about 33 percent, combined rate, for the U.S., which would still place us at a rate above the OECD and the G–7.

Chairman TIBERI. Thank you. Thank you all.

I will yield for questioning to the ranking member, Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Dr. Marron, both you and Dr. Carroll discussed the problem with eliminating business tax preferences as part of an effort to lower the corporate rate. In fact, Dr. Carroll's testimony highlights the annual cost of these preferences and which ones are used equally by both corporations and passthroughs.

Since base-broadening, though, seems to be the best way to accomplish reform, how do you think that Congress should address this real concern?

Mr. MARRON. I would start with broad principles. And from the security of being a think-tank economist kind of guy, the number-one principle I start with is a leveling the playing field. That the first order, the goal of our tax system should be not to play favorites among different types of activities, different organizational forms. And that when you have business tax preferences that are clearly skewing the field in one direction or another, that those are ones that ought to get close attention.

A second one—and this one I want to highlight just because it doesn't come up as much. We often talk about a strategy of rolling back tax preferences, and lowering rates as a strategy for doing corporate reform and business reform. There is another strategy, which is to keep favorable depreciation policies, possibly even move toward expensing, but then pay for that by walking back the deductibility of interest.

And an attraction—I would recommend that as a strategy to keep in mind, because the attraction of that is that it would eliminate some of the distortions in our current system that favor leverage and favor debt. And, in principle, it could be a way that it would have favorable business incentives but in a paid-for way.

Mr. NEAL. Uh-huh.

Dr. Carroll.

Mr. CARROLL. Yeah, I think the challenge is—there has been some discussion of corporate reform focused on trying to bring the corporate rate down, primarily due to the pressures from abroad, with the corporate rates coming down quite a lot over the last couple of decades among our major trading partners. And I think, you know, tax reform—I think business tax reform needs to be somewhat more broadly considered.

I think it is very hard to lower the corporate rate and pay for that by repealing all business tax expenditures or some set of busi-

ness tax expenditures for both flow-throughs as well as C corporations. I think one needs to pursue not just reform of the corporate income tax but, more broadly, reform of the business tax system and look at that in a more holistic fashion.

And the tax system is very intertwined. There are a lot of interrelationships between, as I have discussed in my written testimony, between C corporations and the flow-through sector, but also in the taxation of investor-level income, in the form of capital gains and dividends. You have the part of the double tax on corporate profits.

These things are very interrelated, and I think it is very difficult to take a small piece of the Tax Code and try to reform that in isolation. I think pursuing it in a much broader way is more constructive.

Mr. NEAL. Uh-huh.

Off-script for a moment: But a few moments ago in your comments, you spoke to depreciation allowance. While I think, in my own instance, having rejected the idea, the theology that tax cuts pay for themselves, I do subscribe to the notion, as Chairman Tiberi offered at the outset, that the use of the NOL last year was very important, further suggesting that, at certain times, some tax cuts are better than others.

And I think there is some evidence over the years that acceleration of depreciation allowance has worked, in terms of changing behavior in an economic downturn. Are you prepared to suggest that that ought to be eliminated as a possibility?

Mr. CARROLL. Yeah, I am not really here to suggest what should be eliminated or kept.

With respect to accelerated depreciation and expensing, I think it is a pretty common view among economists that expensing and accelerated depreciation are constructive provisions that help encourage investment. Both in times of economic downturns—the bonus depreciation and 100 percent expensing enacted in late December can be very constructive to help stimulate business investment during periods of economic weakness—but it is also, I think, very helpful in terms of longer-term tax policy. Accelerated depreciation and expensing help to reduce the tax on capital income in the economy, which can help encourage capital formation and promote growth in the longer term.

Mr. NEAL. And, Ms. Thompson, it was dizzying just to read your client scenarios with all the complex depreciation options, but I am sure you understand that Congress was trying to help small business, even though the result was a patchwork of generous rates and confusing expiration dates.

And I share the argument that the four of you seem to be unified around, with respect to the need for predictability, in our tax rules. That is a given.

But since you mentioned how tax accounting here differs from financial accounting, is conformity a recommendation that you would make?

Ms. THOMPSON. We are not really saying that the tax rules need to be the same as the financial accounting rules. But what we are thinking is that it is just one area that could be analyzed to see if it can be made easier and it can be more predictable. Be-

cause, as we had said, during 2010 there were quite a few tax provisions that came in and actually were changing depreciation. So it just adds to the complexity of it.

I don't think that anybody is opposed to accelerated depreciation; my small-business clients aren't. But they would like to know ahead of time so that they could have time to plan for it. So that is really what they are asking for.

Mr. NEAL. Just lastly, Rep. Phil English and I, at one time, worked on that, as you know. And there was substantial evidence that it was an effective approach. And, certainly, tax receipts were up, based upon that initiative.

Chairman TIBERI. Thank you, Mr. Neal.

Mr. Heller is recognized.

Mr. HELLER. Thank you, Mr. Chairman. And I appreciate your comments and holding this hearing.

I appreciate all of you being here.

I am from Nevada. So when you think of Nevada, a lot of times you think of gaming properties, and I can understand that. But I think the fact remains that small businesses make up almost 96 percent of the employers in Nevada.

And just some other statistics, only because I think Nevada is a microcosm of what is going on economically in the country as a whole. In 2004–2005, it created nearly 68,000 new small-business jobs. In 2005 to 2006, we created 77,000, so an increase of nearly 10,000. But in 2006–2007, going from 77,000, it was reduced to 40,000 new small-business jobs. And, clearly, economic factors have everything to do with it.

In 2009, Nevada averaged 3,300 new small-business startups each quarter. The down side is that we averaged 3,700 small businesses being closed each quarter. So, clearly, those that are closing are unfortunately outpacing those new jobs that are being created.

In the Obama fiscal year 2012 budget, he raises taxes on small businesses. He does it in three ways: He raises the top 2 individual income tax rates from 33 percent to 36 percent and then from 35 percent to 39.6 percent. He reinstates the personal exemption phaseout and the Pease limitations on itemized deductions. And, finally, he raises taxes on dividends and long-term capital gains, hoping to raise in his budget $709 billion.

Now, the theme—and I appreciate Mr. Tarnay's comments about what businesses need—and I think it has been a theme for all of you, and that is predictability, stability, and simplicity.

I guess my question, Ms. Thompson, since you alluded to these issues and the importance of planning, long-term planning, as you know, last year we extended the 2001–2003 tax cuts for only 2 years. And you were talking about the ability of a small business to be able to plan long-term, a 5-year plan, a 10-year plan.

With these potential increased taxes of $709 billion and the extension for only 2 years, the 2001–2003 tax extension, how does a small business today put together a 5-year plan or put together a 10-year plan?

Ms. THOMPSON. They don't. Or, they can't. Because you are absolutely right, it was very helpful that the 2001 tax rates were extended for a 2-year period. But what we would like to see is to know either this year or as soon as we can what the rates are

going to be beyond 2012 so it will help that small-business owner know what his tax liability is going to be in the future. Because if he knows that his taxes are going to increase, it is going to have an impact on his cash flow. If it has an impact on his cash flow, there are going to be potentially cuts in other areas, and, unfortunately, that might be workers. It is hard to say.

But they will definitely need to know what their tax liability is going in the future to make business decisions now.

Mr. HELLER. Mr. Tarnay, since those were your words, "predictability, simplicity, and stability," how does a business today plan under the current tax rates that we have?

Mr. TARNAY. I would agree it is very difficult, because for years, for decades, it used to be we understood what the tax rates were, what the law was moving forward, accelerated depreciation, the whole nine yards. Then I would say, in the past 10 to 15 years, laws changed annually, sometimes retro. It is very, very difficult for small businesses to do that. They have to bring in their experts, their tax advisors, and that is costly.

If small-business owners understood what it is going to be for a 5-year period, a 10-year period, they can plan. That is what they are good at. That is what we need.

Mr. HELLER. The President's deficit-reduction commission, is there anything that you disagreed with? There were a lot of tax structural changes talking about deductions and removing—Dr. Marron, you are talking about moving forward with a different type of tax structure.

What in the President's deficit-reduction commission—were there any principles in there that you agreed or disagreed with? You said you sat on a similar commission yourself.

Mr. MARRON. Yes. So, in terms of things agreed with, I very much endorse the idea that, if you are going to do reform, A, it makes sense to do the whole tax system at once, if you possibly can politically, to take into account all of the interactions. That there are a lot of tax preferences out there that really look a lot like spending programs; they have just been dressed up to appear as tax cuts. And that, as a result, if someone is interested in making the government smaller, there are actually some things you can do that will be recorded as tax increases that actually are functionally the reduction of spending, from any sort of economic or budget point of view. And that, as a result, there are ways, basically, to increase revenues that, you know, are not that troubling, frankly.

I am very much encouraged by the idea of bringing down rates, kind of broaden the base, lower the rates. As Dr. Carroll mentioned, a little bit of concern that the plans do raise dividend rates and capital gains rates. And so there is an issue that, while for the corporate form you are reducing rates with one hand, on the other hand you are raising rates, and you are not getting as much of a net incentive for investment as you might get with a slightly different form.

Mr. HELLER. Thank you.

I have run out of time. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you.

Mr. Roskam is recognized for 5 minutes.

Mr. ROSKAM. Thank you, Mr. Chairman.

Well, the good news is we all agree on something, and we all agree that the status quo has to change. There is no voice here on this panel and there is no voice among the witnesses that says, let's stick with the status quo. And that is, actually, good news. I mean, there is this shared premise that we can move forward from.

What I am interested—you know, we are all products of our environment, and we are all reflecting our districts today. Mr. Heller talked about Nevada. I am from suburban Chicago, and my district has an extraordinary number of manufacturers, small manufacturers, tool-and-die types that are selling into foreign markets and are selling around the world, selling to the Caterpillars of the world and so forth.

Illinois has a unique dynamic that I am concerned about. It is nothing that we are going to do anything about today. It was a bad decision, I think, that was made. But it is having an impact on this larger conversation about passthroughs.

Let me just give you a couple of quick facts on Illinois. Illinois just raised its taxes, right? So the individual rate went from 3 to 5 percent, a 67 percent increase. The corporate income tax rate went from 7.3 to 9.5, a 30 percent tax increase. Illinois now has the fourth-highest combined national-local corporate income tax rate. And according to The Tax Foundation, we have dropped from 23 to 36 in the country among States.

Now, that is not your problem; that is my problem, because I am an Illinois resident. But it is also the problem of a lot of companies and businesses that I represent.

So if we are making changes at a macro level, in terms of U.S. tax policy, that have an impact on driving more businesses into a corporate structure, you see what that does to the employers that I represent. They are jammed, right? They have to go into this position. And what we don't want to do is move them so that they have to go that route.

Dr. Carroll, I am interested in your perspective. A lot of times, when we talk about corporate tax rates and, sort of, corporate tax conversations or general tax reform, we tend to shun passthroughs as a little bit of a sideshow.

You mentioned three key points, and I just want to yield you some time. Could you go through those key factors on the distortions within the marketplace, the debt equity distortions and so forth? Because I think that is an important part of the calibration that this subcommittee needs to take into consideration as we move forward.

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[10:00 a.m.]

Mr. CARROLL. Yeah. As I mentioned in my oral statement and explained in some detail in the written testimony, one of the major differences between the taxation as a C corporation and as a flow-through is the double tax on corporate profits, the notion that a dollar investment in the corporate sector, the return to that investment is first subject to the corporate income tax and then taxed again at the individual level, either when it is paid out as a dividend or if the return is retained then it would be taxed as a capital

gain eventually when the shareholder disposes of the stock. So when you combine those two levels of tax you wind up with a double tax, and that distorts economic decision-making in a couple of ways.

