SMALL BUSINESS HEALTH INSURANCE TAX CREDIT

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

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

ONE HUNDRED TWELFTH CONGRESS

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C O N T E N T S

SMALL BUSINESS HEALTH INSURANCE TAX CREDIT

TUESDAY, NOVEMBER 15, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:33 a.m., in Room 1100, Longworth House Office Building, Hon. Charles Boustany [Chairman of the Subcommittee] presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
Tuesday, November 15, 2011
OS–8

CONTACT: (202) 225–1721

Chairman Boustany Announces a Hearing on Small Business Health Insurance Tax Credit

Congressman Charles W. Boustany, Jr., MD, (R–LA), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced the Subcommittee will hold a hearing on the Small Business Health Insurance Tax Credit created by the Patient Protection and Affordable Care Act. **The hearing will take place on Tuesday, November 15, 2011, in Room 1100 of the Longworth House Office Building, beginning at 10:30 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:

The Patient Protection and Affordable Care Act (Pub. L. No. 111–148) (PPACA) included a limited-time tax credit to encourage small businesses to provide health care coverage to employees. The Small Business Health Insurance Tax Credit (Small Business Tax Credit) is available to certain small businesses and covers some of the cost of employee health insurance.

The Small Business Tax Credit covers 35 percent of an eligible small employer's contribution to employee health insurance premiums for each tax year from 2010 to 2013. After 2013, the credit amount increases to 50 percent, but a taxpayer may only elect to take the credit for two consecutive tax years. The calculation to determine eligibility is a complex sliding scale involving employee hours of service and wages, along with certain exclusions.

As the costs of health insurance continue to rise, it remains unclear whether the Small Business Tax Credit is beneficial to a meaningful number of small businesses or whether the Internal Revenue Service (IRS) is administering the credit appropriately. Due to the complex calculations associated with the Small Business Tax Credit, government watchdogs have warned that it leaves room for calculation error and opens the door to potential tax fraud. A recent report by the Treasury Inspector General for Tax Administration found that only 228,000 taxpayers took advantage of the credit as of May 2011, despite earlier claims by the Administration that four million employers would be eligible. The Inspector General also found that the manner in which the IRS is administering the credit has created concerns over tax compliance.

In announcing the hearing, Chairman Boustany said, **"Much of the President's new health care law will be administered by the IRS, and this is the first credit provision to come into effect. With small businesses hurting from a stalled economy and rising health insurance premiums, the Oversight Subcommittee will explore whether the Small Business Tax Credit is providing meaningful help to employers or if it is opening the door to more improper payments."**

FOCUS OF THE HEARING:

The hearing will focus on whether small business employers are currently benefiting from the Small Business Tax Credit, problems they may be encountering when calculating the credit, and whether the IRS is administering it in a way that ensures tax compliance.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit 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 Tuesday, November 29, 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) 225–1721 or (202) 225–3625.

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 BOUSTANY. The Subcommittee will come to order. Good morning, and welcome to this morning's hearing on the implementation and effectiveness of the small business health insurance tax credit.

Small businesses are the backbone of our economy. They account for more than half of America's private gross domestic product, and employ about half of its private-sector workforce.

As our economy struggles to recover from the worst downturn since the Great Depression small businesses are bearing the brunt of the pain. Consumer demand is down, costs are rising, and too often Washington exacerbates the problem through new regulations, higher taxes, and burdensome red tape.

As a former small business owner running a small medical practice in Louisiana, I certainly know the challenges facing small businesses across this country. And so I take special interest in the subject of today's hearing, because I know small business owners need real help when it comes to the rising cost of health care.

The problem is worse today than ever before. The cost of premiums for family policies have gone up by an average of 9 percent in the past year, and I've heard complaints of premiums for small businesses going up by as much as 43 percent. A recent survey by the National Small Business Association found that 32 percent of small business owners have held off on hiring new employees, due to rising health care costs.

Today we're here to consider how the small business health insurance tax credit has been implemented, whether it is effective in reducing health care costs for employers. When it was enacted as part of the President's health care overhaul, supporters said the credit would provide access to affordable insurance, and help small employers insure their employees.

Two years later, we see that the results do not match up to the promises. Instead, it is a convoluted tax credit that temporarily subsidizes the cost of employee health insurance in a very small number of cases. Employers must undertake complicated calculations to determine whether they even qualify for the credit.

The instructions to the form are eight pages long and somewhat complex. And, in fact, we have a chart—and I don't know—we have a chart on the screen here. This chart shows the complex analysis an employer has to undertake before knowing whether they can claim the credit, or how much it's worth. If employers are able to navigate the calculations and confirm they are eligible, they must limit additional hiring and employee compensation in order to keep it, oftentimes.

Although the credit does not appear to be providing meaningful assistance to small business owners, it is still the IRS's job to implement it, and to do so in a way that protects taxpayer dollars from erroneous payments. So, we are here today to discuss two critical issues. Is the IRS administering the small business health insurance tax credit in a way that reduces the risk of erroneous payments and provides necessary information to taxpayers? And two, why is the credit then ineffective in helping many small employers reduce the cost of health insurance, or incentivizing employers not previously offering insurance to begin doing so?

These are important questions, and I look forward to today's discussion. And I want to thank both of our witnesses for joining us here this morning.

Before I yield to Ranking Member Lewis, I ask unanimous consent that all Members' written statements be included in the record.

[No response.]

Chairman BOUSTANY. And without objection, so ordered. Now I yield to the Ranking Member, Mr. Lewis.

Mr. LEWIS. Thank you, Mr. Chairman. Mr. Chairman, I want to thank you for holding this hearing on the small business health care tax credit. In these tough economic times, many Americans fear they are just one medical emergency away from losing their home, their businesses, or their savings. This tax credit is designed as a temporary measure to help small employers afford health insurance for their employees. It is the bridge to broader reforms that will help small businesses purchase affordable, high-quality health insurance in 2014.

To date, more than 300,000 small businesses have claimed and benefited from over $400 million in tax credits to help them provide health insurance to employees. Still, some question whether the credit is meaningful. Maybe I should repeat this. Still, some question whether the credit is meaningful.

It would be a mistake to draw conclusions from the early claim number currently available. Many small businesses request extensions and file their tax returns in September and October. Returns receive in October are still being processed. And, the agency does not expect to finish processing these returns until December of the end of this year. It is simply too early to tell how many businesses will claim the credit.

Finally, we must also remember that any serious discussion of the administration of tax credits must begin with fully funding the IRS.

Today's hearing provides a real-time example of how the $600 million in budget cuts proposed by the House Republicans may affect small businesses and employees. The Inspector General's report states that the agency needs about $24 million to administer this credit next year.

I want to thank the witnesses for being here today, and look forward to hearing from each of you. As we have successfully done in the past, I would like to work with the Inspector General to provide the agency with any additional authority it needs to administer this tax credit.

Mr. Chairman, again I want to thank you, sir.

Chairman BOUSTANY. I thank the Ranking Member for his opening statement. And now I want to welcome our first panel of witnesses.

We have Mr. Russell George, who is Treasury inspector general for tax administration, and Ms. Sarah Hall Ingram, who is commissioner of the tax exempt and government entities operating division of the Internal Revenue Service. I want to thank you both for being here today, and to provide your testimony. You will each have the customary 5 minutes to present your testimony with your full written statement submitted for the record.

And, Mr. George, we will begin with you.

STATEMENT OF HONORABLE J. RUSSELL GEORGE, INSPECTOR GENERAL, TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, WASHINGTON, DC

Mr. GEORGE. Thank you, Mr. Chairman, Chairman Boustany, Ranking Member Lewis, Members of the Subcommittee. Thank you for the opportunity to testify on the Internal Revenue Service's implementation of the Small Business Health Care Tax Credit.

The Patient Protection and Affordable Care Act amended the Internal Revenue Code to provide the credit. As noted, the credit was designed to encourage small employers and certain tax-exempt organizations to offer health care insurance and receive a credit for the employee health insurance expenses that they have incurred. It took effect January 1, 2010. The Congressional Budget Office estimated the credit would cost $37 billion over 10 years.

As it pertains to which taxpayers qualify for the credit and how to calculate the credit amount, the law is very complex. To address this, the Internal Revenue Service issued two Notices which set forth detailed guidance on claiming the credit, copies of which are included in my written testimony.

There are multiple steps to calculate the credit and seven worksheets that must be completed in order to claim it. These worksheets are required to determine the correct amounts to enter on 8 of the 25 lines on IRS Form 8941, which is the form used to claim the credit.

Despite IRS efforts to inform over four million taxpayers who could potentially qualify for the credit, the volume of claims for the credit has been low. Through mid-October 2011, the IRS reported that just over 300,000 taxpayers, including tax-exempt taxpayers, had claimed the credit for a total amount of $416 million. This is substantially lower than the Congressional Budget Office estimate, that taxpayers would claim up to $2 billion of credits for Tax Year 2010.

There is a risk of errors occurring when the credit is claimed or processed. The credit is new, and both taxpayers, as well as IRS employees, will need to educate themselves with the procedures for claiming the credit. Our review found that the complexity of the rules make them difficult for taxpayers to follow. The IRS also had to complete new computer systems' programming to update the new Form 8941 and identify potential compliance risks.

While the credit is specifically targeted to small business employers, some taxpayers may claim it even when they have not filed required employment tax returns. A lack of employment tax returns could indicate an erroneous claim and that the taxpayer is not an employer. However, it could also mean that the taxpayer is using the services of a professional employer organization, also known as a "PEO."

PEOs, acting as the employer, file employment tax returns under their own Employer Identification Number, and the client businesses where the employees work, claim other employment-related expenses, and the related deductions and credits that they paid. This presents a challenge to the IRS to determine whether a company which does not file employment tax returns qualifies for the credit without corresponding with or auditing the company.

We identified the issues by tracking the relationships between the PEOs and client companies in a previous review. In that report, TIGTA recommended that the IRS work with the Department of the Treasury to explore all options, including the use of the revised Form 2678, which is the Employer/Payer Appointment of Agent Form, to document the relationship between PEOs and their clients. The IRS agreed to establish such links between PEOs and their clients. However, their efforts were not successful.

To administer employment tax laws and to effectively use scarce compliance resources, the IRS needs to be able to identify businesses that begin using the services of a PEO, as well as when they terminate those services. Without this ability—which, again, the service does not possess—the IRS may not take appropriate actions against the businesses that do not pay employment taxes or improperly claim credits.

Some errors and omissions made by taxpayers when claiming the credit were not identified by the IRS. Early in 2011 filing season, TIGTA auditors evaluated whether tax returns with errors were identified by the IRS. The types of errors we identified included errors in calculating Full-Time Equivalent employees, incorrect application of percentage allowances or phase-out rules, missing Form 3800, among others. The IRS was not identifying these errors, but has stated to us they are taking steps to address this as a result of our report.

Some errors that the taxpayers made could be addressed with the IRS's existing authority to correct mathematical and clerical errors, which is known as "math error authority." However, the lack of authority for other types of errors could hamper the IRS's compliance efforts. This authority could allow the IRS to stop credit amounts claimed by taxpayers who do not appear to be qualified for these credits.

Chairman Boustany, Ranking Member Lewis, Members of the Subcommittee, thank you for the opportunity to provide TIGTA's assessment of the IRS's administration of the Small Business Health Care Tax Credit.

[The prepared statement of Mr. George follows:]

HEARING BEFORE THE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES

"Implementation and Effectiveness of the Small Business Health Care Tax Credit"

November 15, 2011

Washington, DC

Statement of
The Honorable J. Russell George
Treasury Inspector General for Tax Administration

TESTIMONY OF
THE HONORABLE J. RUSSELL GEORGE
TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION
before the
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES

"Implementation and Effectiveness of the
Small Business Health Care Tax Credit"

November 15, 2011

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, I thank you for the opportunity to testify on the Small Business Health Care Tax Credit (Credit). My comments will focus on the Treasury Inspector General for Tax Administration's (TIGTA) oversight of the Internal Revenue Service's (IRS) efforts to implement the Credit and on recommendations we have made to improve the implementation.

Background on the Small Business Health Care Tax Credit

The Patient Protection and Affordable Care Act[1] amended the Internal Revenue Code to provide the Credit. This is a new business credit for employee health insurance expenses of small businesses and certain tax-exempt organizations. It is effective for tax years beginning after December 31, 2009. The Congressional Budget Office estimated the Credit would cost $37 billion over 10 years.

In general, the Credit is available only to small employers who pay at least one-half the cost of health insurance coverage for their employees. Similar to other small employers, small tax-exempt organizations described in Internal Revenue Code section 501(c) and exempt from tax under section 501(a) may also qualify for the Credit. When claimed on individual or business returns, the Credit is nonrefundable (*i.e.*, only available to offset actual tax liability). The Credit is refundable to tax-exempt organizations, but only to the extent it does not exceed the total amount of income tax and Medicare tax withholding from employees' wages and the employer share of Medicare tax. Employers will continue to be able to deduct the costs in excess of the Credit amount as an ordinary expense for employee compensation. A credit is normally preferred to a deduction because it reduces tax due dollar-for-dollar, as opposed to a deduction, which decreases taxable income.

[1] Pub. L. No. 111-148, 124 Stat. 119, Section 1421 (2010).

The law concerning which taxpayers qualify for the Credit and how to calculate the Credit amount is complex. To address this, the Internal Revenue Service issued Notice 2010-44 and Notice 2010-82, which set forth detailed guidance on claiming the Credit. The IRS notices contain the following information:

To qualify for the Credit, an employer must have the following characteristics:

- Have fewer than 25 full-time equivalents (FTE)[2] for the taxable year.
- Have average annual wages for its employees for the year less than \$50,000 per FTE.
- Maintain a "qualifying arrangement."[3]
- Not be an agency or instrumentality of Federal, State, local, or Indian Tribal Governments.
- If a tax-exempt organization, be described in Internal Revenue Code section 501(c) and be exempt from tax under section 501(a). Tax-exempt entities do not qualify if these sections do not apply.