Dr. Marron had mentioned that economic fundamentals should drive decision-making, not tax considerations. One of the things that the corporate tax does, because it is tax on equity financed investment, interest expenses are deductible but dividends are not, and so it is tax on equity finance investment which creates a bias or adds to the bias for debt finance investment, increases the overall leverage within the economy to the extent that firms are more highly leveraged. Because of this tax bias, they are going to be more susceptible to financial distress during times of economic weakness. So that is one of the distortions. The tax bias for debt finance, the tax bias for greater leverage, that is an issue.

Another issue is you have a different treatment of investment in the corporate sector versus elsewhere in the economy, in the noncorporate, in housing, other sectors in the economy, and that causes a misallocation of capital within the economy. Again, you have investment decisions throughout the economy being made for tax considerations, not economic fundamentals. When you have that misallocation of capital, the capital stock will not be allocated to its best and highest use, and that is going to reduce economic growth.

And then, third, it raises the cost of capital. The double tax and corporate profits, you know, it is another layer of tax on capital formation, that that higher cost of capital discourages capital formation and investment and, again, would reduce the overall growth rate of the economy.

Mr. ROSKAM. Thanks, Dr. Carroll.

Thanks, Mr. Chairman.

Chairman TIBERI. Thank you.

Mr. Thompson, you are recognized for 5 minutes.

Mr. THOMPSON OF CALIFORNIA. Thank you, Mr. Chairman. Thanks for holding this hearing and thanks to all the witnesses for being here. I concur with everyone else who said that this is an issue that we all agree on. We just need to figure out how to get there.

Just a real quick question, Ms. Thompson. On the 1099 issue that you raised, do you have any suggestions on how this Congress should deal with the underlying issues that brought the 1099 matter to the forefront? And that is, the $30 billion or $25 billion worth of tax evasion that is going on, how do you address that?

Ms. THOMPSON. I think that would probably be on enforcement side, which the IRS does have the ability to——

Mr. THOMPSON OF CALIFORNIA. But they don't have the data. You can't put an IRS person at every point of purchase.

Ms. THOMPSON. I think that the existing rules that are in place cover services, and I don't think that everybody is even in compliance with that one. So we might start working on that area first.

I think the way the legislation is written right now it is covering goods and it is covering corporations, and that is not realistic on how you are going to solve the problems. The example that every-

body is talking about is if a small business owner goes into Staples and purchases their office supplies and they happen to spend more than $600 in a year, they are going to be required to send a 1099 to Wal-Mart and Staples, and it just doesn't seem like it is the right target that you are looking for.

Mr. THOMPSON OF CALIFORNIA. A couple of you have raised the whole issue of complexity, and for those of us who were in the meeting that we had in the full committee when we got a briefing on the U.S. tax structure it is pretty hard to argue that the system isn't just overwhelmingly complex.

In another life, I chaired a tax committee in the State legislature in California, and I had business people tell me just, you know, lower the heck out of our taxes. We understand things need to be revenue neutral, and that you need money to do all the things that government does. But the lower our tax rate is, the more people we will hire, the higher wages we will pay, the better off everybody will be. Get it at the employee. We are paying them well. They should pay taxes. Do you think that is a pretty accurate approach?

To any of you, do we have too many tax options for business? I think Mr. Neal said it earlier, that everything that is there that makes it complex was there to address a certain issue or, in most cases, to help business. Do businesses have too many tax options on the table?

Mr. TARNAY. The answer is yes. Also, the answer is, if it can be done so that the law is something that people can understand for a significant period of time, as opposed to things changing year-to-year or less than 5 years, people can plan that. I can plan it. My company can plan that. We understand that. We can move forward. Okay? That is the difficulty that we have.

And the other thing is, simply law changes that are retroactive. When you hear that, you don't do things because you don't know when that retroactive application is. If we knew that, we can plan. That is what we need.

Mr. THOMPSON OF CALIFORNIA. So if there were fewer options, if you didn't have the LLC, didn't have the corporate election, and you had just a business tax?

Mr. TARNAY. Well, I am not saying the type of entity. I am saying within that type of entity that you understand what the law is. It is simple. It is fair.

Mr. THOMPSON OF CALIFORNIA. I get that part.

Mr. TARNAY. That is it.

Mr. CARROLL. I guess I would say that I think one of the distinguishing features of the U.S. business tax system is we do afford businesses with different choices on how to organize themselves, and I have always thought of that as a virtue. It allows companies to make the choice that best fits and suits their capital requirements and their management needs. It is probably one of the many distinguishing features of the U.S. economy in comparison to our major trading partners. That flexibility probably adds to the dynamism of the U.S. economy.

Mr. THOMPSON OF CALIFORNIA. To follow up on that, Dr. Carroll, are there certain anti-avoidance measures that would have to be put in place if you were to devise a system that pushed the rate down and lessened the options?

Mr. CARROLL. Yeah, that is a very, very interesting question, and it is kind of an extension of your earlier question in some sense in terms of how tax rates affect decision-making.

Typically, from an avoidance or a compliance perspective, one would think higher tax rates would encourage greater avoidance and noncompliance activity. Because the benefit of avoiding and the benefit of not complying to the taxpayer is greater with the higher rates. So one of the benefits of lowering rates generally would be that you would help mitigate and reduce avoidance behavior.

Chairman TIBERI. The gentleman's time has expired.

Mr. Thompson, just a side note we tried to find Grandma Thompson to come testify. When we couldn't, we had Ms. Thompson instead.

Mr. THOMPSON OF CALIFORNIA. That is why I cautioned you, you better lay off the Grandma Thompson jokes today.

Chairman TIBERI. Mr. Paulsen is recognized for 5 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. It is nice to be having a hearing that is focused on small business entities, and I appreciate your testimony here today.

Knowing that we are in a very globally competitive economy, absolutely, and, you know, today we have to have a Tax Code that has not only the predictability in the long-term thinking, but, I mean, I really do believe it also has to spur innovation, spur the whole idea of entrepreneurship, and also capital formation and investment. I think there are a lot of staff people in the administration or even Members of Congress that don't understand the allocation of capital, and that is really what this is about, how you allocate capital in the global environment.

One of my concerns with the administration's proposal on tax reform is that it is centered more on the corporate tax side, at least in the President's State of the Union proposal, and he talks about having a revenue-neutral basis for corporate tax reform. I want to make sure that is not going to be an expensive trap for small business entities and pass-through entities such as S corps, LLCs, sole proprietorships, partnerships, et cetera.

If that is the track that is ultimately pursued and a lot of our Nation's employers are going to see tax increases because we eliminated certain tax business, the expenditure side like deductions for depreciation, et cetera, which you talked about, you know, what would be some of the ramifications of that from the standpoint of—while there might be not be any offsetting benefit, in essence, for small employers—and, on top of this, we also heard Secretary Geithner actually, just last week I think, float the idea of having some pass-throughs be pushed more into the C corporation model, actually, ensuring they would also be hit with this inefficient double tax.

So let me ask Mr. Carroll first maybe, if the purpose of tax reform is to actually make the U.S. government more competitive or our economy more competitive, I should say, and encourage job creation, does it make sense to push more people into the C corporation tax model?

Mr. CARROLL. My view is that that is problematic. As I already discussed, we have a double tax on corporate profits. It distorts de-

cision-making in some fairly fundamental ways. It is kind of widely recognized among economists in the policy community that the double tax on corporate profits is a significant problem. It contributes to the leverage among businesses. It misallocates capital, and it raises the overall cost of capital for the economy.

Most other developed nations have provided some relief from the double tax on corporate profits in some way. They have shifted a little bit in the last 10 years in how they do that, whether they do it at the shareholder level, whether they do it at the corporate level, the mechanism in which they deliver it. But the U.S. tends to have fairly—even after the lower rates on dividends and capital gains were enacted in 2003, we still have a fairly high double tax on corporate profits such that a dollar of investment in the corporate sector that is paid out as dividends is taxed pretty highly relative to most other things.

I think that is a problem. It kind of complicates—and I think it really complicates if you try to redraw the line between the flow-through sector and the C corporation sector. To raise more revenue to lower the corporate rate, I think it would make the double tax problem larger, not smaller.

Mr. PAULSEN. And, Ms. Thompson, I am just curious, what would happen to your clients if they got pushed into a C corp model?

Ms. THOMPSON. I think it is really too early to say what would happen if they moved into the corporate form because it hasn't been worked out on what all the details of that are. Are there going to be changes to the expenses? Is there going to be a double tax? So it is really too early to answer that question.

Mr. PAULSEN. Mr. Chairman, I follow up in a different angle to what Mr. Carroll—I know that you looked at the economic issues that are associated with S corporations and with the subset of S corporations, namely, employee owned or ESOP S corporations, in particular. These are companies essentially that are employee owned and they fared much better in tough economic times in terms of actually growing their companies during these trying times and also putting people back to work, providing retirement security, actually, for their employees. If the administration's proposal to move and eliminate some of those pass-throughs on S corps became a reality, for instance, what would this mean for privately employee-owned companies potentially? Who would be affected by such changes within those organizations?

Mr. CARROLL. Yeah, I think the S corp ESOP structure is very interesting. The employee ownership aspect is very interesting, and the performance of those companies based on some work that I have done suggest that those companies performed better during the economic downturn than the rest of the economy in the sense—although it is not a huge segment of the economy, they did in effect provide, in some sense, a backstop during the economic downturn. They tend to pay their workers higher average wages, and they tend to provide a fairly high level of retirement security. So the ESOP provides that benefit as well.

Mr. PAULSEN. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you.

Mr. Berg is recognized for 5 minutes.

Mr. BERG. Thank you, Mr. Chairman. I appreciate you being here.

As a small businessman, it is kind of over the years going through the 1986 tax reform and everything else, small business tends to make decisions, first of all, on the economics, but they are really influenced by the taxation. And it seems to me—I enjoyed the OFO, only financial officer. I think that is what a lot of these small businesses are.

And when there is laws that are passed, they are either convoluted or complicated. They are trying to look at that and figure that out. And the point of having a third party analyze this for the business, I mean, those are things that, again, specifically help at little moments in time but I think overall really cause a lack of focus in what maybe a small business should be focused on.

So one of the things that I heard you saying that potentially when you eliminate some of the accelerated depreciation and other things that you could probably bring the rate down to 28, 27 percent. I wonder if you ever looked at just the silo of pass-through entities. If you said just looking at this group of pass-through entities, if we eliminated, again, or changed this to simplify it, what could that overall rate be brought down to? Would that be the 28 percent? Whoever would like to——

Mr. CARROLL. I think if you were looking at just the flow-through sector by itself, I haven't done the calculations in terms of how low the rate could be brought down. As I mentioned, flow-through entities use about 22 percent of the business tax expenditures, and they report about 40 percent of the net income and pay about 43 percent of the business taxes. So, in that sense, the C corporations kind of make somewhat greater use of business tax expenditures. So that might give you some sense of kind of the relative reduction of the rates.

But I would point out that if one tried to just do corporate reform and tried to draw a line in the various business tax expenditures or business tax provisions so that they would only be reduced or eliminated for C corporations or did the same for pass-throughs, I think that would be a very, very complex, complicated system. Trying to make those distinctions on something like accelerated depreciation that is probably available to all business forms in trying to have one system for C corporations and another system for flow-throughs I think would be an extraordinarily complex system.

Mr. BERG. Ms. Thompson, you had mentioned the 100 percent gain exemption, and that was a little bit new to me. Could you explain that briefly and how that could benefit if it were implemented for pass-through entities?

Ms. THOMPSON. The provision is that if you have a gain on the sale of a small business stock you can exclude 100 percent as long as you purchased the stock between September, 2010, and December, 2011; and starting in January, 2012, it is going to drop down to 50 percent gain exclusion.

But what happens with that provision right now is it is only available to C corporations; and, as we had talked about, most of the small businesses are running as pass-through entities. And so if that is a C corporation provision, it automatically excludes everybody who has been running this small business as a pass-through

entity. The value has to be less than $50 million, and it has to be in certain types of businesses, and it can't be any type of personal services. It can't be restaurants, hotels, motels, those types of things. So it is really very narrow, and it is even more narrow because it is only C corporations, which most of the small businesses aren't.

Mr. BERG. Thank you.

The other issue that has come up time and time again is the uncertainty and unpredictability. I mean, I think whatever our tax rates were, whatever our deductions were, if they were set in stone for 15 years, that would be a good thing for small business and probably all business, as long as it is competitive. And so I guess looking at that—and I am asking myself—what are the taxes out there that are on like a short-term trigger that need to be renewed that create this uncertainty out there? In our current Tax Code, as it relates to the pass-through entities, what are those either deductions or what are those things that you are aware of that creates that uncertainty that could be addressed in this Congress?

Again, I am not, I guess——

Ms. THOMPSON. The first one could absolutely be the tax rate. Because we do know that they are set until the end of the next 2 years, through 2012. But then once you get beyond that depreciation we do know that this is a business incentive that you put in place more when the economy isn't really good. But having that come in and out as frequently as it does, that is causing quite some challenges.

Mr. BERG. Thank you.

So tax rates and depreciation. Is there anything else?

Ms. THOMPSON. From the small business perspective, I think those are the major ones that we come across.

Mr. BERG. Dr. Carroll.

Mr. CARROLL. I think if you look broadly at the tax system, you have a large fraction of the Tax Code that is really in flux from year to year. You have the sunset of the Bush tax cuts at the end of 2012 which raises a considerable uncertainty, and you also have the various expiring provisions, including the R&D credit that is used by small businesses as well as large businesses, and that expires periodically. There is a long list of expiring provisions. All of these things create a lot of uncertainty and instability in the Tax Code and make it very, very difficult for both individual and business taxpayers to make decisions.

Mr. BERG. Thank you.

Chairman TIBERI. Thank you. Thank you, Mr. Berg.

Dr. Boustany is recognized for 5 minutes.

Mr. BOUSTANY. Thank you, Mr. Chairman, and thank you for holding this hearing. This is a very important hearing.

Some time ago, I was back home doing a town hall meeting and I was talking about American competitiveness and the need to lower the corporate tax rates so we could compete in the global economy. And after some lengthy discussion about all of that, I had a small business owner who I had happened to know, a gentleman by the name of Paul Fontana, who owns an occupational therapy business, and he stood up and he said, what about me? What does

this get me? And it got me to thinking and I said, well, you know, you are right, because you have a pass-through entity.

And as we go through this discussion it becomes apparently clear to me that we really have to focus on our small businesses and pass-through entities as we do tax reform. Otherwise, I think we will be negligent in the approach.

Dr. Carroll and Dr. Marron, the administration is talking about reducing the corporate tax rate, which I think we all agree we need to do, and we are looking at targeting it down into the 20s, you know, 20, 25 percent, if we can get it down that low, to be really competitive. But, at the same time, the administration is talking about raising the top level for pass-through entities, the top rate for pass-through entities and individuals to almost 40 percent. So what is going to be the economic consequence if that is allowed to go through? Dr. Carroll.

Mr. CARROLL. Yeah. I think our corporate tax system is very much out of step in the global economy. Most other developed nations within the OECD have lowered their corporate tax rates significantly over the last—certainly since the mid-1980s, and we now have the second highest corporate tax rate exceeded only by Japan. Japan is likely to reduce their corporate tax rate in April, in which case we will have the highest. So that kind of provides a backdrop for why there is an interest in corporate tax reform. You know, we want the U.S. to be able to compete in a global economy, and the world has really changed. It is very different now than it was.

Mr. BOUSTANY. What is the economic consequence here in the U.S. with this disparity if we have a top rate of almost 40 percent for our pass-throughs and for individuals as we lower the corporate tax rate?

Mr. CARROLL. I think it is a very problematic. I think it is very problematic. The flow-through sector, as I said, is a very large segment of the economy, employs 54 percent of the private labor workforce, and to have a very different treatment of pass-throughs relative to C corporations is a problem.

Mr. BOUSTANY. Thank you.

Dr. Marron.

Mr. MARRON. Again, I would go back and reference what the fiscal commission came up with, the Domenici-Rivlin Commission came up with. There was a reason they chose in the end to try to have the top rates on the individual side and the corporate side be the same, and one of those key reasons is to avoid all the distortions that would arise. If you have one rate that is 40 and you have another that is 25, you have created a gigantic incentive for creative people to think about how do I exploit this to best advantage, and that is thinking that would be better deployed doing something else in the economy.

So if you can do fundamental reform of the entire system, that means touching all sorts of other tax preferences that are purely on the individual side and have nothing to do with business, much better to end up with rates being—you know, they don't literally have to be identical but close to each other.

Mr. BOUSTANY. Close. Thank you.

One of the common refrains I hear from small business owners is about the issue of accelerated depreciation, and we saw this after

the hurricanes. It was probably the single most important thing Congress did to spur the Louisiana economy after hurricanes Katrina and Rita; and I appreciated your comments earlier, Dr. Carroll, about both the short-term and long-term consequences that are positive with this type of approach.

And, Ms. Thompson, in your testimony you highlighted a number of the complexities, the varying in rules and everything else, which I read with great interest; and I am going to look at the report that you all have as well. But how could tax reform simplify some of these rules related to capital investment that would allow for small businesses to actually see capital formation?

Ms. THOMPSON. I think the best thing you could do with the depreciation is have it for a longer period of time and put it in place prior to the time that you are thinking about it.

For example, if you wanted it to be effective January 1, 2011, put it in place, if you could, in 2010 and don't have it just for a 1-year period, have it for a much longer period of time. Then that gives the ability to the small business owner to plan their investments better, their purchases, and that would really add a lot to the simplification of the system because everybody does like the accelerated. It is just that it comes in too frequently at various times during the year. It is just challenging.

Mr. BOUSTANY. Does anyone else want to comment on the issue of depreciation versus expensing and, you know, the concerns about debt financing before we conclude this?

Mr. MARRON. If I could just second something I said before, is I am sympathetic to approaches that would move towards expensing if at the same time you think about walking back the deductibility of interest. Otherwise, you accidentally end up in a system where, if interest is deductible, you can have a situation in which we effectively have negative tax rates on capital investment, which I think is going too far. But if you, you know, keep accelerated depreciation and move towards expensing but then think about rolling back interest deductibility, you can have a system that reduces that debt equity distortion and provides incentives for investment.

Chairman TIBERI. Anybody else care to answer?

The gentleman's time has expired.

Mr. BOUSTANY. Thank you.

Chairman TIBERI. Ms. Berkeley, recognized for 5 minutes.

Ms. BERKLEY. Thank you very much, Mr. Tiberi, and thank you for holding this hearing. I thank all the witnesses. I have learned a lot this morning, and I appreciate that.

I agree with my colleagues that reforming the tax system is critical to the long-term health of our economy. I don't think you need to be a genius to figure out that the Tax Code is bloated and it is very complex. It adds unnecessary costs to business operations and distorts business investment decisions.

That the Code is unnecessarily complex is a complaint that I hear often from my constituents in Las Vegas, and I worry that it poses an additional hurdle to my district getting back on its feet economically. We are in a world of hurt in Nevada, particularly in Las Vegas, which is the community that I represent. Half of the businesses—although I know everybody thinks of Las Vegas as the glitz and the glitter and the big hotels, and in fact that is part of

our persona and has served us well until the latest economic crash—about half of the people that are employed in the State of Nevada are employed by small businesses. So what we are talking about today is very important. I know that this is the beginning of a very long process.

In the State of Nevada, pass-through entities outnumber C corporations by almost three to one. So what we are talking about here today is very important to the people I represent.

There are a number of questions that I have. The first one is just some musings. I know that we are all talking about budget neutrality and if we could bring down the corporate rates to 27, 28 percent across the board, get rid of all the tax extenders, the tax breaks, the tax credits, it would add to predictability and simplicity, which everybody believes would be better for small businesses. If you know what is happening, what you can plan for 10 years from now, 5 years from now, obviously, it impacts on your business decisions and gives you an opportunity to make better ones.

But having been through the tax extender debate and having everybody that I knew that owned a business of some kind coming into my office and asking for an extension of their tax break, no matter what business they are in, if it is propane gas or speedways throughout the United States, I am wondering how willing businesses are going to be to give up these tax breaks that we have extended over the years?

And I would imagine that if we lowered the tax rate—and I agree with you, when you look at our tax rate on paper in comparison to other industrialized countries, it seems very, very high. But when you factor in all the tax breaks, tax credits, tax extenders, I think it generally lowers our overall corporate tax rate dramatically.

I can tell you in my congressional district, without naming names specifically, I have one gaming company that pays overall about 8 percent after they take advantage of all their tax breaks, and I have another that pays over 30, and they are both pretty big companies. Now, I wonder how the company that is now paying about 8 percent of their taxes is going to feel when we pass legislation that kind of stabilizes everybody at around 27, 28 percent while eliminating the tax breaks. Can you comment on that?

Mr. CARROLL. Yeah. A lot of points that you have raised there that are all I think very important. One point is, you know, how do we compare to other nations? And there are different ways of measuring that. We do have a high statutory corporate tax rate. We also have a high—what economists call a marginally effective tax rate relative to other nations. There is a recent study that was released by an academic in Canada, Jack Mintz, that makes that point.

We also have a very high effective tax rate and measured on a financial statement basis based on some work by an academic, Doug Shackleford down in North Carolina.

There are a number of ways of thinking about effective tax rates or tax rates generally, and which tax rate you look at really depends on which question you are asking. But by a number of dif-

ferent metrics the U.S. looks like it is pretty out of step relative to other countries. So that is I think one point to keep in mind.

Ms. BERKLEY. Mr. Marron, you pointed out in your testimony the connection between the complexity of the Code and the tendency of small businesses to underpay their taxes. Can you share with us some areas of the Tax Code where simplification would have the highest effect on boosting compliance?

Mr. MARRON. Well, in my remarks I was very careful to use—what was the word I used—responsible and irresponsible just to distinguish small business as a whole, vast array of different kinds of firms, some of which face very high compliance burdens and try to pay the taxes they do; and then, unfortunately, there are other ones who are able to avoid.

You know, unfortunately, I don't have any good recommendations for you. I mean, again, some of these things have to do with, you know, cash transactions which are hard to monitor. It is just sort of a fundamental nature of some of these transactions that they are going to be more difficult to reach to.

There was the effort with the 1099 which has gotten a lot of understandable pushback, and that is that the burden it placed on folks seems to be disproportionate to the additional revenue it is going to raise.

Maybe some of my colleagues have some suggestions for you, but I do not, sorry.

Chairman TIBERI. The gentlelady's time has expired, but any of the other witnesses care to answer her question?

Ms. BERKLEY. So no suggestions on how we can, in fact—what we can do with the Tax Code where simplification would have the highest effect on compliance? No help?

Chairman TIBERI. The gentlelady's time has expired.

We are going to one more round, if the witnesses would care to indulge us, for just one question from each of the members, if they wish. I will start out by asking all four of you—well, two of you—a question; and then I will follow up with the other two.