In brief, an employer must follow these steps to determine eligibility for the Credit:

- Determine the employees who are taken into account for purposes of the Credit.
- Determine the number of hours of service performed by those employees.
- Calculate the number of the employer's FTEs.
- Determine the average annual wages paid per FTE.
- Determine the premiums paid by the employer that are taken into account for purposes of the Credit. The premiums must be paid by an employer under a qualifying arrangement and must be paid for health insurance that meets requirements related to the Credit.

There are multiple steps to calculate the Credit, and seven worksheets must be completed in association with claiming the Credit.[4] These worksheets are required to determine the correct amounts to enter on 8 of the 25 lines on

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[2] FTEs, as defined by the legislation, means a number of employees equal to the number determined by dividing the total number of hours of service for which wages were paid by the employer to employees during the taxable year by 2,080. Additional guidance on FTEs is also provided in the legislation and in IRS Notice 2010-44.

[3] An arrangement under which the employer pays premiums for each employee enrolled in health insurance coverage offered by the employer in an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of the coverage.

[4] The worksheets are contained in the instructions for *Credit for Small Employer Health Insurance Premiums* (Form 8941). See Appendix I for a copy of the Form 8941 showing the steps that must be reported. Appendix III contains a more detailed summary of factors that must be considered in determining eligibility for the Credit.

Form 8941. For example: the number of employees, the number of FTEs, the average annual wages paid, the premiums paid, and the calculation of the reduced Credit amount for businesses with over 10 FTEs and average annual wages over $25,000. In general, the steps include:

- Calculate the maximum amount of the Credit.
- Reduce the maximum Credit in step one in accordance with the phase-out rule, if necessary.[5]
- For employers receiving a State credit or subsidy for health insurance, determine the employer's actual premium payment.

After eligibility is established and Form 8941 is completed to determine the Credit amount, the amount is transferred to another form or forms. In the case of most businesses and individuals, the Credit is reported as part of the General Business Credit (Form 3800) and then transferred again (to the extent allowed) to the U.S. Corporation Income Tax Return (Form 1120) or U.S. Individual Income Tax Return (Form 1040). Partnerships and S corporations[6] report the Credit as part of Schedule K on the U.S. Return of Partnership Income (Form 1065) or the U.S. Income Tax Return for an S Corporation (Form 1120S). Estates and trusts report the Credit as part of Schedule K on the U.S. Income Tax Return for Estates and Trusts (Form 1041). Tax-exempt organizations report the Credit on the Exempt Organization Business Income Tax Return (Form 990-T).

Extensive Efforts Were Made to Implement the Credit

The IRS completed extensive efforts to implement the Credit and other Affordable Care Act provisions. Shortly after the legislation was passed, the IRS began assessing what it would need to do to implement the Credit and tracked these efforts as they were completed. According to the IRS, it has completed more than 1,000 outreach and educational actions, including communication efforts to inform taxpayers and tax professionals about the Credit. The IRS mailed approximately 4.4 million postcards at a reported cost of approximately $1 million, with basic information on the Credit to businesses that could be affected. The IRS also used several means to inform tax professionals about the Credit including press releases, presentations, an internet page to provide information on the Credit, electronic messages such as alerts and news articles, and a telephone line for taxpayer and practitioner questions related to the Affordable Care Act.

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[5] Employers with more than 10 but less than 25 FTEs or average wages of more than $25,000 but less than $50,000 will not be eligible for the full amount of the Credit but may qualify for a reduced amount.

[6] An S corporation is a corporation that elects to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code.

Guidance on Applying State Subsidy Rules is Being Developed

While the IRS has issued guidance to taxpayers on how to account for State subsidies when calculating the Credit, little information was available from the IRS on which States offer such subsidies. The IRS also did not issue guidance to its revenue agents[7] on which States offer this benefit for consideration when auditing taxpayers. When we brought this to the IRS's attention, the IRS acknowledged that it should do more in these areas and plans to obtain tax practitioners' thoughts on how to improve. As of the date of our report, the IRS was in the process of developing a job aid for revenue agents to use during exams.

Potential Compliance Issues Exist

There is a risk of errors or irregularities occurring when the Credit is claimed or processed. The Credit is new, and both taxpayers and IRS employees will need to acquaint themselves with the rules. The rules themselves are complex, making it difficult for taxpayers to follow. The IRS also had to complete new programming to accommodate the new Form 8941 and identify potential compliance risks.

Even though the Credit is specifically targeted to small employers, certain taxpayers may claim it even when they have not filed required employment tax returns. A lack of employment tax returns could indicate an erroneous claim and that the taxpayer is not even an employer, but could also be the result of the taxpayer using the services of a Professional Employer Organization (PEO).

Professional Employer Organizations began operating in the early 1980s and assume some employment-related responsibilities for client companies, including hiring some or all of the client companies' employees whose services are then leased back to the client companies. The PEOs pay wages and file employment tax returns on employees' wages that would otherwise be handled by their client companies. An industry organization, the National Association of Professional Employer Organizations, describes this relationship as "co-employment."

The PEO, acting as the employer of the leased employees, files employment tax returns under its own Employer Identification Number, and the client businesses where the employees work claim other employment-related expenses and the related deductions and credits (as long as these were paid by the client business) under their (different) Employer Identification Numbers. This presents a challenge to the IRS to determine whether a company, which does not file employment tax returns, qualifies for the Credit without corresponding with or auditing the company.

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[7] An employee in the Examination function who conducts face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (*e.g.*, excise tax returns).

While some businesses, such as companies that only process payroll and file tax returns on behalf of other businesses, disclose similar arrangements to the IRS, this is generally not the case for the PEOs. Other arrangements, where one business acts as an agent for another business, are disclosed on the forms for Employer/Payer Appointment of Agent (Form 2678) and the Allocation Schedule for Aggregate Form 941 Filers (Schedule R (Form 941)). However, the PEO business model is premised on the PEO's view that it is a legal employer, not the agent of the client business.

We identified the issue related to tracking the relationships between the PEOs and client companies in a previous report.[8] In that report, TIGTA recommended that the IRS work with the Department of the Treasury to explore all options, including use of the revised Form 2678, to establish accurate links between the PEOs and their clients. The IRS agreed to establish links between PEOs and their clients; however, it did not accomplish this.

The IRS has a high-priority compliance program aimed at identifying and auditing employers who have not paid employment taxes. Businesses using the PEOs may unnecessarily fall into this compliance program, resulting in a waste of IRS resources and an increased burden on the affected taxpayers.

To administer employment tax laws and to effectively use scarce compliance resources, the IRS needs to be able to identify businesses that begin using the services of a PEO, as well as when businesses terminate the use of those services. Without this ability, the IRS may not take appropriate actions against the businesses that do not pay employment taxes or improperly claim credits.

We recommended that the IRS track PEO relationships by inputting cross-referenced Employer Identification Numbers on the client business tax accounts.[9] IRS management agreed with this recommendation and indicated that it will revise impacted form instructions to require reporting that will closely track relationships between businesses and PEOs and Professional Leasing Organizations filing payroll returns. We plan a follow-up audit to ensure this issue has been corrected.

The Credit is refundable to tax-exempt taxpayers, which is a high-risk factor for erroneous refunds. The IRS advised that, as of September 30, 2011, compliance personnel from its Tax Exempt and Government Entities Division had initiated examinations on 769 returns from tax-exempt organizations claiming the Credit. The IRS also advised that through mid-October 2011, 9,697 tax-exempt organizations (taxpayers filing Form 990-T) claimed Small Business Health Care

[8] TIGTA, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (September 2007).
[9] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (September 2011).

Credits, totaling $36.4 million.

The Tax Exempt and Government Entities Division implemented a two-step process for verifying the Credit claimed by tax-exempt organizations on Form 990-T. First, the IRS developed computer programs to detect potential errors on Forms 990-T claiming the Credit. This validation process occurs before funds have been released to the organizations. When errors are detected, the IRS will freeze any associated refund and notify the organization through a notice. Tax Exempt and Government Entities Division personnel will review the Form 990-T to determine if an examination is warranted.

The second step is an examination of the documentation supporting the Credit claimed on Forms 990-T identified by the IRS with potential errors. Examinations can be performed either before the refund is issued or after. If IRS resources are available before the refund is issued, an examination will be initiated to determine if the Credit is valid and whether a refund should be issued. If a determination is made that sufficient resources are not available to perform an examination, the refund will be released within 45 days. For these returns, the IRS will provide a listing of cases to its compliance personnel for potential review during its regular post-refund examination process. At that time, the IRS can perform an audit of the taxpayer's records by a correspondence audit, office audit, or field examination. During these audits, taxpayers will be asked to provide the documentation necessary to verify the Credit claimed on Form 990-T.

The Volume of Credit Claims Has Been Lower Than Expected

Despite IRS efforts to inform 4.4 million taxpayers who could potentially qualify for the Credit, the volume of claims for the Credit has been low. The Credit was designed to encourage small employers to offer health care insurance. However, through mid-October 2011, the IRS reported that 309,000 taxpayers (including the tax-exempt taxpayers previously referred to) had claimed the Credit for a total amount of $416 million.[10] This is substantially lower than the Congressional Budget Office estimate that taxpayers would claim up to $2 billion of Credit for Tax Year 2010. (Appendix II provides the volumes and amounts of Credits filed on each type of tax return.)

Although the IRS sent postcards to businesses that might potentially qualify for the Credit to make sure they were aware of it, the IRS did not have ready access to data that would allow it to determine which of these businesses actually offer health care insurance to their employees or otherwise qualify for the Credit. Many small businesses do not offer health insurance and would not qualify for the Credit. Other factors, such as family members working as employees or the business failing to offer an appropriate health care plan, might also cause businesses to be ineligible.

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[10] Internal Revenue Service statistics on credits claimed under I.R.C. § 45R.

The IRS spoke with industry groups and professional organizations to try to determine why businesses were not claiming the Credit. Some reasons given were: small businesses may take a wait and see approach with the Credit; the Credit is not worth the time and effort to claim it; taxpayers are unclear on the specifics of the Credit and rely on tax professionals to claim it; and business-related information needed to claim the Credit is not readily available.

The IRS conducted focus groups with tax practitioners in conjunction with its Nationwide Tax Forums to identify knowledge gaps on the part of taxpayers and tax practitioners, determine barriers to taxpayers claiming the Credit, and determine better ways to communicate with stakeholders. In general, the focus group participants were aware of the Credit, but many could not explain the specific eligibility requirements and indicated they would not feel confident calculating the Credit themselves. Few participants had completed Form 8941 for their own business or for their clients. They indicated that the Credit is not easy to calculate and the payroll information needed to calculate accurately the Credit amount was not readily available to them. They also stated that the instructions for calculating the FTEs were not clear causing clients who may have been eligible for the Credit not to claim it. In addition, many of the practitioners' clients had not claimed the Credit because they did not offer insurance or did not meet the eligibility criteria. Practitioners indicated that given the current economic environment, the Credit was not enough to encourage their clients to start offering insurance.

Some of the taxpayer errors and omissions were not identified by the IRS

There was insufficient information on the Form 8941 and other forms filed with taxpayer returns to identify all errors made when claiming the Credit; however, based on the information that was available, we concluded that some claims contained errors[11] or were incomplete.

We reviewed a judgmentally selected sample of different return types as they were being processed at the Austin, Texas, and Ogden, Utah, IRS campuses. We chose the returns based primarily on how many forms of a particular type were available during our visit and whether we noticed any anomalies during our review. Our review included 257 returns for individuals, businesses, and tax-exempt organizations. The results of the judgmental sample cannot be used to estimate the extent of actual errors. The purpose of the sample was to identify the types of errors that were occurring, but was not intended to project the frequency of those errors. Additionally, we analyzed computerized data that were available prior to the end of the filing season for possible issues. The types of problems we identified through either the case review or data analysis included:

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[11] The Form 8941 does not contain all of the data and calculations needed to verify each step of Credit eligibility and calculation. It is necessary to complete worksheets in the Instructions for the Form 8941 in order to correctly claim the Credit. The worksheets are not filed with the return.

- Obvious errors in calculating FTEs. The number of FTEs claimed exceeded the number of employees reported.
- Incorrect use of the applicable percentage. Taxpayers either used the wrong percentage to calculate the Credit or left that portion of the form blank. Tax-exempt small employers should use 25 percent and all other small employers should use 35 percent.
- Incorrect calculations of phase-out rules. Taxpayers who had over 10 FTEs or who paid average annual wages of over $25,000 incorrectly calculated the reduced Credit amount.
- Premiums paid that exceeded the maximum premium allowed based on the IRS's State Average Premium for Small Group Markets.
- Taxpayers reported that no employees for whom they paid premiums were covered under qualifying arrangements (*i.e.*, the health insurance coverage provided to the employees did not meet the specifications in the law).
- Missing Form 3800 or missing required information on Form 3800 related to a credit received from a pass-through entity (such as a partnership, trust, or Subchapter S corporation). Credits from pass-through entities are reported on Form 8941. Any remaining pass-through Credit after adjustments for all but Form 990-T is reported on Form 3800, which is attached to Form 1040, Form 1065, or Form 1041.
- Claims made with no evidence of employment-tax returns having been filed to show that the Form 1120 business had employees and was entitled to the Credit.

The lack of targeted math error authority could hamper IRS compliance efforts

Some of the errors that taxpayers made could have been addressed during processing because they were straightforward arithmetic errors, which the IRS has authority to correct. We recommended, and the IRS agreed, to capture more data from the Form 8941 to facilitate addressing these types of errors.

Math error authority allows the IRS to correct certain errors during processing, including calculation errors and entries that are inconsistent or exceed statutory limits, without having to issue the taxpayer a statutory notice of deficiency. This is especially important with respect to refundable credits because such credits are targets for fraud. In our report regarding the Small Business Health Care Tax Credit,[12] we provided examples of specific errors taxpayers were making when claiming the Credit which are beyond the IRS's

[12] TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (September 2011).

current authority to correct through math error processes, but which could be addressed through legislation providing targeted math error authority. Math error authority would allow the IRS to improve compliance and avoid burdensome audits by correcting certain errors or contacting the taxpayer during processing, but prior to allowing the Credit or paying refunds on potentially erroneous returns.

IRS management agreed that math error authority is an important compliance tool, and will explore with the Department of the Treasury whether math error authority is appropriate for this Credit. The IRS agreed that it is beneficial to address potential compliance issues as early in the process as possible and has developed procedures to examine questionable returns prior to the issuance of refunds.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, thank you for the opportunity to provide TIGTA's assessment of the IRS's administration of the Small Business Health Care Credit. In closing, I would like to emphasize that TIGTA will continue to monitor the IRS's implementation of significant provisions of the Affordable Care Act and will promptly alert you and the IRS of any problems or emerging issues. I would be pleased to answer any questions you may have at the appropriate time.

Appendix I

Form Used to Claim the Credit

Form **8941** — **Credit for Small Employer Health Insurance Premiums**

Department of the Treasury
Internal Revenue Service

► See separate instructions.
► Attach to your tax return.

OMB No. 1545-2198
2010
Attachment Sequence No. **63**

Name(s) shown on return | **Identifying number**

1	Enter the number of individuals you employed during the tax year who are considered employees for purposes of this credit (see instructions)	1	
2	Enter the number of full-time equivalent employees you had for the tax year (see instructions). If you entered 25 or more, skip lines 3 through 11 and enter -0- on line 12	2	
3	Average annual wages you paid for the tax year (see instructions). If you entered $50,000 or more, skip lines 4 through 11 and enter -0- on line 12	3	
4	Premiums you paid during the tax year for employees included on line 1 for health insurance coverage under a qualifying arrangement (see instructions)	4	
5	Premiums you would have entered on line 4 if the total premium for each employee equaled the average premium for the small group market in which you offered health insurance coverage (see instructions)	5	
6	Enter the **smaller** of line 4 or line 5	6	
7	Multiply line 6 by the applicable percentage: • Tax-exempt small employers, multiply line 6 by 25% (.25) • All other small employers, multiply line 6 by 35% (.35)	7	
8	If line 2 is 10 or less, enter the amount from line 7. Otherwise, see instructions	8	
9	If line 3 is $25,000 or less, enter the amount from line 8. Otherwise, see instructions	9	
10	Enter the total amount of any state premium subsidies paid and any state tax credits available to you for premiums included on line 4 (see instructions)	10	
11	Subtract line 10 from line 4. If zero or less, enter -0-	11	
12	Enter the **smaller** of line 9 or line 11	12	
13	If line 12 is zero, skip lines 13 and 14 and go to line 15. Otherwise, enter the number of employees included on line 1 for whom you paid premiums during the tax year for health insurance coverage under a qualifying arrangement (see instructions)	13	
14	Enter the number of full-time equivalent employees you would have entered on line 2 if you only included employees included on line 13	14	
15	Credit for small employer health insurance premiums from partnerships, S corporations, cooperatives, estates, and trusts (see instructions)	15	
16	Add lines 12 and 15. Partnerships and S corporations, stop here and report this amount on Schedule K; all others, go to line 17	16	
17	Credit for small employer health insurance premiums included on line 16 from passive activities (see instructions)	17	
18	Subtract line 17 from line 16	18	
19	Credit for small employer health insurance premiums allowed for 2010 from a passive activity (see instructions)	19	
20	Carryback of the credit for small employer health insurance premiums from 2011	20	
21	Add lines 18 through 20. Cooperatives, estates, and trusts, go to line 22. Tax-exempt small employers, skip lines 22 and 23 and go to line 24. All others, stop here and report this amount on Form 3800, line 29h	21	
22	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)	22	
23	Cooperatives, estates, and trusts, subtract line 22 from line 21. Stop here and report this amount on Form 3800, line 29h	23	
24	Enter the amount you paid in 2010 for taxes considered payroll taxes for purposes of this credit (see instructions)	24	
25	Tax-exempt small employers, enter the **smaller** of line 21 or line 24 here and on Form 990-T, line 44f	25	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37757S Form **8941** (2010)

Source: IRS web site.

Appendix II

Volumes of Credits Claimed By Return Types

Return Type	Number of Credits Claimed	Amounts of Credits Claimed	Average Credit Claimed
Form 1120	23,724	$91,458,588	$3,855
Form 1120-S	88,848	Not Applicable[13]	
Form 1120-C	62	$5,959,005	$96,113
Form 1120-F	2	$5,113	$2,557
Form 1120-FSC	0	$0	$0
Form 1120-H	111	$996,441	$8,977
Form 1120-L	0	$0	$0
Form 1120-PC	73	$282,597	$3,871
Form 1120-POL	0	$0	$0
Form 1120-REIT	0	$0	$0
Form 1120-RIC	0	$0	$0
Form 1065	15,550	Not Applicable[14]	
Form 1041	27	$87,106	$3,226
Form 990-T	9,697	$36,422,240	$3,756
Form 1040	171,129	$280,382,758	$1,638
Total	**309,223**	**$415,593,848**	

Source: IRS, ACA Oversight and Non-Exchange Provisions

Form 1120: *U.S. Corporation Income Tax Return*
Form 1120-S: *U.S. Income Tax Return for an S Corporation*
Form 1120-C: *U.S. Income Tax Return for Cooperative Associations*
Form 1120-F: *U.S. Income Tax Return of a Foreign Corporation*
Form 1120-FSC: *U.S. Income Tax Return of a Foreign Sales Corporation*
Form 1120-H: *U.S. Income Tax Return for Homeowners Associations*
Form 1120-L: *U.S. Life Insurance Company Income Tax Return*
Form 1120-PC: *U.S. Property and Casualty Insurance Company Income Tax Return*
Form 1120-POL: *U.S. Income Tax Return for Certain Political Organizations*
Form 1120-REIT: *U.S. Income Tax Return for Real Estate Investment Trusts*
Form 1120-RIC: *U.S. Income Tax Return for Regulated Investment Companies*
Form 1065: *U.S. Return of Partnership Income*
Form 1041: *U.S. Income Tax Return for Estates and Trusts*
Form 990-T: *Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))*
Form 1040: *U.S. Individual Income Tax Return*

[13] Form 1120-S is a pass-through form. Therefore, all credit amounts should have been reported to individual shareholders.
[14] Form 1065 is a pass-through form. Therefore, all credit amounts should have been reported to individual partners.

Summary of Considerations in Determining Eligibility

IRS Notice 2010-44 describes the following factors in determining eligibility for the Small Business Health Care Tax Credit (Credit):

- Determine the employees who are taken into account for purposes of the Credit.
  - Exclude any wages and premiums paid related to partners, most owners,[15] or family members of these partners or owners.
  - Seasonal workers are disregarded in determining FTEs and average annual wages unless the seasonal worker works for the employer for more than 120 days during the taxable year, although premiums paid on their behalf may be counted in determining the amount of the Credit.
  - Employers who are part of a controlled group or affiliated service group[16] are treated as a single employer.
- Determine the number of hours of service. Consider hours for which employees were paid or entitled to payment (including vacations, holidays, illness) and use any of three methods for calculations (actual, days-worked equivalency based on eight hours of service per day, or weeks-worked equivalency based on 40 hours of service per week).
- Determine the number of an employer's FTEs.
  - Divide (1) the total hours of service (but not more than 2,080 for any employee) by (2) 2,080. The result, if not a whole number, is then rounded to the next lowest whole number. In some circumstances, an employer with 25 or more employees may qualify for the Credit if some of its employees work part-time.
- Determine the average annual wages paid. Divide (1) the total wages paid for employees taken into account by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000. Only wages that are paid for hours of service as determined under Credit-related rules are taken into account.

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[15] Specifically, sole proprietors, partners in a partnership, shareholders owning more than two percent of an S corporation, and any owners of more than five percent of other businesses are not taken into account as employees for purposes of the Credit. For purposes of the Credit, a very comprehensive list of potential relatives and dependent members of their households are excluded from eligibility.

[16] Groups covered under section 414(b), (c), (m), or (o) of the Internal Revenue Code.

- Determine the premiums paid by the employer that are taken into account for purposes of the Credit. Only the portion paid by the employer is taken into account.
  - Determine the premiums related to qualifying arrangements. Qualifying arrangements may cover a wide range of medical expenses (*e.g.*, hospital or medical policies, certificates, or service plans; dental or vision; long-term care). However, certain specific types of plans do not qualify.[17] Different types of plans are not aggregated for purposes of meeting the qualifying arrangement requirement. So if an employer pays for a health insurance plan and a separate vision plan, determinations must be made for each plan with respect to whether it is a qualifying arrangement.
  - The amount of an employer's premium payments that are taken into account is limited to the premium payments the employer would have made under the same arrangement if the average premium for the small group market in the State (or an area within the State) in which the employer offers coverage were substituted for the actual premium. For example, if an eligible small employer pays 80 percent of the premiums for coverage provided to employees, the premiums taken into account for purposes of the Credit are the lesser of the 80 percent of the total actual premiums paid or 80 percent of the premiums that would have been paid for the coverage if the average premium for the small group market were substituted for the actual premium.

[17] See I.R.C. § 9832(c)(1).

Chairman BOUSTANY. Thank you, Mr. George.

Ms. Ingram, you may proceed.

STATEMENT OF SARAH HALL INGRAM, COMMISSIONER OF THE TAX EXEMPT/GOVERNMENT ENTITIES OPERATING DIVISION, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Ms. INGRAM. Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, my name is Sarah Hall Ingram, and I am commissioner of the tax-exempt and government entities operating division at the Internal Revenue Service. And I also serve as the executive lead for the IRS operational planning and implementation of the tax law provisions of the Affordable Care Act of 2010. I appreciate the opportunity to testify with you here today.

My purpose this morning is to discuss the credit and what actions the IRS has taken and plans to take to help insure that small employers that may be eligible for the credit are aware of it.

The small employer health care tax credit is designed to help small businesses and tax-exempt organizations afford the cost of premiums for health coverage for their employees. In general, the credit is available to small employers that primarily employ low and moderate-income workers and who pay at least half the cost of single coverage for their employees.

For tax years 2010 to 2013, the maximum credit is 35 percent of premiums paid by eligible small businesses, and 25 percent of premiums paid by eligible employers that are tax-exempt organizations. After 2013, eligible employers will be able to take the credit for 2 additional years, and the maximum credit will increase to 50 percent for eligible small businesses, and 35 percent for eligible tax-exempt organizations. I provided further details on how the credit works in my written testimony for the record.

Now, to claim the credit, a small business uses Form 8941 to calculate the credit amount, and then includes that amount as part of the general business credit that it takes on its income tax return. A tax-exempt organization, which generally, by definition, has no income tax liability, uses the same Form 8941 to calculate its refundable amount, but then claims the credit on Form 990T.

Because the credit was enacted mid-year in 2010 but was effective immediately—in fact, back to January 1—the IRS was concerned that not all small employers that might qualify for the credit would know about it, and would claim it on their 2010 return. So the IRS launched a significant outreach campaign in the months following enactment.

In April, to increase awareness in the community, the IRS mailed postcards to more than four million small businesses and tax-exempt organizations that were identified as potentially eligible for the credit, based on the limited payroll data maintained by the IRS, which gives a general indication of the number of employees and their wages.

The IRS issued detailed guidelines in May. And based on our continuous engagement with the small business and practitioner communities, we have regularly added materials and tools to a dedicated webpage on IRS.gov, including frequently asked questions, multi-language videos, practical tool kits, and even a recorded webinar.

Since the provision was enacted, the IRS has held or participated in more than 1,500 outreach events targeted at small businesses and the tax practitioners and business professionals who serve them, both to increase awareness and knowledge in the community, and also to obtain practical feedback on our outreach strategies and on our materials.

The IRS is now developing a new outreach campaign to ensure that small employers that are eligible for the credit in 2011 will know how to claim it on their returns filed for the 2012 filing season. Based on our experience to date, and feedback from the community, this campaign will focus on working with our partners and stakeholders, including the tax software industry, insurance agents and brokers that work with small businesses, and the tax practitioner community.

The IRS is working to enhance information available through IRS.gov, as well as through social media and other venues in order to better communicate information to the small business community and the professionals who advise them.

Mr. Chairman, this concludes my oral testimony, and I'd be happy to answer any questions.

[The prepared statement of Ms. Ingram follows:]

WRITTEN TESTIMONY OF
SARAH HALL INGRAM
COMMISSIONER OF THE
TAX-EXEMPT AND GOVERNMENT ENTITIES OPERATING DIVISION
INTERNAL REVENUE SERVICE
BEFORE
THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
ON THE SMALL EMPLOYER HEALTH CARE TAX CREDIT
NOVEMBER 15, 2011

Introduction and Summary

Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee on Oversight, my name is Sarah Hall Ingram and I am Commissioner of the Tax-Exempt and Government Entities Operating Division at the Internal Revenue Service. I also serve as the executive lead on the IRS's operational planning and implementation of the small employer tax credit and other tax law provisions of the Affordable Care Act. I appreciate the opportunity to testify on the Small Business Health Care Tax Credit, which was enacted as part of the Patient Protection and Affordable Care Act of 2010.

My purpose here this morning is to explain how the credit works, what the eligibility requirements are, how to claim the credit, and what actions the IRS has taken to help ensure small businesses that may be eligible for the credit are aware of it.