Earlier this week, in a publication called Tax Notes, an article, a gentleman by the name of Marty Sullivan, who the minority actually invited as a witness a couple of weeks ago on tax reform, argued that double-taxing on corporate income is bad economic policy; and let me quote what he wrote in the article: We should recognize that the movement from double taxation to flow-through taxation is a step in the direction of sound policy. Tax reformers and professors will tell anyone who will listen that all business income should be taxed on a flow-through basis.

I would like to get opinions from Dr. Carroll and Dr. Marron on Dr. Sullivan's point that double taxation on business income is bad for jobs and the economy, and good policy means moving toward taxing business income once. Do you agree or disagree or and why?

Mr. CARROLL. I do agree with that. As I have already alluded to or stated in my comments, the double tax on corporate profits distorts economic decision-making in a number of very important ways. It leads to a higher degree of leverage in the economy, which is problematic; it leads to a misallocation of capital throughout the economy, which is problematic; and it raises the cost of capital, which discourages capital formation. That is also problematic.

Using something Donald said earlier, you know, economic fundamentals, not tax considerations, should drive decision-making, and the double tax I think violates that principle.

Chairman TIBERI. Thank you.

Dr. Marron.

Mr. MARRON. I agree as well. There are lots of plans over time that said, you know, if you could go back to the beginning and redesign a tax system from scratch, how would you want to design it? And there are different ways of doing it, but they all have this feature that you eliminate the double tax.

Chairman TIBERI. Mr. Tarnay, if you were forced to go and become a C corp, how would that impact your ability as a CFO to create jobs from your current tax system?

Mr. TARNAY. I think it would diminish it greatly. A small business owner thinks one way: I made a dollar. I should pay tax on that dollar. Not a dollar and then, after I get some money from it, then pay tax at the individual level. This is how they think. One-time tax on that earnings. Flow-through entities allow for that.

Chairman TIBERI. Ms. Thompson, you had mentioned that you do tax returns for a variety of clients, a lot of small business owners. How would a majority of your clients be impacted if we forced all businesses to pay at a C corp rate?

Ms. THOMPSON. Without knowing all of the details of the tax reform and if you were purely to say everything is going to stay in place except you are now going to be corporations and you are going to need to double-tax employees, they would be hurt tremendously. I have had clients who have been C corporations in the past who, when they went to sell their business, they end up paying more than 50 percent in taxes, and it was overwhelming to them. So it would really hurt them significantly if they had to go a C corp level tax and pay double.

Chairman TIBERI. Thank you.

I will yield time to Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Dr. Carroll, you mentioned that ESOP entities tended to do better in the recession in terms of retirement savings, and you know that is something I have in interest in.

Mr. CARROLL. Yeah. In a number of different metrics, based on some analysis that I have done, it looks like the ESOPs did fare better during the recession than—S corp ESOPs fared better during the recession. They grew at a faster rate. They added more jobs. Generally, they have higher average wages; and, generally, they have a greater retirement security.

Mr. NEAL. Let me follow up on the point Mr. Thompson was making to you about anti-abuse rules. You pointed out that if the corporate tax was significantly lowered, that the lower rates don't usually foster abuse, I think what he was trying to get at was that abuse might arise if the corporate rate was at 15 percent and the highest individual rate was at 35 percent. In this scenario, would you see some movement of earnings to the corporate form?

Mr. CARROLL. Oh, there is movement between—at a high level, there is movement between the flow-through sector and the C corporation sector, depending on the relationship of the individual tax rate and the corporate tax rate. We saw that after the 1986 Act

with the repeal of the general utilities doctrine and as well as the change in the relationship of the rates, we saw a movement that, some research that I did a while back, ascribed to the change in the rates. Austan Goolsbee has done some research in the area as well that has found that the number of businesses or the level of activity within each sector is sensitive to the relative taxation.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you.

Mr. Paulsen is recognized.

Mr. PAULSEN. Thank you, Mr. Chairman.

And maybe I will just follow up with Mr. Tarnay. I didn't get to ask you a question before, but you listed several items as a part of your testimony that were important for tax reform to be in consideration. And, you know, we all agree tax reform is necessary. You have got the corporate component, you have got the pass-through entities which we are talking about today, but can you just discuss in greater detail a couple of the items or maybe the top handful of the most important issues that should be focused on that would be the best—I mean, the absolute best, actually, to help spur economic growth and capital formation and investment, if there is just sort of a top wish list that should absolutely be focused on.

Mr. TARNAY. I think the timing in the requirements of an S corporation, because it is complex because of the levels of—if you have certain stock structures, you can't be an S corporation, certain number of shareholders, you couldn't be—I think that could be simplified. I don't agree with the alternative minimum tax, but I think that if you can't take it away then I think it needs to be revised and simplified.

Mr. PAULSEN. Okay.

Mr. TARNAY. Those are the two.

Mr. PAULSEN. Do you have any idea how many small business entities end up falling into sort of the alternative minimum tax because of their pass-through income? And maybe, Mr. Carroll, you may know. You kind of nodded your head.

Mr. CARROLL. I actually don't know the answer to that question, but it is a very interesting question.

Mr. PAULSEN. Okay. Well, Mr. Chairman, if we can somehow have tax staff to look into that, too. Because I know the alternative minimum tax is something that keeps trapping more and more people, and a lot of these people—small businesses that pay also under the individual rates obviously would get trapped in that. So I yield back.

Chairman TIBERI. Thank you.

Mr. Berg is recognized.

Mr. BERG. Thank you, Mr. Chairman.

We have seen a lot of statistics that show our corporate rate relationship to other countries across the world. My question is, tell me about the pass-through entities in these other countries; and, again, maybe, Dr. Carroll, you could start.

Mr. CARROLL. Yeah. A lot of other countries push businesses into the corporate form in pursuit of limited liability. That is one of the distinguishing features I think between the U.S. and other countries, is it is much easier to get limited liability in this country

because of the flow-through form and the various organizational forms in that sector. And so that is one of the reasons we have a much larger flow-through sector than most other nations.

You know, I think that is—one could also do a comparison of the kind of the tax rates that the flow-through income received by individuals in the U.S. is subject to as compared to other nations. I am less familiar with those statistics.

Mr. BERG. Mr. Chairman, my question, kind of here in America we are trying to keep those two rates pretty close. I argue that we should look at the net rate and not the gross rate. But my question related to other countries, is their pass-through rate similar to their corporate rate or is there a disparity in these other countries that we are aware of?

Mr. CARROLL. I think there does—without having looked at the data in detail, my sense would be that there tends to be some disparity. The corporate tax rates tend not to be particularly high relative to individual tax rates. There are a few countries that have tried to apply, in a sense, separate tax systems, particularly in the Nordic countries where they treat partnership income, you know, very differently than the income of wage earners in order to coordinate the corporate sector tax and the flow-through sector tax.

Mr. BERG. Let me, Mr. Chairman, wrap up just—my question, when that nets out to the individual, the stockholder, where we are competing with another country that has a low corporate income tax, are they paying a very high personal income tax so that net that that person is paying, you know——

Mr. CARROLL. Yeah. So looking at it a different way, if you look at kind of the net after-tax amount received for a dollar invested in the corporate sector abroad, you know, kind of what is the sum total of the double tax on corporate profits, for a dollar paid out as dividends, that tax bite when you look at both levels, the corporate and individual level, tends to be higher abroad than here. The U.S. tends to have a higher level of tax on a dollar invested in the corporate sector and paid out as dividends than our major trading partners. And if the rate were to go up, the dividends and capital gains rates were to go up, then that difference would become fairly substantial.

Mr. BERG. Thank you. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you, Mr. Berg.

Ms. Berkeley is recognized.

Ms. BERKLEY. Thank you, Mr. Tiberi.

I kind of caught something, Ms. Thompson, that you said, and I just wanted to make sure that I understand it completely. Secretary Geithner has suggested that some pass-through entities are—in fact, very large firms, not the traditional small businesses, at least I think of it—these large firms have revenues in the tens of millions of dollars. Mr. Paulsen, I think, asked you what the impact of being taxed as a C corporation would be on your clients. Could you share with us what percentage of your clients are of the size that Secretary Geithner was referring to?

Ms. THOMPSON. That is not the level of my clients. My clients are very small businesses. They have probably four to six members and revenues are probably——

Ms. BERKLEY. You mean employees or members?

Ms. THOMPSON. No, owners of the company. So you are talking about either C, S, or pass-through entity owners. There is probably four to six of them. So they are very small from the measure of owners. As far as revenue, they are probably, I am going to say, $25 million or less.

Ms. BERKLEY. Okay. So the comments that Secretary Geithner made would not——

Ms. THOMPSON. It is not typical of my firm.

Ms. BERKLEY. All right.

And, Mr. Marron, in your opinion, what percentage of pass-throughs are of the very large size that Secretary Geithner was referring to?

Mr. MARRON. It is a very small percentage of the population but a significant fraction of the economic activity.

Ms. BERKLEY. Please say that again.

Mr. MARRON. If you do it by counting the number of firms or the number of businesses, the number that are in that size range appears to be very small. But because they are large, they account for a fairly large fraction of the economic activity, whether it is assets or revenues or income that are accounted for by pass-throughs as a whole.

Ms. BERKLEY. All right. Thank you very much.

Chairman TIBERI. Thank you.

Dr. Boustany is recognized.

Mr. BOUSTANY. Thank you, Mr. Chairman.

Dr. Marron's testimony talked about partnership activity conducted through large partnerships and not small businesses, but aren't many of these large partnerships actually joint ventures whose partners happen to be corporations themselves? Dr. Carroll.

Mr. CARROLL. Yeah. There is a significant fraction of partnership income where—stated a different way, the owners of partnerships can be individuals or corporations, unlike, say, an S corporation where there is a restriction. Only individuals can own an S corporation. A sole proprietor, by definition, is an individual. But for partnerships, based on the statistics I have seen, roughly 50 percent of partnership income results from partnerships that have corporate owners. So you could think of two companies that engage in a partnership, a joint venture to do something, build a project, and then they distribute the income to the two corporate owners. So about half of the partnership activity seems to be owned by corporations.

Mr. BOUSTANY. So if we were to tax those entities, those large partnerships or joint ventures like C corps, then in effect we are subjecting them to triple taxation; is that correct?

Mr. CARROLL. Yeah. If you did that, there is a long tradition of having flow-through treatment of partnerships for that very reason that, you know, if they are owned by the other businesses, just as if a C corporation owned another C corporation, then you wouldn't want to kind of have multiple layers of tax in the same activity. There is usually a dividends-received deduction associated with income that flows from one part of a complex business unit to another.

Mr. BOUSTANY. So, in effect, a joint venture is being taxed, the corporate partners are being taxed, and then the shareholders of

the corporate partners would be taxed. So, in effect, really triple taxation.

Mr. CARROLL. Right, that was the change.

Mr. BOUSTANY. Thank you. I yield back, Mr. Chairman.

Chairman TIBERI. Thank you, Dr. Boustany.

Thank you all, all the witnesses who are here today; and members are advised that members may submit written questions to our witnesses. Those questions and the witnesses' answers will be made part of the record of today's hearing.

Again, thank you to the four of you for appearing today. It has been an educational discussion, and I hope just the beginning, and it is hopefully helpful in moving the conversation forward on comprehensive tax reform.

This hearing is adjourned.

[Whereupon, at 10:42 a.m., the subcommittee was adjourned.]

[Submissions for the Record follow:]

Statement before the

Committee on Ways and Means

Subcommittee on Select Revenue Measures

United States House of Representatives

Hearing on Small Business and Tax Reform

Alvin S. Brown, Esq., Tax Attorney[1], Specializing in IRS Controversies

Chairman Tiberi, Ranking Member Neal, and distinguished members of the Subcommittee on Select Revenue Measures, thank you for the opportunity to provide comment on the special burdens that the tax code imposes on small businesses and pass-through entities. I represent individuals and small businesses, including pass-through entities, with tax issues pending before the IRS and, for that reason; I have unique first-hand knowledge of the tax issues and problems relating to "unnecessary burdens" imposed by the IRS on pass-through entities and their equity owners.