The credit is designed to help small businesses and tax-exempt organizations afford the cost of providing health coverage to their employees. In general, the credit is available to small employers that primarily employ low- and moderate-income workers, and pay at least half the cost of single coverage for their employees.

For tax years 2010 to 2013, the maximum credit is 35 percent of premiums paid by eligible small businesses and 25 percent of premiums paid by eligible employers that are tax-exempt organizations. For tax-exempt organizations, the credit cannot exceed the total amount of income and Medicare tax withheld from employees' wages for the year and the employer share of Medicare tax for the year. After 2013, eligible employers will be able to take the credit for two additional years. Beginning in 2014, the maximum credit will increase to 50 percent of premiums paid by eligible small business employers and 35 percent of premiums paid by eligible tax-exempt organizations.

The maximum credit goes to smaller employers – those with 10 or fewer full-time equivalent (FTE) employees – paying annual average wages of $25,000 or less. The credit is completely phased out for employers that have 25 FTEs or more or pay average wages of $50,000 per year or more. Because the eligibility rules are based in part on the number of FTEs, not the number of employees, businesses that use part-time help may qualify even if they employ more than 25 individuals

Qualifying Arrangements

By law, only premiums paid by the employer under an arrangement meeting certain requirements are counted in calculating the credit. Arrangements that meet these requirements are considered to be "qualifying arrangements." Under a qualifying arrangement, the employer pays premiums for each employee enrolled in health care coverage offered by the employer in an amount equal to a uniform percentage (not less than 50 percent) of the premium cost of the coverage. However, a qualifying arrangement can also be one under which the employer pays at least 50 percent of the premium cost for employee-only, or single, coverage for each employee enrolled in any health insurance coverage offered by the employer.

The IRS issued guidance last year clarifying that the credit is available to a broad range of employers, including religious institutions that provide self-insured coverage through denominational organizations, small employers that cover their workers through insured multiemployer health and welfare plans, and employers that subsidize their employees' health care costs through a broad range of contribution arrangements.

Determining FTEs and Average Annual Wages

To determine whether an employer with a qualifying arrangement is eligible to claim the credit, the employer must first calculate the number of FTEs for the year. This is done by dividing the total hours of service for which the employer pays wages to employees during the year by 2,080.

Because the limitation on the number of employees is based on FTEs, an employer with 25 or more employees could qualify for the credit if some of its employees work part-time. For example, an employer with 40 half-time employees – those who are paid wages for 1,040 hours for the year – is deemed to have 20 FTEs and therefore may qualify to claim the credit.

For purposes of computing the number of FTEs, the law generally does not require employers to count seasonal workers. In addition, business owners such as sole proprietors and partners in a partnership are not counted as employees for purposes of the credit and are not counted toward the number of FTEs, even though these individuals may provide services to the business. A similar exclusion applies to a business owner's family members who work for the business.

In determining eligibility, the employer must also calculate the amount of average annual wages paid to employees. To calculate the amount of average annual wages, an employer must divide the total wages paid during the tax year to employees by the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000. As with FTEs, the average wage computation does not include seasonal workers, generally, and does not include business owners or their family members working in the business.

How Employers Claim the Credit

To claim the credit, a small business uses Form 8941 to calculate the credit amount, and then includes that amount as part of the general business credit that it takes on its income tax return. A tax-exempt organization, which generally by definition has no income tax liability, uses Form 8941 to calculate its refundable credit amount, and then claims the credit on Line 44f of Form 990-T. Though the Form 990-T is filed primarily by those organizations liable for the tax on unrelated business income, it can also be used by any eligible tax-exempt organization claiming the credit, regardless of whether they are subject to unrelated business income tax.

The credit can be used to offset an employer's alternative minimum tax (AMT) liability for the year, subject to certain limitations based on the amount of an employer's regular tax liability, AMT liability and other allowable credit. Also, under the general business credit rules, as amended by section 2012 of the Small Business Jobs Act of 2010, the unused 45R credit determined in taxable years beginning after Dec. 31, 2009 and before January 1, 2011, may be carried back five years or forward up to 20 years.

IRS Education and Outreach

Because the credit was enacted mid-year in 2010 and was effective immediately upon enactment, the IRS launched a significant outreach campaign to small businesses in the months following enactment. Actions taken as part of this campaign included the following:

- In April of 2010, to increase awareness, the IRS mailed postcards to more than 4 million small businesses and tax-exempt organizations that were identified as potentially eligible for the credit based on limited payroll data maintained by the IRS which gives a general indication of number of employees and wages (without knowledge of whether they otherwise qualify);
- In May of 2010, the IRS issued detailed guidelines, illustrated by more than a dozen examples, to help small employers determine whether they qualify for the credit and assist them in estimating the amount of credit they could receive;
- During 2010, the IRS posted videos in English, Spanish, and American Sign Language (ASL) to its YouTube channel describing the basics of the credit and how to claim it;
- Since enactment, the IRS has held or attended more than 1,500 outreach events (ranging from large conferences and webinars to workshops and focus groups) targeted at small businesses and the tax practitioners business professionals who serve them; and

- On a regular basis, the IRS has added materials and tools to a dedicated page on irs.gov (frequently-asked-questions, tax tips, teaching materials, etc.), reached out to a wide range of stakeholders through E-news lists and newsletters, and provided partners with materials and links to use in their own channels and programs.
- IRS collaborated with HHS and SBA on outreach and useful materials to maximize effective education of the small business community, including SBA webinar and HHS e-news.

The IRS is now developing a new outreach campaign, to ensure that small employers that are eligible for the credit in 2011 will claim it on their 2012 returns. This campaign will focus on working with our partners, including:

- The tax software industry, to improve access to educational information and to help alert small employers and practitioners when taxpayers may be eligible for the credit;
- Insurance agents and brokers who work with small businesses, to help ensure that participants in the health insurance marketplace understand the features and benefits of the credit. The Department of Health and Human Services recently sent an email to 2,000 agents and brokers alerting them to the credit for their small business clients; and
- The small business and practitioner community, to provide additional materials and educational opportunities regarding the credit, including webinars and toolkits.

The goal of our outreach and education has been to inform eligible small businesses and tax-exempt organizations how they can claim the Small Business Health Care Tax Credit to reduce their taxes. To do this, we highlighted the advantages of claiming the credit to both eligible small businesses and practitioners.

We continue to seek input to further deliver our messages to a number of key audiences: small business owners, tax-exempt organizations, tax preparers, insurance agents and brokers. The IRS will continue to communicate through social media and other venues, including IRS YouTube videos and Twitter feeds. We plan on continuing and expanding our relationships with external stakeholders as we collaboratively find new and innovative ways to market this valuable tax credit.

Conclusion

Mr. Chairman, this concludes my testimony. I appreciate the opportunity to testify about the Small Business Health Care Tax Credit. I will now be happy to answer any questions that you may have.

Chairman BOUSTANY. Thank you, Ms. Ingram, and I appreciate your testimony.

We're talking about a relatively new tax credit that appears to be somewhat complex for the small business owner trying to navigate through it. And now we have preliminary figures that show that it's not being utilized or claimed to the extent that was initially thought would be the case.

And so, Ms. Ingram, I know IRS has gone through great efforts, sending out 4.4 million postcards, holding numerous outreached programs, as you outlined, and it's certainly detailed in your written testimony. Yet, as of mid-October, the figure that we have is 309,000 taxpayers out of a potential 4 million have taken the credit. And while we recognize it's early and we're not finished with the season yet, do you have more recent numbers as to who has filed for the claim—or for the credit?

Ms. INGRAM. No, Congressman. The 309 figure is the most recent.

Chairman BOUSTANY. The most recent. What's the cost to date to the IRS for the outreach program and for the implementation efforts?

Ms. INGRAM. I don't have figures broken out by this provision. We use many of the same people to work on a number of provisions. So we would have to reconstruct that carefully——

Chairman BOUSTANY. Okay.

Ms. INGRAM [continuing]. And provide that followup.

Chairman BOUSTANY. If you could provide that to the Committee——

Ms. INGRAM. Yes, we will give you what we can.

Chairman BOUSTANY. I appreciate that. And, Mr. George, I think TIGTA estimated that it's been about $29 million that's been spent on this?

Mr. GEORGE. Well, we know that the IRS has requested that amount. And to assist my colleague here, they've expended over $1 million in the effort to inform the potential eligible taxpayers about this tax credit. But again, they have requested over $24 million to help implement this credit.

Chairman BOUSTANY. Thank you. And, Ms. Ingram, TIGTA's report noted that the IRS has asked industry groups and professional organizations to determine why businesses are not taking the credit. Does the IRS engage in similar outreach programs, and for other types of tax credits? For instance, an R&D tax credit?

Ms. INGRAM. We have a fairly continuous process of talking to the practitioner community or industry associations about how their understanding and implementation of provisions are that affect that particular group.

Whenever we have new provisions coming into the tax laws, we do take opportunities to try to get focused feedback, both about the level of awareness, and anything we can do to assist people in either understanding whatever the provision is, or improve our tools so that they can take advantage of them.

So, for example, in our summer tax forums, which is a practitioner—gathering of tax professionals every summer across the country, we do focused feedback sessions with practitioners to get at that kind of information.

Chairman BOUSTANY. Thank you. And does the IRS want math error authority for this particular tax credit? And if not, why?

Ms. INGRAM. We engaged in some good conversations with the TIGTA audit team about how the current math error authority or augmented legislative math error authority could be used in this setting. And we have shared those conversations with the Treasury Department, who is looking at ways in which there might be some policy choices around this credit.

Chairman BOUSTANY. Thank you. And is there some concern at this stage—this tax credit was proposed as a means of helping to mitigate the high cost and rising cost of health insurance premiums for small businesses, which are under tremendous pressure right now.

And my sense is, based on testimony I've read and other reports, that this tax credit is not achieving that goal of helping to bring down those costs, and helping, you know, small businesses to provide health insurance for their employees. Is there a concern right now at the IRS, or are you just focused now on purely the administration of this tax credit?

Ms. INGRAM. Well, the analysis about the policy and economic impact would be better addressed to the Treasury Department. My role is to take what we have and implement it as well as possible. And, as I mentioned, my two goals are to educate the community and get them what they need, and listen to them about what they need, and then to make sure that what gets filed is an appropriate claim for the credit.

Chairman BOUSTANY. Mr. George, in the TIGTA report on IRS efforts to implement this tax credit, you discuss problems with tracking employees when employers use professional employer organizations. I read your written testimony with great interest on this. And can you explain what the problem is with regards to this particular tax credit, and how the IRS could potentially fix this particular problem?

Mr. GEORGE. Yes. Again, in effect, the IRS has—or there are entities called, again, PEOs, which are outsourced to by small businesses and the like, so that certain aspects—accounting, you know, leave, medical leave, what have you, these businesses will take over those responsibilities for a small or, you know, individual practitioner to help alleviate that burden from that person, and they will be paid a fee. The PEOs will be paid a fee.

And so, the problem is there is a disconnect between what the IRS knows and doesn't know, as to who is actually paying the employee taxes and the various taxes, as they relate not only to this credit, but to other credits. And we recommended in a report over two years ago that the IRS, seek legislative help from the department—because it is the department who has responsibility for developing tax policy—and to address better ways in which the IRS could develop processes, internal processes, to match the various Employee Identification Numbers between the PEOs and the organizations with which they contract.

And for some reason, which—I will defer to the IRS—that hasn't been done. And had that been done, it would assist not only in the implementation of this particular credit, but in others.

Chairman BOUSTANY. Before I turn to the Ranking Member, Ms. Ingram, do you want to respond to that?

Ms. INGRAM. The issue of how to handle professional employee organizations has been a matter of discussion as we've tried to work through the extent to which what is needed is legislative change, and to the extent what is needed is changes in systems and forms.

I don't think that we have any difference of philosophy about what would be advantageous. I think as we work through the logistics of what we can do administratively, in addition to sharing analyses with the Treasury Department, we continue to welcome all of the advice we get from TIGTA about ideas of how to do that.

There were some additional ideas in this report, and we're working on those now, and I assume we will have further dialog, in case we have questions about TIGTA's advice.

Chairman BOUSTANY. So, are you confident that that can be fixed?

Ms. INGRAM. The——

Chairman BOUSTANY. Without legislation?

Ms. INGRAM. We could do some things. We have to make sure that we're not burdening legitimate arrangements, and that we do it in a way that enables us to check what we need to check without being burdensome on people who are otherwise just following the rules just fine.

So I think those logistical issues we want to continue to work on internally.

Chairman BOUSTANY. Thank you. Mr. Lewis.

Mr. LEWIS. Thank your, Mr. Chairman. Commissioner Ingram, I believe it is too early to draw any conclusions about the credit. Commissioner, many businesses request extensions and file their returns in October and November. Is this correct?

Ms. INGRAM. Yes, they do.

Mr. LEWIS. When will the agency finish processing these and other tax returns?

Ms. INGRAM. As you stated earlier, sir, it's toward the end of the year that we would finish processing and posting the returns all the way through the season. In fact, today is the last day that the exempt organizations could file and claim those credits. So, they would—returns are still coming in for this credit. It will be the end of the year.

Mr. LEWIS. Commissioner, early data show less than 5 million business returns have been processed through mid-October, and that over 10 million business tax returns were processed in 2010. Is this correct?

Ms. INGRAM. I don't have the figures directly with me, but I believe—the difficulty with those figures is that it depends on which returns you look at, if you look at 1120s and 1120Ss and 1065s, or whether you also include the 1040 returns that include schedule C's and the other schedules that indicate business activity. So I would prefer to respond afterward, with a full set of data.

Mr. LEWIS. Thank you. With respect to small corporations, the so-called, I guess, S-corporation, early data show that less than 2 million returns have been processed through mid-October, and that about 4 and a half million returns were processed in 2010. Do you believe this to be correct?