The reference by the Committee to the term "special burdens" on pass-through is an understatement because many of the burdens imposed by the IRS represent misconduct. The term "misconduct" is a term I deem appropriate in circumstances where a tax code, tax regulations or Internal Revenue Manual is clear and the IRS actions are inconsistent with the clear statement of the law or the intent of Congress in connection with law, regulations and administrative guidelines.

IRS Levy Misconduct

Individual and business taxpayers, at times, fall behind in paying their tax liability. When that happens, the IRS appropriately can take enforced collection actions to collect an unpaid tax debt. However, there is clear law that the IRS shall not levy if the levy will create an economic hardship (§ 6343(a)(2)(D)[2]). This tax code provision has an interpretative tax regulation that defines "economic hardship" as a levy that denies the taxpayer the funds needed for food, housing transportation, medicine, health insurance, child care, court ordered payments, and other reasonable and necessary living expenses (Treasury Reg.§ 301.6343-1(b)(4)). There is repetitive IRS misconduct of its power to levy as indicated by the following:

- The IRS **will levy the gross income of small business taxpayers** (including pass-through entities) even if that income is needed to pay necessary business expenses such as payroll, income tax payroll taxes and other necessary business expenses. These levies

[1] The opinions expressed are my own, based on my experiences representing clients before the IRS. Alvin Brown & Associates, LLC is a tax law firm representing clients throughout the U.S. and abroad. Web page: www.irstaxattorney.com E-Mail: ab@irstaxattorney.com.

[2] § 6342(a)(2)(D) states that the IRS ***shall release*** *the levy* if the IRS *has determined that such levy is creating an* ***economic hardship*** *due to the financial condition of the taxpayer.*

are continuous levies. No business can survive if its gross income is subject to a continuous levy. Gross income levies on a business cause its failure and the subsequent job losses for its employees. It is misconduct where the business is otherwise viable.

Who are the losers with this IRS abuse of a clear and unambiguous tax statute? Treasury loses the tax revenue from the closed business and the tax revenue from its jobless employees. The former employees seek unemployment benefits, and there is an additional burden on the social service networks. Simply put, businesses cannot survive if their gross income is subject to a continuous levy. These gross income levies do more than create an economic hardship on a business, these levies destroy the business. Employees without income cannot make rent or mortgage payments resulting in additional home foreclosures. The local economy is also a loser. This is a systemic problem, not an isolated case. The IRS routinely uses it power to levy on the business gross income of Taxpayers even in circumstances where the Taxpayer has the ability to fully pay its tax liability. I see this willful misapplication of 6343(a)(2)(D) repeatedly in cases where the business is viable and there is also excess income available to make payments on the outstanding tax debt in installments. It is one of the clearest cases of IRS "misconduct." The tax policy of Congress and the Administrated is united in the policy of growing businesses and growing jobs. Unfortunately, the IRS does not follow that tax policy or take that policy into account. These decisions to levy gross income are made by low level Revenue Officers who are not independently trained on the economic viability of a business. Mangers routinely sign-off on these business-destroying continuous levies that are, in my opinion, clear cases of documentable "misconduct."

- The IRS will also levy a taxpayer's business bank account and retain funds earmarked in that account to pay income tax, payroll tax liabilities, necessary business expenses and employee salaries. Without those funds, taxpayers get behind in their payroll tax and income tax debt. The bank account levy is a slower death for a business. Although the bank account levy is not a continuous levy, IRS Revenue Officers will often repeat bank account levies. Taxpayers have the opportunity to request a refund of the funds necessary to continue their business operations. The problem here is that the refund procedure, even when favorable, is not immediate and it remains difficult for these taxpayers to continue their business operations. This is another case of IRS misconduct (violation of § 6343(a)(2)(D) prohibition of a levy that causes economic hardship) because these bank account levies take funds essential to sustain the ongoing business operations. There are alternatives to enforced collection. A business bank account levy should only take place in circumstances when the business has no potential to repay any of its tax debt. Congress has made it clear to the IRS that collecting some revenue in a part-pay Installment Agreement (one that will not fully pay the tax debt within the 10-year statute of limitation for collections on a tax debt)[3] is preferable to having no viable collection at all. Part-payment Installment Agreements represent extremely strong Congressional guidance to get some money paid in by delinquent Taxpayers. Some tax debt repayment is better than closing the business with the resulting domino effect of lost jobs and lost Treasury revenue. The failure of the IRS to follow the economic hardship prohibition and the clear guidance of Congress is another instance of IRS misconduct.

[3] § 6159(d).

- The individual owners of the pass-through businesses end up with the tax debt. Even where there is no business levy, the IRS will violate the tax code limitation on "economic hardship" by levying funds needed for housing, transportation, health insurance and other reasonable and necessary living expenses. Here again, there is repeated IRS misconduct (violation of 6343(a)(2)(D) prohibition of a levy that causes "economic hardship") .

- The National Taxpayer Advocate and the IRS have taken the position that a business cannot have an economic hardship[4] within the meaning of section 6343(a)(2)(D)[5]. The IRS and NTA positions are each wrong (hence "misconduct") because § 6343(a)(2)(D) and Reg.§ 301.6343-1(a) do not distinguish between individual and business "economic hardship." A plain reading of § 6343(a)(2)(D) states that the IRS shall not levy in any manner that creates an economic hardship. The IRS and the NTA cannot deny the reality in our present economy, or at any other time, that businesses can suffer an economic hardship. The incredulous position of the IRS that a business cannot suffer an economic hardship from a tax levy is contrary to the reality of business failures caused by levies of either assets or gross income that destroys the business and the jobs of the employees who worked in that business. It even fails common sense for the NTA and the IRS to take a position that a business cannot suffer an economic hardship. Since that error is discernable from the plain language of § 6343(a)(2)(D), it meets my definition of misconduct.

- IRS wage levies do not include specific instructions as the allowable amount of income that may be paid due to the garnishment. This leads to garnishments that create an economic hardship for the taxpayer. I also view this as misconduct because § 6343(a)(2)(D) uses mandatory language prohibiting levies that create an economic hardship on the employee taxpayer. For this reason, employers invariably over pay the IRS income needed by the taxpayer for reasonable and necessary living expenses. This is a practice well know to the NTA who has never advised Congress of this abusive IRS willful nonfeasance. For that reason, employers think all of the employee's wages must be handed over to the IRS. Each request for levy of wages is accompanied by Publication 1494[6] which identifies the amounts excluded from levy under § 6334[7]. The statutory exclusions from income under § 6334 are quite limited and are essentially summarized in the chart within Publication 1494. For example, in the case of a single person, the amount required to be paid to the Taxpayer is $791.67 per month, <u>an amount below the poverty level.</u> Publication 1494 does not test for economic hardship contrary to the explicit intent of Congress as expressed in the economic hardship prohibitions

[4] The regulations under § 301.6343-1 are incomplete in that they have not been promulgated for businesses. However, the statue is unqualified and applies to both individuals and businesses under the clear unqualified language of § 6343. The IRM of the NTA does not discuss this issue, but it only addresses "individual" economic hardship. See IRM 13.1.

[5] TD 9007 that published the final OIC regulations on July 23, 2002. TD 9997 states that the economic hardship standard of § 301.6343-1 if the regulations "specifically applies only to individuals."

[6] Publication 1494 (2011)

[7] These are statutory exclusions that include wearing apparel, school books, workmen's compensation and other items specified in this statute.

expressed under § 6343(a)(2)(D). The employers are given no instructions to pay the employee all of the earned income needed for the employee's reasonable and necessary living expenses. This trickery is coupled with IRS nonfeasance for its failure to instruct employers that they must not pay all of the remaining income to the IRS. This is a systemic IRS practice and for that reason I view it as systemic misconduct.

- Tax code § 7811 authorizes the National Taxpayer Advocate (NTA) to issue a "Taxpayer Assistance Order" (TAO) if the NTA *determines the taxpayer is suffering or about to suffer a* ***significant hardship*** as the result of the manner in which the IRS is administering the tax law. A TAO[8] would require that the IRS not levy or file a tax lien if those actions would create a "significant hardship." The definition of a "significant hardship" means a serious privation[9]. For all practical purposes, the NTA has ignored this statute. In the NTA 2010 annual report to Congress, the NTA received nearly 300,000 requests for assistance and issues a TAO is less than ½ of 1% of the requests for TAO assistance. To underscore the lack of importance of TAOs to the NTA, the numbers of TAOs issued were listed in a single footnote to a 600 page 2010 report to Congress. The unused TAOs would, if used, order the IRS revenue officers and their manager to refrain from the kind of IRS levy misconduct I have identified above. Congress would not authorize the NTA to use TAOs under § 7811 unless they were also concerned with the lack of taxpayer assistance. Congress did not pass § 7811 with the intent that it not be used to stop IRS abuses of power, abuses of discretion and clear misconduct of the kind that I have identified. Accordingly, the clear failure of the NTA to use that authority is a serious administrative failure of that office and it meets my definition of misconduct[10].

- Since the NTA has a clear record of substantial noncompliance with § 7811, the NTA has also proven the point that the 2,000 employees under the NTA are neither needed nor necessary. If administrative cuts are necessary at the IRS for budgetary reasons, the first place to start is with is the office of the NTA and all of the employees under that office. The NTA operates mostly as an ombudsman to provide helpful liaison services. Indeed, those liaison services are helpful, but those services are inconsistent with the overriding mandate of Congress to issue TAOs in hardship situations. The NTA does not need a staff of 2,000 to write 600 page reports that few read.

- Revenue officers, other collection personnel, including the IRS service centers, will sometimes use their authority to reduce a levy or even release a levy in the event that the levy is creating an economic hardship. Some levy relief is possible from these sources. Most often the service centers request up to 30 days to consider a request for levy relief even when the levy is creating a current economic hardship.

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[8] The application for a Taxpayer Assistance order is made on Form 911.

[9] Reg. § 301.7811-1(a)(4).

[10] This is another case of nonfeasance. This nonfeasance is very serious because the TAOs would be effective to stop IRS levy, tax lien, and other abuses and/or misconduct that have injured taxpayers and businesses every since that authority was established in 1998.

- Installment Agreements[11] are options in all cases to prevent a levy and to stop a levy. However, financial statements are required before the IRS will consider an Installment Agreement and those financial statements.[12] Those financial forms require attached documentation and the process is too cumbersome and time consuming stop a business-destructive IRS levies to complete the required forms before the Taxpayer's business suffers irreparable harm. This is a problem that could be alleviated by a TAO (as intended by Congress under § 7811), but that assistance is never available. The other problem with Installment Agreements is that they are subject to the discretion of an IRS Revenue Officer. Under the Internal Revenue Manual, a Taxpayer will not qualify for installment payments unless all funds used for "unsecured debt" are paid over to the IRS as the mandated installment payment. Businesses have to make payments on unsecured loans and other unsecured debt (e.g., inventory or back rent) to stay afloat. Even though there is strong tax policy for the IRS to encourage full payment of a tax debt, the IRS creates difficult guidelines and administrative barriers before they will accept an Installment Agreement. The IRS is not tuned into the reality that businesses will fail and jobs will be lost under the existing inflexible, bureaucratic and cumbersome qualifying procedures before an Installment Agreement is approved. There is a streamline Installment Agreement procedure for taxpayers with tax liabilities of $25,000 or less that does not require a financial statement. That $25,000 limitation is far too low and ineffective for the pass through entities under consideration in this Hearing. There is no downside to raising that threshold because the Installment Agreement will be terminated automatically if the installment payments are not made. It is my opinion that the IRS has been misapplying § 6159 and, hence, meets my definition of "misconduct." The statute requires the IRS to make a determination that the Installment Agreement ***will facilitate full or partial collection* of the tax debt.** The IRS needs to be reminded that their administration of delinquent Taxpayers is to collect revenue in installments in those cases where full payment is not possible.