Ms. INGRAM. Again, I'd like to make sure I can confirm that after the hearing.

I think what is true is that the partners in flow-through—the recipients of flow-through adjustments like this credit, if they're filing on extensions, would go to October 15th. And the data that we were able to pull for the request for this hearing would not include everybody who had filed on the October 15th date, for a variety of reasons, whether they came in on paper, or whether they were in the queue for posting and processing. So it is an incomplete data set at this point.

Mr. LEWIS. Commissioner, so with less than 50 percent of business returns processed through mid-October, is it too early to know how many businesses will claim the tax credit this year?

Ms. INGRAM. It is definitely too early to know how many total claims we are going to get. And, as I mentioned, although the tax-exempts are a very small portion of this picture, their deadline is not even until today. So, yes, we do not have final numbers.

Mr. LEWIS. Thank you very much. Mr. Inspector General, what grade would you give the Service on its outreach effort for the health credit? If you had to give a grade right now, this moment.

Mr. GEORGE. Well, if I may, sir, answer the question in the following manner, the overall implementation of this credit by the IRS, we would give them a B to a B+. We think they have done an effective job implementing the credit, reaching out to people, and changing the computer processes that are needed to be changed to help accommodate it.

Again, the challenge is the complexity of the law itself. And so that is a different issue. But overall, we would—I would give them a B, B+.

Mr. LEWIS. Mr. Chairman, I am concerned that the proposed Republican budget cuts would hurt taxpayer service such as outreach efforts, compliance, and enforcement.

Without objection, I would like to enter into the record an October letter from the Commissioner that provides an example of how the budget cuts would hurt small businesses.

Without objection, I would also like to enter into the record the Commissioner's November notice to employees announcing an early out, or buy-out program.

Chairman BOUSTANY. Without objection, both will be entered into the record.

[No response.]

[The information follows:]

COMMISSIONER'S CORNER

*A Message from **IRS** Commissioner Doug Shulman* IRS

As I shared with you recently, our fiscal year 2012 budget outlook is challenging. I have continued to explain to Congress that a significant reduction in our budget would have serious detrimental effects on the nation's tax system.

Because employee-related expenses account for the vast majority of our budget, we must reduce our workforce if our final budget is reduced by the amounts now being discussed in Congress. Last year, we were able to achieve the needed workforce reduction through attrition, but this year we will need to use some new tools. While we continue to have conversations with members of Congress, we must take additional steps for potentially significant budget reductions.

Today, I wanted to let you know that we will soon be offering early outs and buyouts for a limited subset of our employees. These programs are formally called Voluntary Early Retirement Authority (VERA) and Voluntary Separation Incentive Payments (VSIP); both options involve voluntary separations for employees who are retirement-eligible or close to it.

We plan to make these buyout offers to a limited set of employees in positions that do not involve direct service or enforcement interactions with taxpayers. Our budget situation remains quite uncertain, and it's possible we will have to offer a second round of buyouts to a wider range of employees who deal directly with taxpayers in service and enforcement matters. However, in light of the importance of the filing season, we would generally not offer buyouts in campus operations. We are keeping a close watch on the situation in Congress and will respond accordingly.

We recognize there will be a lot of questions, and we will make sure you have all of the information you need. More details will be coming early next week. In addition, we are continuing to work with Colleen Kelley and NTEU on the roll-out of the VERA / VSIP offers.

The IRS has weathered many down budgets and workforce challenges over the years. Those who have been in the Service for a while know that we have a tradition of doing everything we can to minimize involuntary workforce restructuring.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

October 17, 2011

The Honorable John Lewis
Ranking Member, Oversight Subcommittee
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Lewis:

In recent years, your committee has had an interest in IRS core operations, including our management of tax filing season, taxpayer service, and the enforcement of the nation's tax laws. I write to update you on the effects to the IRS and taxpayers if the budget cuts voted out of the House and Senate Appropriations Committees were ultimately enacted.

I recognize the fiscal challenges facing the nation and am committed to continuing to look for savings in IRS operations where we can improve efficiency without cutting into core taxpayer service and front-line enforcement. To that end, over the last several years the IRS has maintained a disciplined focus on identifying cost-effective solutions in order to maximize IRS productivity. For example, through our focused efforts to increase electronic filing of tax returns, we have cut the number of tax return processing sites in half–from ten to five. Through this effort and other targeted efficiency programs, we have generated hundreds of millions of dollars in savings.

However, cuts of the magnitude contemplated in the current appropriations bills (approximately $525 million from core IRS accounts in the Senate bill and $650 million in the House bill) would lead to noticeable degradation of both service and enforcement and would have a serious detrimental impact on voluntary compliance for years to come.

Although the current Continuing Resolution, set to expire November 18, sets funding for IRS at levels 1.5 percent below fiscal year 2011, the full-year cuts currently being contemplated are so substantial that we have no choice but to immediately reduce our spending run rate (above and beyond the aggressive efficiency initiatives already planned). The operational realities of the federal budget process do not allow us to wait for a final FY 2012 budget because if we did, we would not have enough time left in the year to make the spending cuts that could be required.

executing a budget with the reductions of the magnitude recommended by the Appropriations Committees. Of course, I respect the Congress's prerogative to set funding for the IRS as it sees fit, but higher funding levels for the IRS would also help reduce the deficit. I note that the Administration has proposed a program integrity initiative for the Joint Select Committee on Deficit Reduction's consideration.

You have my commitment that the men and women of the IRS will work hard to mitigate any damage to the tax system and will continue to serve the nation proudly.

I am also writing to the Chairman and Ranking Member of the House Ways and Means Committee (and the Chairman of the Oversight Subcommittee) and the Chairwoman and Ranking Member of the House Appropriations Financial Services Subcommittee, as well as to the Chairmen and Ranking Members of the Senate Committee on Finance and the Senate Appropriations Financial Services Subcommittee. Please call me if you would like to discuss this matter further or have your staff call Floyd Williams, Director, Legislative Affairs, at (202) 622-4725.

Sincerely,

Douglas H. Shulman

Mr. LEWIS. Mr. Inspector General, in your testimony before this Subcommittee in September, you stated that the Service had limited resources to examine claims after energy tax credits had been paid. Does this statement apply to the health care tax credit?

Mr. GEORGE. It does, sir. I mean the IRS—one of the previous commissioners of the IRS used to use a formula of customer service plus enforcement equals compliance. And that theory still exists today. That concept, I believe, is still accurate now. For the IRS, it is almost a zero-sum gain. They have limited resources. They have to make a determination as to whether they are going to focus on this aspect of their responsibilities or that aspect. So, whether it is customer service, or whether it is enforcement.

And so, yes. Unless there are additional resources, a cut in their appropriations would adversely impact their ability to do their job.

Mr. LEWIS. Thank you. Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the Ranking Member. Ms. Black.

Ms. BLACK. Thank you, Mr. Chairman. And I want to go back to the issue of the supporting documents. The chairman started to explore the documentations with the PEOs. But while many credits do not require supporting documentation to be submitted to the IRS, the small business tax credit appears to be especially complicated. And despite the fact of this complication, what, I think 8 pages that they need to fill out since $435 million in credits have already been claimed, and the IRS does not require filers for the small business tax credit to provide documentation to support their claims.

Would additional documentations—this question is for you, Ms. Ingram—do you believe that additional documentation would help the IRS to administer the credit and prevent any erroneous payments?

Ms. INGRAM. Well, Congresswoman, we're always looking for ways to prevent or reduce erroneous payments. It is important to remember about this credit that the credit that is available to small businesses is one of many credits that fall into the general business credit category. And those are not refundable credits. And we do not ask for attached documentation in most instances. And compliance is generally quite high.

Where we are worried, particularly on the refundable credit side, we sometimes do ask for additional documentation. We did that with the adoption credit this year, because of the timing of having—when we could implement that.

On the refundable side of this credit, which is what the tax-exempt organization small employer could get, we have not asked for additional documentation but we have put in additional filters that are particularly suitable for a refundable credit. So on the—where the risks are higher with refundable credits. And we do freeze those refunds and correspond, as needed, with that taxpayer.

But more than 95 percent of the credits claimed—at least as far as we can tell at this point—are being claimed by the taxable small employers, and that is one of the many credits that goes into the general business credit.

Ms. BLACK. So you don't feel that you need any legislative authority to go further with any additional documentation. You have all the authority you need right now, if you see that there is a need for additional documentation?

Ms. INGRAM. I think we have—yes, I think we have the authority if we wanted to ask for more documentation. But we are also very mindful that additional documentation, in connection with the return itself, changes the dynamics around electronic filing, it can add burden to the compliant taxpayer.

And so we try to use that very carefully, particularly when we don't have information that shows that we have a real compliance problem, or where it is the type of credit or the type of refundable credit that might indicate a higher risk, and the need to do that. So, we try to balance those, those things.

Ms. BLACK. Mr. George, could you also weigh in?

Mr. GEORGE. Yes, thank you. As you are well aware, refundable credits are available to people, even—whether or not they have a tax obligation. And as Ms. Ingram indicated, it is the tax-exempt community in this instance that has access to this credit on a refundable basis.

We have estimated that there are over $36.4 million in refundable credits that have been requested thus far, using this credit, and that overall, the non-business, so the non-refundable credits, are at around $379 million.

I believe that additional information can be helpful, if it is used. The IRS requests a lot of information that it does not necessarily utilize. And so I share Ms. Ingram's concern about overburdening taxpayers unnecessarily. But at the same time, again, any information that can help stem inappropriate requests, improper requests for the credit, that—will help the IRS better do their jobs.

Ms. BLACK. Thank you. I yield back my time.

Chairman BOUSTANY. Mr. Becerra, you are recognized.

Mr. BECERRA. Thank you, Mr. Chairman. And to the two of you, thank you very much for the update on the information.

We could get very technical sometimes, and when you go into the weeds you lose a lot of folks. But at the end of the day, what we are talking about is trying to figure out how to make a tax credit that is going to small businesses who offer health care to the employees work. And we need to get the information out there, because it is a new tax credit. These small businesses that have been filing taxes didn't have this before. Many small businesses are making decisions on whether or not to offer to their employees health insurance to begin with. And sometimes these small businesses are trying to file their taxes without a lot of professional help, because it is expensive to get professional help.

And so, it is good that we are doing a hearing. But Commissioner Ingram, as we have just heard, we can't make—or can't reach—conclusions yet without all the information to know how it is working best, where we can make changes. And I think, Mr. George, you would agree that once we have the full set of data that help us understand how this credit has worked so far, you can then come back to us and really give us some concrete ideas of how to make it work best.

This, at the end, is a bridge. This tax credit is a bridge to get us to the point in 2014 when we have the full implementation of the historic health care reform, so that small businesses will be able to offer to their employees real health insurance.

Now, I just wanted to check on something. Small businesses are paying, on average, for health insurance for their employees, for an individual employee, something in the order of $5,300 a year. And if that employee has a family, and if the business offers an insurance policy for the family, it is about $14,000 a year. That is a chunk of money that a small businessman or woman who is trying to survive a business is making, in terms of a commitment to his or her employees.

And I think all of us applaud a small business man or woman who figures out a way not only to make a profit, but at the same time to offer decent affordable health care to their employees. So this tax credit, which gives them some assistance to be able to offer that, or to keep offering that health insurance, is something we should try to really make work well. And so we thank you for your testimony.

But my concern is this. And, Commissioner Ingram, you know this directly, because you work in the IRS under the Commissioner. If the Commissioner is sending us a letter essentially saying, "The budgets you are sending us don't give us a chance to do the outreach, don't give us a chance to do the enforcement"—sometimes the enforcement brings to the American taxpayer savings of $7 on every dollar of enforcement we spend, because we are able to go after the tax cheats and so forth—that we do more harm for programs like this tax credit if we don't give you the ability—which I think Inspector General George would agree is necessary for you—to police the activity of this new tax credit.

And so, let me paraphrase what the Commissioner said in a letter recently to Congress. Cuts of the magnitude in their budget contemplated in the current appropriations bills would lead to noticeable degradation of both services and enforcement, and would have a serious detrimental impact on voluntary compliance for years to come. He goes on to give some specific examples of how this would hurt small businesses if we don't provide the IRS the funding it needs to do its work properly.

And so, I hope what you will do is let us know what resources you need, one, to make the credit less complicated; two, to do effective outreach to make the credit work for those small business men and women; and three, let us know what resources you need to not have this impact the work that you have to do not just on this tax credit for small businesses, but for everything else you have to do to make sure that those who are willing to voluntarily comply with the Tax Code do so in a way that isn't harmful to them.

It is hard for me to ask you a lot of questions, because the data you have is incomplete. But I do appreciate that you are willing to give us an update, and point out some of the areas where we can try to help you make this work. But I would hope that what we don't do is make it harder for a business that right now is willing to offer health insurance to its employees at a time when times are so tough. We make it more difficult for them to take advantage of a tax credit that was meant to help them offer to American people who are working a chance to get decent, affordable health care.

And so, I appreciate your being here. I look forward to hearing from you again, once we have the complete data and can make some real judgements about the program.

So I thank you, Mr. Chairman, for holding this hearing, and I thank the witnesses for having been here.

Chairman BOUSTANY. Thank you, Mr. Becerra. Ms. Jenkins.

Ms. JENKINS. Thank you, Mr. Chairman. Thank you for holding this hearing, and thank you both for being here.

Proponents of the tax credit claim that it has been designed to provide an incentive to small businesses to offer health insurance to their employees. However, according to the Small Business Administration report released in September, this credit will primarily benefit those businesses that already offer health insurance.

So, for both of you, from your experience with this credit, is there data available that could tell us whether the tax credit is being used by small businesses that otherwise have not offered health care? And do you have any data on the amount of small businesses—those with 10 or fewer employees—that offer health insurance coverage to their employees?

Mr. GEORGE. Actually, I do not at this time, Ms. Jenkins, have that information.

Ms. INGRAM. At the IRS we don't have a good way of knowing who already offers health insurance. So the data question isn't one that we can really help you with at this point.

I think the key is when we go out and we ask people what their experience was in the first filing cycle, one of the things they mention is that because the act was passed in March, or toward the end of March, that many of them had already locked in to their health care decisions, because they tend to make—in the industry they tend to have calendar-year health packages for their employees if they have health care.

So, what we have been told by small businessmen is that even if they don't have health coverage today they will consider it. But we don't' have any data that would be responsive to your question.

Ms. JENKINS. Okay. Well, thank you. If data becomes available, I hope you will share it with us.

And Commissioner Ingram, the IRS agreed with TIGTA that the use of professional employer organizations pose a problem with regard to the small business tax credit, and it appears that this is a long-standing problem for the IRS. How do you intend to address the problem with regards to this credit?

And, given that it is really not a new problem, are you confident you can resolve the issue so that the IRS can properly link employers and their employees?

Ms. INGRAM. Well, Congresswoman, I always get a little nervous about getting too specific about methodology of finding problems, because I don't wish to give anybody any ideas. But in the conversations with the inspector general's team, and in the suggestions made in some recent reports as well as in this one, we are looking closely at what we could do administratively to make the kind of connections and the kind of crosswalks that Mr. George has mentioned.

There are a lot of ideas, and we are working through the logistics of each one. I would say most of them cost money, and we need to do it efficiently. And we also, as I mentioned before, need to do it in a way that doesn't throw taxpayers who have no problem into a filtering system that creates work for them.

So, I think there are some things we can do. We are working on the logistics and the ideas that we continue to throw back and forth between our teams.

Ms. JENKINS. Okay, thank you. Inspector General George, this hearing was designed, I think, to highlight the complexity of the tax credit as a key factor as to why small businesses maybe have not raced to embrace the credit. This is despite TIGTA's findings that the IRS made extensive efforts to implement the credit. And I think our next panel, we are going to hear from small business men and women about the burdens that they are dealing with.

But I am just curious, Mr. George. This tax credit also puts an administrative burden on already scarce resources for the IRS. So can you elaborate on the amount of time and effort the IRS has devoted to administrating this credit, and if you have any ideas on what we can do to simplify it?

Mr. GEORGE. Yes. I would just simply elaborate on a point that I embraced earlier. When I made reference to the IRS expending $1 million trying to alert people as to the availability of the credit, that $1 million was spent simply on sending 4.4 million postcards to taxpayers. So that was just the start of this.

Again, they have requested almost $25 million in the most recent appropriations to help implement this credit. And I would simply note also again—this goes back to an earlier point that you raised—the IRS did a lot of focus groups. They did good outreach to people. And a lot of the responses that they received was that this is such a complicated credit in which to implement, that a lot of their customers were uncertain as to whether the cost benefit analysis really paid off for them.

Ms. JENKINS. Just to clarify, so have we requested nearly $25 million to implement a credit that in 2010 was supposed to cost $2 billion?

Mr. GEORGE. That is my understanding, but I think I would defer to Commissioner Ingram for the exact figure.

Ms. INGRAM. The President's proposed budget had about $24 million—something like that—in it, which was requested in order to work on the examinations coming out of the first cycle, as well as to work with the second cycle of filings. It also was to cover the work around the adoption credit which, as I mentioned earlier to Congresswoman Black, was—did involve additional documentation and a much different process.

Ms. JENKINS. Okay, thank you. I yield back.

Chairman BOUSTANY. Dr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. I am pleased that we are having a hearing, but I am not quite sure of the value of it, because I learned very early—I think it was in geometry in about sixth grade—that with one point you can't draw a line. You have to have two points or three points or four points. And the only points we have are 228,000 and then 309,000, which looks like things are going up. So I think that it means that more people are taking advantage of this.

But what I am struggling with is trying to figure out how do you get a credit like this known by the small business people in this country. These are people with 25 or less employees and their employees are paid less than $50,000, on average. And they are struggling to keep it together in the worst economy in years. And so they get a card.

Now, I don't know how many people have ever received a card from the Federal government that they didn't pay total attention to. Or, how many of you received a political brief from somebody on a card that you didn't pay total attention to? But you send out four million cards.

Now, I understand that you sent them to businesses under 25 employees, and average salaries of less than 50,000. But you had no data about who had or who was offering health insurance. Is that correct?

Ms. INGRAM. That is correct.

Mr. MCDERMOTT. So, a tax credit aimed at people who are offering a tax credit, and one that is in the middle of a year, they are going to get a card in July. People are saying, "What am I getting a card in the IRS in July about?" Because this says something about tax credits. "I am not filing until January," or whatever.

Give me a better design to get it to the people who would benefit from it. Because it defies my understanding of why somebody wouldn't want to figure it out if they could save money, if they could get 35 percent back of their premiums that they have paid, why wouldn't they apply for that?

I mean what should have been done to make it better? How would you make it simpler—help us.

Mr. GEORGE. Well, Mr.—if I may?

Ms. INGRAM. Go ahead.

Mr. GEORGE. Thank you. The community which, for the most part, would take advantage and be involved in this credit is such that they most likely would use tax preparers. And so, it would have behooved the IRS to focus their efforts on reaching out to tax preparers, the tax preparer community, and they have done that.

But, that focus, whether it is through the national tax annual programs they put around the country, or through more directed mail to groups that represent tax practitioners—the National Association of Tax Preparers and the like—to help spread the word, there could have been much more of a targeted approach here, I think, that would have helped address the question you are raising.

Ms. INGRAM. Yes. I think that one reason we turn to the postcards, any time there is a new piece of legislation and—that is immediately effective, and we are worrying about how do people, A, know about it in the first place, and then who is—who needs to know detailed information about it and how to do it, and so forth, we have tended in the small business community to look at—the small businesses need to be aware, but they tend to turn to their practitioners and advisors to solve it for them. So, we have received anecdotes of practitioners telling us, "Yes, my client brought me the postcard."

So we tried to do a two-prong track during 2010 to get both of those needs addressed, both awareness and the professional ability to assist their clients in figuring out what they wanted to do as a business. Because some of those decisions needed to happen during that year, we were anxious to do that outreach ahead of what we might normally do with the filing season cycles, and that is why we acted——

Mr. MCDERMOTT. Okay. So in about a month or 2 months, we are going to start a new filing season. And all the filers, now all the preparers, will have had 2 years to know this exists. Is that correct?

Ms. INGRAM. They have been through one cycle and be starting their second cycle.

Mr. MCDERMOTT. They will be starting their second cycle. And they will have had at least one notice from you. Have they had any further notices about the fact that this tax credit exists?

Ms. INGRAM. We haven't done direct mailings of the same kind, but we have tried to be very visible out at conferences and programs. We have tried to do cost-effective tools like webinars for busy practitioners and small business men who have trouble taking time away to go to a conference, and we have tried to increase the kinds of materials from alert flyers, all the way to how-to kits that are available for practitioners to use themselves or with their clients.

This evolution of the materials that we have been developing and the outreach we have been doing is very much in response to the feedback discussions that we have had with small businesses themselves, as well as with the practitioner groups.

So the advice that we have received, consistent with what Mr. George said, was, having done the awareness to a certain point, to turn to the professional channels and focus on tax practitioners, those assisting businessmen in decisions around insurance products, and the software industry, to see if through tools like different software or different return filing mechanisms, things could be made more clear and easier for the businesses themselves.

So, that is our shift from the first filing cycle to the second filing cycle to try to reach the right people and leverage that.

Mr. MCDERMOTT. So we need another hearing at another time to find out the results of your efforts.

Ms. INGRAM. Whenever you would like to ask me to come, sir.

Mr. MCDERMOTT. Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman. Mr. Marchant.

Mr. MARCHANT. Thank you, Mr. Chairman. We are all going through tough economic times now. We are trying to reduce the Federal budget, the spending cuts. That is what we have been sent to Washington to do. In these hard economic times, all of the government has to find a way to work more efficiently. And the IRS will be no exception.

What is the IRS doing on trying to stop fraud on this particular credit that is being requested? Ms. Ingram.

Ms. INGRAM. We have a two-prong approach, sir, on this credit. One is designed around the non-refundable credit, the one that is going to more than 95 percent of the people claiming the credit, the business side, and an augmented methodology that we are using on the refundable credit side with the small exempt organizations or employers.

All the returns go through certain kinds of checks that are the same for both groups. And these involve filters and checks that are a comprehensive set developed based on all of our experience with other kinds of credits, including advice that we received from people like TIGTA and GAO.

And then, on the refundable side, we add certain additional filters that might be particular to that type of community, that type of group, because those—with the refundable side, we are pulling before payment is made.

Mr. MARCHANT. Yes, sir.

Mr. GEORGE. Mr. Marchant, if I may, again, while they are doing yeoman's work in certain areas, this is an Achilles heel for the Internal Revenue Service. If they don't address problems—and especially in the refundable credit area—at the outset, during the processing of it, the moment the credit goes out the door it changes the dynamic of the situation entirely, in that it costs much more to try to recover dollars that have already been sent out the door than it would to prevent them from going out in the first place.

And so, again, while this is a tax policy issue, and we touched on this earlier, if they could buttress up their math error authority policies in both this area and elsewhere, that would allow them to prevent—make corrections to tax forms before they go out, as opposed to having to subsequently audit and/or reach out to organizations and individuals who inadvertently received or erroneously received tax credits.

Mr. MARCHANT. With the time I have left, the biggest concern I have about this tax credit was when the Administration was selling this affordable health care act to the public, millions of small businesses heard the message that they were going to get a tax credit, they were going to benefit if they provided health care for their employees. Yet when we are given an explanation of this tax credit and given this chart, I don't know of a small business in my district that would look at this chart and say that this is a simple tax credit.

And my biggest concern is that the compliance, the cost that it would take for a small business to employ an accountant to simply navigate through this chart and navigate through the qualifications, in many cases, would far outstrip any savings that they would get from the credit. So I think it is a testament to the complexity of this, the Code, to say that 4.4 million people were told, "You might qualify by it," and 309,000 claimed it.

Do you—have you figured out what the average tax credit issued to an applicant that takes advantage of it is, Ms. Ingram?

Ms. INGRAM. I tend to be somewhat allergic to raw data, but it is several thousand. And it depends very much on the situation of that small business. I have heard from small businesses that they received 5,000, and I have heard from small businesses that it has been smaller. So it very much depends on where they land, in terms of their size and the kinds of premiums that they pay.

Mr. MARCHANT. Thank you very much.

Chairman BOUSTANY. Mr. Paulsen.

Mr. PAULSEN. Thank you, Mr. Chairman. And thanks for holding this hearing. It is pretty clear from some of the discussion testimony this morning that you have a tax credit that small businesses were probably primarily hoping to take advantage of, and it is obviously the folks that are taking advantage of it or using it is substantially lower, or significantly lower—surprisingly lower—than was ever expected, about 8 percent of those that are eligible.

I know we are going to hear from some folks in the next panel that will be able to talk a little bit about why that might be the case, but I want to dive a little bit deeper. And I assume a lot of it is about the complexity, but I do want to follow up a little bit and ask this question. Because it does seem that it is the burden perspective that is one of the reasons why companies are not participating in it.

And I just—I remember I spoke to one small manufacturing company in my district about health care in particular, and to its credit this company does provide health insurance for its employees. And like many companies, this company is seeing its health insurance rates go up. But I think the reaction that I heard from the leaders that I talked with at the company when they say, "Look, we are covering our health care costs, we wish Congress would address the cost issue, but we are not going to participate in any of the potential benefits in the new health care law, because we are not convinced it is worth the time and the effort to participate in these potential benefits."

And so, I mean that is of concern. I think it adds to the whole factor of uncertainty and how companies are investing in their people and in their equipment in the down economy.

But let me do this. Let me ask this question, because we talked a little bit about fraud and accuracy. I want to dive a little bit deeper. Mr. George, in the report on the IRS efforts to implement the small business tax credit, you discuss the problems with tracking employees when employers are using these professional employer organizations. Can you explain a little bit about exactly what the problem is in regard to the credit, and how the IRS can fix the problem for—when these organizations are actually used?

Mr. GEORGE. Yes. One of the points that I raised earlier was simply having the IRS have the ability to cross-check the Employee Identification Number between the PEO, the Professional Employer Organization, and the entity which they are representing.

Now, I don't know whether or not the commissioner thinks that the IRS needs legislation in order to accomplish that. But again, we recommended that over 2 years ago in a report that related to this.

Going back to your point about complexity, sir, what we have found in our study of this matter is that the taxpayer, in order to take advantage of this, has to determine which employees may be counted for credit purposes, what constitutes a qualifying arrangement, determining the number of FTEs for the purposes of the credit, determining the annual wages for purposes of the credit. The premium payments for purposes of the credit are capped, so they have to make sure that they don't exceed that. The phasing out of the credit, if the number of FTEs exceeds 10, and the average amount of wages exceeds $25,000, as you pointed out, and then the effect that state and local credits have on the overall issue. I mean that is a factor that needs to be taken into consideration.

So, I know there—this is an extraordinarily difficult credit to implement. Very few people would be able to do it without the help of professional preparers. But I will, again, yield to the commissioner.

Mr. PAULSEN. Well, and let me just—because it sounds like, okay, there is complexity, obviously. But if the math is correct on the form, the company could be complying from the math perspective but there could be erroneous—not fraud, potentially, but erroneous reporting based on these professional service organizations that may be employing the individuals, rather than the true small business.

And so, I mean, how do you get away from doing an actual audit? You know, Ms. Ingram, Commissioner Ingram, how do you get away from doing an actual audit? Does the IRS plan to audit more companies, more businesses? And, in particular, now that tax-exempt entities are eligible for this credit taken against income, which has not been a practice in the past, from what I understand, with other credits, I mean, does the IRS plan to audit and increase audits for tax-exempt entities?