IRS Tax Lien Misconduct

The IRS uses tax liens for enforced collection of a tax debt even if the tax lien serves no economic purpose for many pass-through entities. A tax lien, when filed in the public records, gives the IRS priority status over property and not income. In the case of a service business (insurance agency, stock or mortgage brokerage firm, CPA firm, etc.), the assets are nominal and the lien serves no economic purpose for the IRS. Other pass-through businesses have no asset equity value that is more than nominal. In these situations, the tax lien will destroy the credit of the business, it will go on the credit report of the Taxpayer and remain there for 7 years after the debt is discharged. The net effect of a tax lien is that it makes it difficult for the business to grow. In many cases, the business is forced to close with a tax lien on their credit report.

The IRS has the plenary power to file a "Notice of Federal Tax Lien" (NFTL) tax lien in the public records on a taxpayer if there is any tax liability[13]. The IRS Internal Revenue Manual requires the filing of a tax lien for tax assessment balances of $5,000 or more and states that the

[11] § 6159 Installment Agreements are discretionary.
[12] Form 433A or Form 433F for individuals and Form 433B for businesses
[13] Section 6321

tax lien should be filed even if the tax balance is less than $5,000 if the filing of the tax lien will promote payment compliance[14]. The tax lien will not be released until the tax debt is paid or otherwise discharged. The NFTL has severe negative economic consequences on individual and business taxpayers often initially and long after any tax obligation is resolved.

The IRS files a NFTL in the public records. Most businesses cannot function profitably if they cannot get credit. When requests are made for credit, lenders always check the most recent credit scores. I have seen lenders immediately withdraw funds from an account and I have seen other businesses denied loans. Customers also do credit checks on suppliers and then shop for a different supplier since they feel the lien makes the business a greater risk. It is very difficult for any business to remain a viable business after their credit reports reflect IRS tax liens. When the businesses close, jobs are lost, and taxable revenue is lost.

All of the U.S. credit agencies record tax liens in their credit reports, and that tax lien remains in place under the tax debt is discharged. At the present time, credit reports are instantly available and they are commonly referenced for most commercial and employment practices. Even if the IRS tax lien has a short life, the credit agencies will still keep that tax lien in their credit reports for seven years after the IRS releases its tax lien. For this reason IRS tax liens are a long term economic disaster for individual and business taxpayers.

It is not unusual for a business to have a tax debt at the end of its tax year that it cannot fully pay at the time the tax return is filed. The failure to full pay a tax debt by any individual or business is common. Yet the IRS will file a credit-destructive and business-destructive tax lien even if the taxpayer agrees to fully pay the outstanding tax liability with interest and penalties in an Installment Agreement, documenting the financial ability to fully pay that tax liability. The results of a tax lien include loss of credit, business failures, job losses, and a loss of tax revenue from the income. The federal loss is exasperated because those who lose jobs must survive on federal and local assistance provisions for the unemployed. In this chain reaction of events, creditors of the business reduce profit with even a greater loss of tax revenue collected by Treasury. Consequently, the capricious and mechanical filing of tax liens under current IRS administrative practices cause irreparable economic harm, especially in situations where the business taxpayers have the ability to make payments on their tax debt.

In the case of individual taxpayers who have received IRS tax liens, the loss of credit impacts negatively on their ability to get employment and housing. Employers and landlords commonly take into account IRS tax liens identified in credit reports. This credit impairment means that the individual taxpayer will less likely to buy a car, a home and other items that stimulate economic activity and grow taxable business income. The counterproductive policy of the IRS for filing tax liens is one haplessly ignored by the IRS and Treasury.

Obviously, there are reasons that justify a tax lien filed in the public records. A tax lien gives the IRS a secured priority interest against other unsecured creditors. That priority is meaningless if there are no significant assets subject to seizure and sale. As a general rule, the IRS seizures are limited to real estate that with equity in excess of 20% of the fair market. Absent that equity interest, there are zero reasons that your justify a tax lien that will destroy the credit of the

[14] IRM 5.12.2.4.1 (10-30-2009).

Taxpayer and serve no other purpose but to harm the ability of the taxpayer to grow income and jobs.

There are taxpayers and businesses with no serious assets. Some of these businesses are service businesses, yet the IRS will still file a tax lien even in these cases where there are no assets to give the IRS a secured creditor preference. In these circumstances, the tax lien only serves the purpose of destroying the credit of the business and the individual taxpayers. Tax liens filed in these circumstances are frivolous, punitive and imprudent. In some cases, the filing of a tax lien, when it will obviously cause irreparable harm, is malicious. It is my personal opinion that the IRS use of tax liens without regard to its usefulness is counterproductive and not what Congress intended when it enacted § 6321.

The IRS recently published IR-2011.20 on February 24, 2011 to be a bit more liberal in its use of tax liens. This information release states that *The IRS will significantly increase the dollar thresholds when liens are generally filed. The new dollar amount is in keeping with inflationary charges since the number was last revised. Currently, liens are automatically filed at certain dollar levels for people with past-due balances.* It is my personal opinion that the policy of the IRS to file mandatory tax liens is a **legislative function,** and therefore misconduct. Congress did not draft a mandatory tax lien statute. The language drafted by Congress under **§** 6321 creates an unperfected lien, and not one that requires that the tax lien be perfected by a filing of the tax lien in the public records. The statute does not require the IRS to file the notice of lien in the public records. When the IRS created a mandatory filing of tax liens in the public records in its Manual, it converted a discretionary power to a mandatory rule that is in conflict with the intent of Congress. If Congress wanted to write a mandatory lien statute, requiring that unperfected tax liens be fired in the public records, that would be an easy addition to § 6321. The IRS mandatory tax lien policy is direct conflict with the intent of Congress under § 6321 to make the public-record filing of tax liens discretionary. The obvious legislative purpose of a tax lien is to facilitate the collection of assets from a delinquent tax payer. In the case of a consulting or other service business with no significant assets relative to the tax debt, the tax lien will destroy credit, destroy businesses, result in job losses and, overall, reduce the collection of tax revenue. I have no problem quantifying that IRS conduct as an abuse of power, a form of misconduct, because the IRS is transmuting a discretionary tax lien statute into a mandatory tax lien statue. As noted in IR-2011-20, the IRS will always file a tax lien in all cases where the tax debt reaches a yet unannounced threshold.

Call for IRS Abuse Hearings

If Congress and the IRS expect Taxpayers to follow the tax code, then the IRS must certainly follow the tax code. I have noted instance where the IRS, including the NTA, are not following some very important sections of the tax code. All of my comments made in this statement can be documented with actual individual and business clients. Every statement can be supported by witnesses injured by irresponsible and punitive tax levies and tax liens. I have not covered other abuses and misconduct that I have witnessed in civil and criminal examination. Frankly, there is no Congressional oversight on how the IRS administers the tax law. Congress assumes that the NTA and the Treasury Inspector General for Tax Administration (TIGTA) provide that oversight. That assumption is incorrect. As noted above, the NTA has substantively rejected its

authority to issue TAOs. Further, the employees of the NTA and TIGTA are not attorneys; they are substantially untrained on tax law issues. The managers know even less because their training is managerial and report writing. There are also problems with the present administrative structure of the IRS because it nearly impossible to find a higher level manager who can intervene on a technical issues. The IRS has a cadre of "technical advisors" who are invisible and unnamed for Taxpayers and their representatives. My general sense of the IRS at this time is that it is in dire need of restructuring because it has too many levels of bureaucratic managers who make no contributions to substantive decisions of those in direct contact with Taxpayers and their businesses. The Office of the IRS Chief Counsel has always been and remains a competent professional office, but few decisions reach that level of competence and they are understaffed too to get more directly involved with the front line decisions being made by those in direct contract with taxpayers.

The current tax hearings are intended to support tax reform or tax simplification. That objective is better served by identifying the problems taxpayers have in dealing with the IRS. I have identified just of few of those problems in this Statement. To the extent that we will have improved tax law in the 112th Congress, that result should fix the problems identified by Taxpayers who are called as witnesses to testify about their IRS experiences. Congress cannot fix those problems without identifying those problems.

What is necessary in all of the administrative agencies of the U.S. government is transparency. Due to privacy law, the IRS is especially non-transparent. That lack of transparency can be reversed if Taxpayers are provided a platform to voluntarily upload their experiences with the IRS on a web page, organized by issue. That data, subject to unlimited accumulation, if organized by issue would create a valuable data base available to Congress and to the public. This very simple internet platform will create the missing transparency that could identify IRS abuses and misconduct in its infancy. Consider www.irsforum.org as a vehicle available to the public and Member constituents. The IRS Forum has been recognized as a non-profit educational organization. In effect the IRS Forum web page can provide *de facto* IRS transparency to the extent that it becomes well known to the public and to the constituents of Members of Congress. Any transparency with a taxpayer documented data base would reveal the kind of IRS abuses I have discussed in this Statement.

Respectfully submitted,

Alvin S. Brown, Esq.

March 17, 2011

The Honorable Patrick J. Tiberi
Chairman
Subcommittee on Select Revenue Measures
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

The Honorable Richard E. Neal
Ranking Member
Subcommittee on Select Revenue Measures
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

Dear Representatives Tiberi and Neal:

As the trade association representing private equity firms that invest in domestic small businesses, we thank you for holding this subcommittee hearing on "The Tax Burden Placed on Small Businesses and Pass-Through Entities." Pass-through entities, such as general, limited, and limited liability partnerships, have always been critical to the formation of capital that investment funds use to make investments in our nation's job-creating small businesses. As tax reform is being contemplated, we would strongly encourage you to consider impacts on small business investing. Small business investors are themselves small businesses structured as pass-through entities.

Pass-through entities were originally created to provide investors with the ability to avoid double taxation on their investments. Pass-through structures allow capital to be pooled with positive returns being taxed only once at the rate of the original business owner, investor, or investment fund. Pass-through entities are not a way for investors to avoid paying taxes; rather, they protect capital providers from being unfairly double-taxed. Tax reform that hinders the pooling of capital for investment would greatly diminish small business investing. The giants of American industry started off as small businesses. A properly reformed tax code will ensure that some of our current small businesses will be major employers tomorrow.

There are too many issues dealing with pass-through entities and small business investing to list in one letter, but an initial sampling of issues that do or could affect small business investing is attached below.

Carried Interest and Small Business Investing

A proposal in President Obama's Fiscal Year 2012 Budget would change the tax treatment of carried interest that flows through pass-through entities from being treated as capital gains to being treated as ordinary income. This tax-treatment change would be particularly harmful for small business investing, and its unintended consequences would be far-reaching.

Because smaller funds survive on performance-based compensation, not administrative fees, dramatically raising the tax rate on carried interest will cease to make economic sense. The only way for a small fund to survive will be to become a very large fund that can survive on fees – fees which are completely disconnected from performance. While large funds play an important role in the market, they generally do not invest in small businesses because it is simply impractical for them to do so. It is far easier for a large fund to make ten $200 million investments in larger companies than to make 400 investments of $5 million in smaller businesses. It is for this reason that small investments are nearly impossible for very large funds. Further, small business investments are not quick flip transactions, but longer term investments. Increasing taxes on these pass-through entities that are small business investors will cut off investment in small businesses.