Ms. INGRAM. Well, one of the interesting things on the tax-exempt entity side is, because that is a refundable credit and we have additional filters involved, we have been very interested in what kinds of folks are getting kicked out by those filters.

And so, learning from the profile, the demographics of which organizations seem to be hitting filters on that side has been important for us to monitor and to figure out how to tweak or cross-check those filters to make sure that we are getting the folks who do appear to have a reason that we should correspond with them prior to payment, and those which are getting caught up, and which we could resolve without contact.

A good example would be—is if you were going to check certain databases about an exempt organization, you might find that a church that has no requirement to apply to be exempt, nor a requirement under the statute to file an annual return, might get kicked out and yet is filing an employment tax return and has the right range of employees and wages.

So, that is a good example of kick-outs where we want to look at what is getting kicked out, and make sure that we are calibrating it to fit what really needs to be pursued——

Mr. PAULSEN. And, Commissioner, I know my time is just out. But can you just tell me, so does the IRS intend to do increased audits of tax-exempt entities as a part of this now?

Ms. INGRAM. If a tax-exempt entity has claimed a credit that we can't be comfortable with, we will correspond with them prior to payment.

Chairman BOUSTANY. Mr. Kind.

Mr. KIND. Thank you, Mr. Chairman. I appreciate you holding this important hearing. Hopefully, we will have another opportunity at some point to reconvene and have another hearing and an update because I think, in a lot of respects, it is a little premature. Obviously, the credit didn't take effect until last year. The Affordable Care Act didn't pass until March of last year. We are still waiting to see all the small business filings coming in, and the impact, who is going to take the credit. So, in some respects, it is a little bit premature.

But let's get to the complexity a little bit, because I think we all have a shared goal. When you take a look at the number of uninsured individuals in this country, the vast majority of them are working people in small businesses. In fact, for small businesses the size of three to nine employees, less than half of them are offering health care coverage for their employees today.

So, if we are going to be serious at all about trying to attack the number of uninsured, you have to do something to deal with small businesses to make it more affordable. And that is why, in previous years, there has always been bipartisan support for providing tax relief to small businesses and providing health care coverage for their employees. That is what we are trying to attempt here.

Now, if there is a problem with complexity, let's address that and come up with some recommendations on what we can do to tighten it up and make it less complex. That is what I hope we can try to accomplish at a hearing and the feedback that we are getting.

But, Mr. George, based on your study and analysis of the credit so far, have you offered any recommendations on how to simplify the tax credit to deal with the complexity that is out there right now?

Mr. GEORGE. Again, it is the Secretary of the Treasury that has delegated substantive tax policy to the Office of Tax Policy. And so, I am not here to advocate any particular——

Mr. KIND. Right.

Mr. GEORGE [continuing]. Substantive tax policy. That said, something as simple, again, as math error authority, expanding it——

Mr. KIND. Sure.

Mr. GEORGE [continuing]. So that—to keep the IRS from having to send out money when they know there is a problem, and yet they don't have the authority to keep that money from going out, which would be a simple solution to this.

Mr. KIND. I am talking from the employer's point of view, trying to simplify so that it is easier for them to take advantage of the tax credit.

Mr. GEORGE. Well, when you——

Mr. KIND. Are there any recommendations that you have there?

Mr. GEORGE. Well——

Mr. KIND. Ms. Ingram, has IRS been looking at this at all, as far as steps that we could take to try to simplify it, or can IRS do it on your own?

Ms. INGRAM. I think that what we have to do, from our perspective, is look at whether we can simplify forms, simplify instructions, get better how-to kits in people's hands, help them with decision trees to reduce the number of questions they need to ask themselves.

Many of the portions of the provision are getting at more complicated business arrangements, and not everybody needs to——

Mr. KIND. Right. Well, Ms. Ingram, just for the sake of clarification now, it is not mandatory that a taxpayer complete the worksheets and the instructions in order to claim the tax credit. Is that right?

Ms. INGRAM. Absolutely.

Mr. KIND. Now, just so I am clear—and I have my own calculator on my website for small businesses to plug in information to see what they could qualify for under the tax credit—check me if I am wrong, but is it basically three pieces of information a small businesses owner is going to need or provide the accountant in order to take advantage of the tax credit? One, individuals considered as employees; two, employee hours of service; and three, employee wages paid. Are those basically the three criteria that they are going to need to plug in, in order to determine their tax credit under this?

Ms. INGRAM. That is where most of the math questions are, yes. They do need to make sure that the insurance they are providing and the employer's share of the contribution also meets the rules.

Mr. KIND. And that is the 50 percent rule.

Ms. INGRAM. Yes.

Mr. KIND. And most states, like Wisconsin, already require that at the state level. So, that is not a problem. I mean that is something that already applies.

But those are basically it. And I can't think of a small business owner who wouldn't know that data or those facts that they could just plug in. Otherwise, your business probably isn't going to be open very much. If you don't know how many employees you have, how much you are paying them, and how many hours they are working, there is a problem, I think.

Am I missing something here? Is it more complicated than that?

Ms. INGRAM. I think the thing that we have been trying to listen to when we talk to stakeholders and small businesses and advisors is to try to hear where they would like assistance, where we could make it simpler, where we could say, "Answer these couple of questions, and if the answer is yes for each of them, go straight to"——

Mr. KIND. And the only reason you see a chart like this is just to score cheap political points and to confuse people. I mean realistically, this is what this is all about. But do you know, Ms. Ingram, how many small business owners that are filing taxes have a paid preparer, professional preparer, doing it for them?

Ms. INGRAM. I don't have the exact statistic, but it is high.

Mr. KIND. It is pretty——

Ms. INGRAM. It is high.

Mr. KIND [continuing]. Pretty high number. Right.

Ms. INGRAM. Yes.

Mr. KIND. And they are the ones who are supposed to have the expertise in being able to take advantage of all the credits, all the deductions that small business owners can claim anyway. Is that right?

Ms. INGRAM. Yes, it is why we are shifting our strategy for outreach for the next cycle, to include the——

Mr. KIND. Professional preparers.

Ms. INGRAM [continuing]. Tax preparation industry, the electronic industry, to see what they can also do.

Mr. KIND. Great. Thank you. Thank you, Mr. Chairman.

Chairman BOUSTANY. Mr. Reed.

Mr. REED. Thank you, Mr. Chairman. Mr. George, your point was very well taken about chasing the money once it is already out the door. That is a very practical point. Coming from a small business world, I know exactly what that issue relates to.

So, my question actually is to Ms. Ingram. You talk about the filters as being kind of a primary tool—if I am hearing your testimony correctly—the filters being the primary tool to prevent that from occurring. Can you just articulate what are you—what kind of filters are you deploying? How are you determining those? What are you—how does that process work?

Ms. INGRAM. I will try to be responsive, but again I am going to be a little cautious about specificity.

But the—for all returns we do a certain number of layers of validating the return itself, of looking for basic indicators of fraud that might be, for example, of interest to our criminal investigation unit. So there is sort of the basic process that returns go through.

In addition, we have a set of filters that are designed around cross-checking secondary information inside the service, information that we would not be able to use the ordinary type of math error to address. And, depending on whether it is refundable or non-refundable—because historically, the risks are quite different in our experience—we either use the additional filters to kick out any real outliers immediately, but otherwise to identify cases in which we would like to correspond, even if the return is processed first. Whereas, on the refundable credit side, we do all of that before any dollars leave the house.

Mr. REED. Okay. And then, so what kind of success rate are you demonstrating with utilizing those filters, for example, on this credit? How are you—what is the metric that you are using in the agency to determine whether the filters are working or not?

Ms. INGRAM. Well, we do that a couple of ways. And really telling how well they are working here is going to take a little bit of time.

One of the things we looked at in designing our program was the work that we had done around the COBRA issue a couple of years ago. And GAO actually came in and looked at our filters there, threw some fake test cases at us, which we caught all of. So we thought we had a pretty good methodology developed through that experience, thought we had gotten some good advice in that case from GAO. And so we took a similar approach here.

In the general business credit area, as I mentioned before, we are just not seeing the big issues in the early kick-outs in this return, in this issue.

Mr. REED. Okay. So then, beyond filters, what other tools are being utilized to make sure that it is being monitored appropriately?

Ms. INGRAM. Well, the filters are particularly good for up-front identification, and the trick always is to get the filters right, feedback from our own observations, as well as from our oversight bodies.

The other thing is to check on whether the filters are effective is also to sample and look at some returns, some of which went through filters and some of which did not kick out. There are various ways in which we try to look at sort of control groups—I don't know what you want to call that—to see what is being caught and what didn't get caught.

Mr. REED. Okay. Mr. George, did you have any additional information on that?

Mr. GEORGE. Again, I am repeating from my oral statement—the IRS does have a program to attempt to identify taxpayers who don't file employment tax returns, and yet might still be able to have this legitimately paid by a PEO, the Professional Employer Organization. But the IRS truly can't tell the difference between whether or not the PEO had the responsibility to comply with this, or that the employer does.

And so, when it is something that basic that they still can't determine, it is troubling. It is problematic, and I think would lead to more difficultly.

Mr. REED. And that is a great point, because that would be—that would seem to me to be a very simple check. If you are doing the payroll tax and you are filing that, that you would match that up with the provider. What is the barrier to that? What am I missing?

And that seems like a very simple—Ms. Ingram, what am I missing, why that doesn't match up with each other?

Ms. INGRAM. I think the issue is if one of our filters for the small business is to compare their information about this credit with their employment tax filings, and if they have hired a firm to do that for them, the information may be in the system under two different employer identification numbers, and it is the connection that Mr. George is referring to.

Mr. REED. So how do we fix that? How do we fix that, Mr. George?

Mr. GEORGE. Their computer systems need to be updated. There is no question about that. That would seem like low-hanging fruit, but it depends on the resources available to them, and their priorities.

Mr. REED. All right. My time is up. Thank you, Mr. Chairman. I yield back.

Chairman BOUSTANY. I thank the gentleman. Inspector General George and Commissioner Ingram, we thank you both for being here today and for testifying in front of the Subcommittee. Please be advised that Members may have written questions they would like to submit to you, and we would ask that you respond to those, and they will be made part of the official hearing record.

And with that, we will conclude our first panel. Thank you.

Mr. GEORGE. Thank you, Mr. Chairman.

Ms. INGRAM. Thank you, Mr. Chairman.

Chairman BOUSTANY. I will ask the second panel to come up and take their seats.

I would like to welcome our second panel. We have Ms. Patricia Thompson, who is with the American Institute of Certified Public Accountants, and is chair of its tax executive committee. We have Mr. Todd McCracken, who is the president of the National Small Business Association. And Mr. Hisel is co-director of Home Resource. I want to thank you all for being here today to testify in front of the Subcommittee.

You will each have 5 minutes to present your oral testimony, with your full written statement being made a part of the official record. And, Ms. Thompson, we will begin with you.

STATEMENT OF PATRICIA THOMPSON, CHAIR, AICPA TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC

Ms. THOMPSON. Good morning, Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee. My name is Patricia Thompson, I am a CPA and chair of the AICPA tax executive committee. I am also the tax partner at a small CPA firm in Rhode Island. And I would like to thank the Subcommittee for the opportunity to appear at today's hearing.

This credit was designed to encourage small businesses and small tax-exempt organizations to offer health insurance to their employees for the first time, or help them afford coverage they already have. The AICPA does not have a position supporting or opposing this incentive. My testimony today is based on our members' experiences with working with small businesses, and will focus on the technical aspects of the credit, and address how they can be improved to make the exercise of the tax credit simpler and more transparent.

The AICPA has a long-standing tradition of advocating for sound tax policy. The tax law should be simple, so that taxpayers can understand the rules and can comply with them correctly in a cost-efficient manner.

Transparency is an important partner with tax simplification. Transparency is the basic notion that taxpayers should know, namely, that a tax or a tax incentive exists, and how and when the tax incentive applies to them.

Based on our members' experiences working with small businesses, we believe there are a number of areas where the new code section 45–R could be made simpler. We 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 IRS should be complimented on providing guidance on the application of the credit, and also on informing taxpayers and tax professionals on the availability of the credit.

Since most small employers did not know until the end of the year or later, when their tax returns were prepared, whether or not they qualified for the credit, there was less incentive for them to provide health insurance coverage. Also, many of the variables, such as the number of full-time equivalents and the hours worked per employee are difficult to estimate early in the year. It was not very helpful for most employers with 10 or more employees to begin testing eligibility or potentially calculating the credit before the end of the year.

Many taxpayers found the credit to be quite complex, because the definitions of "eligible small employer," "full-time equivalent employees," and "employee" are not straightforward or consistent with other definitions in the Code. For example, the definition of "eligible small employer" was unique to this provision. The business was required to accumulate information sometimes not readily available, and perform several complex calculations before it knew whether or not the provision applied to them.

It is also necessary to evaluate each qualified health plan to determine if the employer makes sufficient non-elective contribution on behalf of each employee, as well as determining the premiums eligible for the credit.

Other complexities include the calculation of the number of full-time equivalent employees, and the phasing out of the credit, once an employer's full-time equivalent count exceeded 10, or its average annual wages exceeded $25,000. For small—some small employers, it was not uncommon this year for tax preparers to have spent a significant amount of time necessary to prepare an entire small business return, just on the credit calculation, only to find that the client did not qualify for the credit.

The AICPA believes the tax credit should be simplified. We suggest that you consider changing the definition of a small business to either base the definition on gross receipts or employee count from the prior year, or the average of the prior two years. Prior-year information would be readily available, allowing small businesses to calculate early in the year the tax savings for purchasing or continuing the health insurance.