Capital Gains Exclusion on the Sale of Qualifying Small Business Stock

The recent passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided for a 100 percent exclusion of the gain from the sale of qualifying small business stock that is acquired before January 1, 2012 and held for more than five years. While this provision is likely to stimulate some investment in small businesses, it is unfortunate that small businesses structured as pass-through entities do not qualify. Including Limited Liability Corporations (LLCs) in this capital gains exclusion would increase capital investment to a broader range of small businesses.

Business Development Companies

A business development company (BDC) is a type of closed-end investment company that elects to be regulated under a specialized regime added to the Investment Company Act of 1940 by the Small Business Investment Incentive Act of 1980. BDCs play an important role in the economy by investing in private or thinly-traded public companies in the form of long-term debt or equity capital, thus, BDCs serve as an important source of capital for small and mid-cap, start-up and pre-IPO companies.

Like typical closed-end funds and ordinary mutual funds, BDCs are eligible to elect to be taxed as regulated investment companies (RICs) under subchapter M of the Internal Revenue Code of 1986. A RIC is a type of pass-through entity similar to a partnership. But unlike a partnership, which is not subject to federal income tax, a RIC is generally subject to federal income tax, but is entitled to claim a deduction for dividends paid to its shareholders. To be eligible to elect RIC status, a BDC must satisfy, among other things, certain source-of-income and asset diversification requirements. The source-of-income requirement requires a BDC to earn at least 90% of its gross income for each year from income that constitutes "good RIC income." This means at least 50% of the value of a BDC's total assets must consist of cash, cash equivalents, U.S. government securities, securities of other regulated investment companies, and other acceptable securities that are issued by issuers that represent no more than 5% of its total assets and in respect of which, it holds no more than 10% of the total voting power; and no more than 25% of the value of the BDC's total assets can be invested in the securities of any one issuer. If a BDC fails to comply with these requirements, it would be subject to tax as an ordinary corporation and would not be entitled to a deduction for any dividends paid to stockholders.

A typical closed-end fund or mutual fund invests in public securities generally has no trouble satisfying these requirements. However, because BDCs invest in small private or thinly traded companies, they often encounter problems complying with, or are limited with regard to their investment alternatives in order to comply with, these requirements.

1. Many small businesses today are organized as partnerships or LLCs that are treated as partnership for tax purposes. If a BDC acquires an equity interest in a partnership or LLC, which is exactly the type of investment BDCs were created to make, the income from such investment during the ownership phase likely will not qualify as "good RIC income" for purposes of the source-of-income test. Whether any gain is recognized on the disposition of such an investment is uncertain. In addition, there is a risk that the BDC would be required to look through such investment for purposes of applying the asset diversification tests. Congress should amend or provide rules that make it easier for BDCs to acquire equity interests in partnerships and LLC without jeopardizing their RIC status.

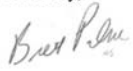
2. Because typical closed-end funds and mutual funds generally acquire securities in publicly traded entities not organized as partnership or LLCs, any such amendments or provisions could be narrowly focused on and limited to BDCs. To comply with the RIC diversification tests, BDCs are currently limited in their ability to hold more than 10% of the voting interests in portfolio companies. While this restriction provides almost no practical limitation for typical closed-end funds or mutual funds that invest in publicly traded securities, BDCs are often the primary outside investor the small private and thinly traded companies in which they are required to invest and are required by statute to offer managerial assistance to such entities. As a result, limiting the voting rights of BDCs unduly limits their ability to participate in the management of portfolio companies consistent with their ownership interests and requires the creation of new classes of stock or securities to comply with these requirements, which adds additional costs and complexity to the investments.

3. Because the investments held by BDCs are private or thinly traded, to provide greater certainty to BDCs in determining their qualification for RIC status Congress should amend the diversification requirements to allow BDCs to use the basis of their investments rather than the values for testing purposes.

4. Finally, BDC efforts to comply with "good RIC income" requirements (mentioned in 1. above), such as creation of blocker subsidiary corporations, run into direct conflict with SBA rules in cases where BDCs also operate Small Business Investment Companies. In this regard, SBA rules prohibit the setting up of blocker subs (considered "passive" investments). If the BDC rules aren't changed to permit direct equity investing in partnerships and LLCs, then tax and SBA rules should be changed to permit BDC-SBICs to invest equity through blocker subs.

We thank you for the opportunity to provide you with recommendations we feel are vital to ensuring the continued ability of pass-through entities to formulate capital to provide to our nation's job-creating small businesses.

Sincerely,



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SBLC STATEMENT FOR THE RECORD
TAX REFORM AND SMALL BUSINESS
Hearing
The Subcommittee on Select Revenue Measures
Committee on Ways and Means
United State House of Representatives
March 3, 2011

As Congress and the Administration contemplate tax reform, we believe it is important to fully understand the ramifications for small business. Let us make no mistake about it: While small business has complained as much as anyone about "life" under the current tax code, small business has also been a significant beneficiary.

We have always held to the premise that the tax code can be a powerful economic policy tool. Indeed, from a graduated corporate rate structure to direct expensing to the mortgage deduction and countless other provisions, small business has benefited from the bias built into the code. We make no apologies for that reality. We are absolutely certain the economy and the nation are better off for it.

Small businesses depend on their retained earnings. The history of our small business economy demonstrates that small businesses are not able to routinely raise capital or secure funds from alternative sources, as big businesses can. Small business requires patient capital, and even then, the financial return on investment can be modest. Yet, in terms of job creation, innovation and economic diversity, the return on the investment by us, as taxpayers, is well worth it. That is why we believe the current code allows small business to be taxed less and retain earnings, and includes economic incentives to encourage investment in small businesses.

We expressed similar concerns during the debate regarding the Tax Reform Act of 1986. Under the guise of lowering and flattening the rates, some incentives and beneficial provisions were washed out of the code. In today's terminology, these are often referred to as "tax expenditures." Based on our 1986 experience, we are particularly leery of the trade-offs involved in lowering the corporate rate by broadening the base. How many of the deductions and credits that are "candidates" for elimination are used by small businesses doing business as sole proprietorships, partnerships and S Corporations? We are all familiar with the adage, "Be careful of what you wish for, you might get it." It is tempting to overlook the value of the current code to small business and the inherent flaws of the proposed alternatives, when faced with the massive evidence of complexity and flaws in the current system and the allure of simplicity, but we must tread carefully.

We have identified two general problem themes regarding the current system: the overall complexity of the code and the problems of a blended business/personal tax system. Admittedly, some of the provisions of the code most beneficial to small business are ones that contribute to those problems--hence our dilemma.

By a blended system, we mean that the code allows for the taxation of wages and business income under one structure for wager earners, sole proprietors, partners, and S corporation

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shareholders. We point to the debacle of the 1993 increase in the personal rate structure as an example of the problems that resulted from this design feature. By increasing the tax on the wealthy, we increased the tax on the incomes of operating S corporations. It pulled small business into a debate it did not need to be in, and the end result had an unintended but negative impact on the retained earnings of small businesses.

Therefore, it would seem that any alternative to the current system should "wall-off" the taxation of personal income from operating business income. This, unfortunately, leads us down the road of double taxation of business income, a policy the code currently imposes on C Corporations and their shareholders. This, in turn, will lead to the hypothetical question, "We can eliminate some of the complexity of the code, but the price will be the elimination of the single taxation status so many small businesses enjoy. Can small business survive the trade-off?" The benefits of a lower graduated corporate rate would have to be quite extraordinary to make the migration to C Corporation status worthwhile. Otherwise, it is a "lose-lose" situation for small businesses; their tax liability goes up either way to pay for big business' tax relief, whether they remain a "pass-through" entity or convert to C Corporation status.

As to the code's overall complexity, this is a result of many factors, not the least of which is that the code has just been around too long and is a 1950's car (notwithstanding the Tax Reform Act of 1986) in a 2000's race. Again, the question is how do you retain the bias of the old system for small business, if you change to a different system?

A major contributor to complexity have been the frequent changes made to the tax code in the 1980's, 1990's and 2000's under a "revenue neutral" policy that has undermined tax policy development during this period. We operated, and for the most part still do, on the "morsels and crumbs" theory of tax policy. Instead of making tax policy because it is the right thing to do, we are forced to ensure all actions are revenue neutral, and therefore we never fix anything straight out--we "do a little of this, and a little of that." Look no further than the saga of estate tax relief as exhibit one. What a mess! This is not to suggest we should not be mindful of deficit ramifications, but perhaps, make fewer changes and do them right.

A fundamental question that must be answered before undertaking any analysis of a tax system change is, "What is your effective rate of taxation?" There is a huge difference between the marginal rate that may appear on a tax liability schedule and the rate of taxation a small business pays after all deductions and credits are taken.

We look forward to the opportunity to participate in the dialogue to make certain we fully understand the ramifications of tax reform for small business. Thank you.

The Small Business Legislative Council is a permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views.

Statement Submitted

By

The National Association of Home Builders

Committee on Ways and Means

Subcommittee on Select Revenue Measures

Hearing on Small Businesses and Tax Reform

March 3, 2011

Introduction

The National Association of Home Builders is a Washington-based trade association representing more than 160,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting, design, housing finance, building product manufacturing and other aspects of residential and light commercial construction. NAHB is affiliated with 800 state and local home builders associations around the country. NAHB's builder members will construct about 80 percent of the new housing units this year.

Small businesses and pass-thru entities, such as S Corporations and Limited Liability Corporations, play a critical role in the U.S. economy and are the dominant players for the U.S. home building and construction sectors. The home building industry has been hit hard by the impacts of the Great Recession, with the construction sector currently experiencing a 21% unemployment rate and more than one million jobs lost in the residential construction sector, which includes single-family and multifamily construction, land development and remodeling. In normal economic times, housing constitutes approximately 15% of Gross Domestic Product and is an important generator of jobs. Future tax policy should not harm an emerging recovery in this sector, and should recognize the important role of small businesses and pass-thrus in this industry.

Importance of Small Businesses for the Residential Construction Sector

Small businesses are the heart of the residential construction sector, which includes single family and multifamily construction, land development and home remodeling. NAHB Census of Membership data for 2009 reveals that 80% of businesses that belong to NAHB are organized as pass-thru entities or sole proprietorships. In particular, 47% of businesses are organized as S Corporations and 25% are LLCs.

Overall, approximately one-third of NAHB's membership is made up of dedicated builders. The remaining share of its membership consists of associate members who also work within the residential construction sector.

As measured by workers, 80% of NAHB builder members have less than ten employees, with the average member have approximately 11 employees. Only 1% of NAHB builder members have more than 100 employees. For NAHB's associate members, nearly 90% of such members have less than 50 employees.

Approximately 50% of NAHB builder members have less than $1 million in gross receipts, and 86% have less than $5 million in gross receipts. Approximately 80% of NAHB builder members built 10 or fewer homes in 2010. NAHB's associated members are very similar to its builder members with respect to dollar size of business, with 77% having less than $5 million in gross receipts.

Statistics of Income data from the Internal Revenue Service provide a similar story for the construction sector as a whole. Data for tax year 2007, the most recent available, indicate that there were 781,000 C Corporations in the construction business. On the other hand, there were approximately 570,000 S Corporations, 209,000 partnerships, and 2.9 million sole proprietorships. All of these non-C Corporation

taxpayers in the construction industry pay their business income taxes on the individual income tax forms. They also face certain restrictions and complications that C Corporations do not face, including but not limited to, certain passive actively loss restrictions and AMT issues due to the reporting business tax items.

Tax Policy Considerations

Given the large and important role played by small firms in the residential construction industry, it is critical that future tax policies do not harm these job creators. For example, NAHB analysis shows that the construction of an average single-family home creates three jobs, $90,000 in federal, state and local taxes, $145,000 in wage income, and $86,000 in business income. [1]

Some analysts have proposed doing away with certain business tax expenditures in exchange for corporate tax rate cuts. While reducing the tax burden on business will certainly help foster a more robust economic recovery, a subset of businesses should not face tax increases to accomplish this goal. If tax rules that currently are used by both corporate and non-corporate, pass-thru businesses are eliminated, and rates are reduced only for C Corporations, then pass-thru businesses will realize tax increases. Tax increases on small business will consequently result in jobs losses and lost spillover economic activity in areas of the country where small businesses play a larger role.

There are many examples of business tax rules that benefit both C Corporations and pass-thru entities, such as the Section 199 Domestic Production Activity deduction. For home builders, an important tax accounting mechanism is the Section 460(e) home construction contract rule. The tax code's long-term tax accounting rules require pre-payment of some expected tax revenue for contracts that spill over from one tax year to another. Home construction can last months or a year or more. Hence, the 460(e) rule allows home builders to pay taxes on homes once the home is sold, rather than during the construction period, which would require additional up-front financing. Elimination of this rule would negatively affect home builders of all sizes and increase the cost of housing for homebuyers.

Importance of Debt to Finance Small Business Expansion

Access to affordable credit is the lynchpin to the success of small business. In general, the tax code currently allows businesses to deduct interest as a necessary and ordinary business expense. This has the effect of lowering the cost of carrying debt, and for many small businesses, makes their operations financially practical. In many parts of the country, home builders have found they are completely cut off from access to credit. This is due, in part, to the difficult economic environment facing residential construction in many parts of the country, but also due to inflexible regulatory policies. As the housing market enters its recovery phase, without access to credit small builders and small product suppliers will find themselves at a disadvantage to larger, corporate entities who can turn Wall Street to finance their business activities.

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[1] The Direct Impact and Remodeling on the U.S. Economy. NAHB. 2007. (http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311)

Some tax reform proponents have suggested that the tax code carries a bias in favor of debt rather than equity, and this bias should be eliminated. NAHB urges the committee to consider that small businesses lack the access to equity capital that corporations often have. For small home builders and nearly any other small business, their sole source of financing may be limited to lending by community banks and other sources of debt. If Congress eliminates the present-law tax treatment for debt, small businesses will face significantly higher costs to raise capital, placing them at a distinct disadvantage to large, corporate entities.

Regulatory Flexibility Act—An Underutilized Tool

The Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Act (SBREFA), requires agencies, including the IRS, to consider the potential impact of regulations on small businesses and other small entities.[2] NAHB believes that the RFA, in certain circumstances, can be utilized more effectively by the IRS to minimize the burden imposed on small businesses. Unfortunately, the IRS, like many agencies, avoids the RFA requirements by issuing guidance. Issuing guidance—rather than a notice-and-comment rulemaking—avoids any serious analysis or consideration of the impact that the new reporting requirements will have on small businesses.

The IRS' avoidance of the RFA motivated Congress to amend the Act with SBREFA in the mid-nineties.[3] SBREFA expressly expanded the scope of the RFA to include interpretive rules involving the internal revenue laws, so long as they are published in the federal register and impose a collection of information requirement on small entities.[4] When issuing informal guidance, however, the IRS can do an end run around the RFA.

NAHB acknowledges that the IRS, when implementing tax provisions, often lacks the authority to exercise discretion and regulatory flexibility. However, the IRS has successfully worked through the RFA process in the past. For example, in 2006 the IRS partially withdrew regulations and submitted a revised regulatory flexibility analysis to proposed regulations that would change like-kind exchanges.[5] These changes occurred following a slew of adverse comments from stakeholders after the initial regulatory flexibility analysis was conducted. The impacts would never have been meaningfully considered if the IRS had merely issued guidance.

Of course, there are also circumstances where it is appropriate for the IRS to implement policy through informal guidance. Even in cases where the IRS lacks discretion, NAHB believes that Congress and the

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[2] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

[3] The Impact of Regulation on Small Business, Joint Hearing Before the S. Comm. On Small Business and the H. Comm. on Small Business, 104th Cong. 13 (1995) (statement of Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Bus. Admin.).

[4] The legislative history associated with SBREFA explains: "One of the primary purposes of the RFA is to reduce the compliance burdens whenever possible under the statute. To accomplish this purpose, the IRS should take an expansive approach in interpreting the phrase 'collection of information' when considering whether to conduct a regulatory flexibility analysis. " 142 Congr. Rec. S3242-02 (March 29, 1996) (Joint Managers' Statement of Legislative History and Congressional Intent).

[5] 71 FR 6231.

Administration would benefit from RFA analyses in order to effectively determine the impact of tax changes on small businesses. NAHB would encourage the committee to look further into this issue.

Conclusion

Putting the federal government on a sustainable fiscal path is critical, especially for an industry like home building that depends on debt finance for business and homebuyers. The federal government should strive to constrain the growth of government spending so that tax increases – particularly tax increases that disproportionately affect particular sectors of the economy – are not required. And policymakers should be certain to not increase tax on certain businesses, like small businesses organized as pass-thru entities, in order to achieve other policy goals.

Statement of the U.S. Chamber of Commerce

ON: **Hearing on Small Businesses and Tax Reform**

TO: **Subcommittee on Select Revenue Measures of the Committee on Ways and Means**

DATE: **March 3, 2011**

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 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 – is represented. 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 115 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. More than 1,000 business people participate in this process.

INTRODUCTION

The Chamber thanks Chairman Tiberi and Ranking Member Neal for the opportunity to comment on the impact of tax reform on small businesses. The Chamber believes that the Subcommittee should carefully consider both the importance of small businesses and the economic challenges they face as it evaluates possible changes to the federal tax code[1] that will foster growth, competitiveness, innovation, and job creation.

THE RELEVANCE OF PASS-THRU ENTITIES

Some proponents of tax reform recently have suggested that reform be limited to corporate taxes, without consideration of the impact on those businesses that operate in pass-thru form and, thus, remit tax under the individual code. The Chamber believes this ignores a substantial number of businesses and in particular threatens to harm small businesses that are more likely to operate in pass-thru form.

According to research by the nonpartisan Tax Foundation,[2] roughly one-third of all business taxes are paid by owners of pass-thru businesses – the sole proprietorships, LLCs, partnerships, and S corporations that are often small in size and entrepreneurial – who report the income of these enterprises on their individual tax returns. Further, data from the National Federal of Independent Businesses indicates that 75 percent of small businesses operate as pass-thru entities. These small businesses are a critical source of job creation and innovation, creating between 60 and 80 percent of net new jobs, and employing over half the labor force.[3]

The past 30 years has seen a significant increase in businesses that operate in these pass-thru forms. During that time, the number of pass-thru businesses, such as sole proprietorships, S-corporations, LLCs, and partnerships nearly tripled, from 10.9 million to 30 million.[4] The most numerous type of pass-thrus was sole proprietorships, growing from 8.9 million to more than 23 million. S-corporations and partnerships grew the fastest, from 1.9 million to more than 7 million. As a result, more business income is now taxed under the individual income tax code than the traditional corporate code.[5]

This data makes clear that tax reform that addresses only the corporate tax structure would neglect a significant portion of the business community. Thus, the Chamber believes Congress must carefully consider the impact of a corporate rate reduction on these pass-thru entities and small businesses.

RECENT REFORM IDEAS

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[1] All references to the "code" are to the Internal Revenue Code of 1986, as amended.
[2] See Tax Foundation, Fiscal Fact 182, The Economic Cost of High Tax Rates, available at http://www.taxfoundation.org/research/show/24935.html#_ftnref5.
[3] See Tax Foundation, Commentary: Small Business and the Personal Income Tax Rates, available at http://www.taxfoundation.org/commentary/show/23860.html.
[4] See Tax Foundation, News Release: Business Income to Shoulder over a Third of Tax Increase on Top Earners, available at http://www.taxfoundation.org/news/show/26702.html.
[5] See id.

Piecemeal Approach

Treasury Secretary Timothy F. Geithner, at a Senate Finance Committee hearing last month stated, "You can do corporate without doing individual at the same time."[6] What Secretary Geithner seems to suggest is that it is possible to reform the corporate tax code, presumably reducing certain business tax preferences to generate the revenue necessary to pay for a corporate rate reduction, while leaving individual reform or individual rate reductions for a later date.

The suggestion of undertaking corporate reform without regard for the impact of a corporate rate reduction on pass-thru entities is problematic. Preferably, the Chamber believes that Congress should pass comprehensive tax reform legislation; conversely, Congress should avoid undertaking tax reform on a piecemeal basis. Further, the Chamber believes that one specific sector, industry, or income group should not disproportionately bear the burden of paying for tax reform.

The Chamber is concerned that small businesses would disproportionately shoulder the cost of corporate tax reform if undertaken separately from individual tax reform. Under Secretary Geithner's approach, for example, pass-thru entities presumably would lose the benefit of business tax preferences, much like those entities operating in C corporation form, but would not receive the benefit of a tax rate reduction that those operating as C corporations would receive.

Modified Integration Approach

Earlier this month, Secretary Geithner posed another suggestion on how to approach reform; he suggested, at another Senate Finance Committee hearing, that Congress should consider "whether it makes sense … to allow certain businesses to choose whether they're treated as corporations for tax purposes or not."[7] Essentially, Secretary Geithner seemed to suggest that all entities should be taxed under the C corporation structure.

Again, the Chamber finds this approach to reform troubling. Generally, those electing treatment as a pass-thru entity do so for many reasons, both tax related and otherwise. Thus, forcing all companies to operate under the C corporation structure raises a multitude of concerns.

From a tax perspective, operating as a pass-thru entity avoids the double taxation that C corporations face – they are taxed at the corporate level on their profits and many of their shareholders pay tax again when those same earnings are distributed as dividends or when shareholders sell their stock and remit capital gains taxes; conversely, pass-thru entities pay no entity level tax and, instead, profits are reported on the individual returns of owners. This double taxation creates a bias in favor of debt financed investment rather than equity financed investment, a problem generally viewed as a serious weakness in our current tax code. Rather than fix this, the recent approach suggested by Secretary Geithner would put all businesses into this inefficient system of double taxation.

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[6] See Schatz, "Small-Business Status Complicates Tax Rewrite Talks," *Congressional Quarterly* (Feb. 16, 2011).
[7] See "Pass-Throughs Dominate Tax Reform Conversation," *Journal of Accountancy* (Mar. 4, 2011).

This proposal also fails to recognize that taxpayers choose to operate as pass-thru entities for a variety of non-tax reasons. Pass-thru entities provide flexibility that the C corporation structure does not allow. For example, partnerships can have one partner put in cash, another put in property, and another expertise. They can then set up their own agreement for how the profits will be divvyed up; a C corporation structure does not have that flexibility.

Simplicity is another non-tax reason taxpayers choose a pass-thru entity form. To form a partnership all that is needed is two people with a profit motive and an agreement. Conversely, with a C corporation a taxpayer has to file articles of incorporation, elect a board of directors, have regular shareholder and director meetings, etc. Further, pass-thru entities make it easier to plan for business succession and ease estate tax planning concerns.

Accordingly, because of the many tax and non-tax factors which influence a taxpayer's choice of entity, the Chamber has serious concerns about the plan suggested by Secretary Geithner that would force all businesses into a C corporation structure.

CONCLUSION

The Chamber thanks the Subcommittee for the opportunity to comment on the impact of tax reform on pass-thru entities and small businesses. The Chamber believes that as the Subcommittee considers fundamental tax reform, both the importance of and challenges facing these entities must be given the utmost consideration to ensure changes to the tax code allow these businesses the opportunity to grow, compete, and innovate. We look forward to working with the Subcommittee on this vital issue.