We also suggest that the phase-out calculations for the employee count and the annual salary be eliminated. Phase-outs create difficulties in estimating an employer's benefit from purchasing or continuing to provide health insurance coverage. We appreciate your efforts in examining some of the difficulties that businesses face in navigating through the rules of this credit.

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

[The prepared statement of Ms. Thompson follows:]

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TESTIMONY BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON SMALL BUSINESS HEALTH INSURANCE TAX CREDIT
NOVEMBER 15, 2011

Good morning Chairman Boustany, Ranking Member Lewis and Members of the Subcommittee. My name is Patricia Thompson. I am a CPA and Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants ("AICPA"). My testimony today is based on our members' 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 the implementation and effectiveness of the small business health insurance tax credit.

The small business health insurance tax credit, enacted as part of the Patient Protection and Affordable Care Act[1], was designed to encourage small businesses and small tax exempt organizations to offer health insurance coverage to their employees for the first time or help them afford coverage they already have. The AICPA does not have a position supporting or opposing this tax incentive. However, in my testimony today, I plan to focus on the technical aspects of the credit and address specific provisions of the credit from complexity and transparency perspectives. I also will share real life examples of challenges small employers faced this year in either determining whether they were eligible for the credit or calculating the credit itself.

SOUND TAX POLICY

The AICPA has a longstanding tradition of advocating for sound tax policy. In that regard, the AICPA has developed tax policy concept statements and published material on fundamental tax reform. One significant guiding principle of good tax policy is simplicity. The tax law should be simple so that taxpayers can understand the rules and can comply with them correctly and in a cost-efficient manner. The guiding principles for tax simplification are:

(1) Seek simplest approaches. Once tax lawmakers identify desired tax policy or revenue objectives, the simplest and most transparent approaches to implementation should be sought.
(2) Minimize compliance burdens. Compliance costs, in terms of both time and money, should be minimized and should be commensurate with the resources and abilities of the affected taxpayers. Higher compliance costs may be appropriate for complex business and investment transactions, but not for small businesses and small tax exempt organizations.
(3) Reduce frequency of tax law change. Change in and of itself increases complexity in the short run, even if the change will produce long-term simplification. Tax laws should be changed only to address changes in revenue needs, to implement significant changes in tax policy, or to alleviate existing complexities and inconsistencies.

[1] Pub. L. No. 111-148, 124 Stat. 119 (2010).

(4) Use consistent concepts and definitions. Inconsistencies in legal concepts and definitions should be eliminated in existing law and avoided in the drafting of new laws.
(5) Consider administrative burdens. The ability of tax agencies to administer, provide guidance on, and enforce the law must be considered in the development of legislation and administrative guidance.
(6) Avoid limited applicability. Tax rules that apply to a limited set of taxpayers or for only a short period of time should be avoided.

Transparency, another guiding principle of good tax policy, is an important partner with tax simplification. Transparency is the basic notion that taxpayers should know, namely, (1) that a tax or tax incentive exists and (2) how and when the tax or tax incentive applies to them. The more complex a tax system is, the less transparent it tends to be. Complexity obscures how, when, and on whom a tax is imposed (or a tax incentive is available), which increases confusion, frustration, and the perception that the tax system is unfair. In addition, obscurity in the tax law may cause harm by making it difficult for taxpayers and their tax advisers to plan transactions and comply with the law. With regard to the health insurance tax credit, unintentional misstatements in the credit may result when the provision's applicability is not clear.

Listed below are the guiding principles for transparency:

(1) Make the promulgation of a good tax system a priority. Transparency is expected to achieve a fair tax law, improved compliance and a healthy economic environment.
(2) Implement transparent approaches. Taxpayers should be able to understand their true tax and have confidence in calculating their tax liability.

Increasing the transparency of the tax law should:

(1) Result in a system that is fairer, and is perceived by taxpayers as being fairer;
(2) Enhance the efficiency of administering the tax system;
(3) Increase taxpayer and tax practitioner certainty in tax planning and compliance;
(4) Reduce tax return error rates;
(5) Provide a stimulus for growth by making economic decision-making more efficient; and
(6) Reduce the direct and indirect costs of complying with and administering a complex and nontransparent tax system, freeing up resources for productive activities.

GENERAL COMMENTS

Based on our members' experiences working with small businesses, there are a number of areas in the new Internal Revenue Code (Code) section 45R – Employee health insurance expenses of small employers – where our simplicity and transparency principles are not followed. These areas warrant your attention in order to provide an effective incentive for small employers to provide health insurance coverage to their employees. We 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.

We understand a social objective has been identified – the need to reduce the number of uninsured individuals. Once this was identified, the simplest and most transparent approaches to implementation should have been sought. Small businesses, or their professional advisors, are increasingly spending more time preparing tax-related forms and schedules resulting in significant increases in cost for complying with the laws. Complex or multistep calculations should not be required. Tax recordkeeping should closely emulate normal business practices. The language used in definitions, explanations, and eligibility requirements should be understandable by the target group of taxpayers. Uncertainties and an inability to understand the tax laws should be avoided to reduce anxiety and frustration by taxpayers.

The small business health insurance tax credit was not viewed by most small employers as an incentive to provide health insurance coverage to their employees last year. In order for an incentive to be effective, taxpayers must know of its existence, know whether it applies to them and how it applies to them. Since most small employers did not know until the end of the year (or after the year ended when their income tax returns were prepared) whether or not they qualified for the credit, there was no incentive for them to provide health insurance coverage. Since many of the variables (such as, the number of full-time equivalent employees and the hours worked per employee) are difficult to estimate early in the year, it was pointless for employers or their tax practitioners to begin testing eligibility or potentially calculating the credit. Only in situations where the employer employed less than ten full-time employees did it make sense to evaluate, before the end of the year, the benefit of purchasing health insurance and taking advantage of the credit. The reason for this is explained in more detail below.

ISSUES ENCOUNTERED

The Internal Revenue Service ("IRS") should be complimented on providing guidance on the application of the credit and also on informing taxpayers and tax professionals on the availability of the credit. However, even with this guidance, many tax professionals and taxpayers found the credit to be quite complex. The complexity of the credit results from the various components of the credit as follows:

- Definitions used to determine eligibility for the credit. The definition of eligible small employer, full-time equivalent employees, average annual wages, and employee are not straightforward or consistent with other provisions of the Code.
- Definition of eligible small employer. An eligible small employer was based on the number of full-time equivalent employees (FTEs), the average annual wages and the health insurance arrangement in place. This definition was confusing and hard to apply. It is also inconsistent with the definition of small business used in various other Code sections. Examples of the definition of small business include the following:
    - Research credit for contract research expenses under Code section 41 defines a small business as any person if the annual average number of employees employed by that person during either of the two preceding calendar years was 500 or fewer.
    - Archer Medical Savings Account under Code section 220 defines the term as any employer if such employer employed an average of 50 or fewer employees on business days during either of the two preceding calendar years. The provision

continues to allow certain growing employers to retain treatment as small employer even though the average number of employees exceeds 50.

- Credit for pension plan startup costs under Code section 45E uses the same definition in Code section 408(p)(2)(i) which is any employer that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. Section 408(p)(2)(i) relates to employers eligible to use Savings Incentive Match Plan for Employees (SIMPLE) retirement accounts.
- The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) continuation requirements also provide a small employer exception. A small employer is one that normally employed fewer than 20 employees during the preceding year.

- Phase out of the credit based on number of employees and average annual wages. The credit is phased out once the full-time equivalent employee count exceeds ten and the average annual wages exceeds $25,000. The credit is completely eliminated when the employer has either 25 full-time equivalent employees or if the average annual wages exceeds $50,000. The full credit is allowed if the eligible small employer has ten or fewer full-time employees and the average annual wages do not exceed $25,000. These phase-outs made the credit difficult to apply and required numerous calculations before determining the amount of the credit available.
- Calculating the number of employees. A determination first has to be made as to which employees are counted. Self-employed business owners, more than 2% shareholders, 5% owners and these individuals' family members are not considered employees. Part-time employees and leased employees are eligible. Because the eligibility rules are based in part on the number of FTEs, not the number of employees, employers that use part-time workers may qualify even if they employ more than 25 individuals.
- Calculating the employee hours of service is needed to determine the number of FTEs. Often the number of annual hours worked by employee is not readily available especially for a fiscal year taxpayer. A detailed analysis of each employee's hours is needed to arrive at the actual hours required to meet this requirement. Hours in excess of 2,080 are not included. For employers that experience high turnover or hire seasonal workers, this requirement is particularly troublesome. IRS issued Notice 2010-44, Tax Credit for Employee Health Insurance Expenses of Small Employers, which provides guidance on how to determine the number of hours of service. The Notice provides three methods to determine the total number of hours of service as follows:
  - Determine actual hours of service from records of hours worked and hours for which payment is made or due (payment is made or due for vacation, holiday, illness, incapacity, etc.);
  - Use a days-worked equivalency whereby the employee is credited with eight hours of service for each day for which the employee would be required to be credited with at least one hour of service for services performed and for certain periods when no services are performed such as vacation; or
  - Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week for which the employee would be required to be credited with at least one hour of service for services performed and for certain periods when no services are performed such as vacation.

- Determining which qualified health plan offered by the small business is eligible for the credit. Each qualified health plan needs to be evaluated separately to determine if the eligible small employer makes non-elective contributions on behalf of each employee of a uniform percentage, but not below 50%, of the premium cost of the qualified health plan. Qualified health insurance plans include health insurance, dental or vision, long term care, Medicare supplemental health insurance among others. It is possible that some health plans are eligible while other plans are not.
- Determining whether or not the 50% coverage is met. For 2010, as long as the employer paid at least 50% of single coverage, the requirement was met even if the employer actually provided more expensive coverage, such as family coverage, and contributed less than 50% of the more expensive coverage.
- Determining the premiums eligible for the credit. The eligible premium is the smaller of the actual premium paid by the employer or the average premium for the small group market in which the employer offers health insurance coverage. The IRS provides the average premium for the small group market based on single and family coverage. Employers conducting business in multiple states are required, for each employee, to determine the premium by state and by type of coverage.
- Treating multiple employers as a single employer for purposes of this credit. Many small business employers may not have to be treated as a single employer for any other purposes of the Code resulting in a one-time calculation for purposes of this credit.

For many small employers, tax compliance costs were created without an offsetting benefit. As stated by one of my colleagues, "many times there was a lot of work for not a lot of return." It was not uncommon this year for tax preparers to have spent up to 20% of the time necessary to prepare an entire small business return just on the credit calculation, only to learn that the client did not qualify for the credit. As such, many small employers felt the entire process was a fruitless effort or wasted expense.

RECOMMENDATIONS

The AICPA recommends making tax simplification and transparency in regard to the small business health insurance tax credit a priority. Complexity is often overlooked in drafting legislation because negative impacts on the tax system are often less obvious to lawmakers trying to solve "today's" problems and only become apparent in the long run. Many tax professionals believe that legislation is needed to ensure the continued viability of the small business health insurance tax credit. We believe a simpler provision is possible and necessary to allow the credit to be used as an incentive for small employers to purchase health insurance or continue providing health insurance to its employees. Seeking a simpler approach to determine eligibility for the credit would minimize the small business taxpayers' compliance burden. Many small businesses find tax compliance challenging as they lack the resources to comply with the rules. Also, a taxpayer would more likely be able to determine the impact of purchasing health insurance for its employees. Based on the current legislation, there is no easy way to quickly evaluate whether or not a small business would be eligible for this credit. Qualification is based on FTEs and average compensation. A small business does not have these items readily available. An accumulation of information and complex calculations were required this year to determine if a credit would be available. Many times the small business, or most often their advisor, gathered all of the required information, ran through the calculations and determined they were not eligible, or were only partially eligible, for the credit because of the average annual wages paid to their employees or the employee count.

The AICPA recommends that you consider changing the definition of a small business to either base the definition on gross receipts or employee count from the prior year or the average of the prior two years, or increase the full time equivalent employee count number. Special consideration should also be given to small exempt organizations when defining gross receipts since some of their gross receipts include "unearned income," such as charitable contributions received.

A small business' gross receipts could be based on the prior year's gross receipts or the average of the prior three years gross receipts. Basing the definition on prior year gross receipts or wages would increase simplicity and transparency since employers would not need to gather any information on its number of current year full-time equivalent employees or its average annual wages. Using prior year information would be readily available allowing the taxpayer to be able to calculate early in the year the tax savings by purchasing health insurance for its employees. The employer would merely use the amount already reported on its tax return to the IRS.

We also suggest that the phase-out calculations for the employee count and the annual salary be eliminated. Phase-outs create difficulties in estimating a taxpayer's benefit from the economic choice of purchasing or continuing to provide health insurance to its employees. The interactive provisions of employee count and annual salary would also be eliminated.

Alternatively, if changing the definition of small business is not an option, consider raising the average annual salary and the employee count number.

The AICPA also recommends that you address the two-year requirement starting in 2014. Having the provision apply to a taxpayer for only a two-year period starting with the first year the taxpayer provides coverage to its employees adds confusion and obscures the law's effect. In addition, the requirement would add an administrative burden to the IRS as it would have to monitor whether or not the taxpayer is taking the credit for more years than they are eligible. If the provision will continue to be limited to two years after 2013, consider giving the IRS "math error" authority to be able to automatically change a taxpayer's return if it is determined that the credit was taken beyond the two years.

One potential consequence of seeking the simplest approach may be reduced precision. Under current law, simple general rules are often followed by definitions of specific terms used, as well as exceptions to the general rule and limitations. This is deemed necessary to anticipate all possible scenarios and close potential loopholes. Unfortunately, this level of detail tends to introduce significant complexity. Although simpler and less precise approaches may raise or lower taxes for an unintended few, less detail would simplify the tax law and reduce administrative and compliance burdens for many small businesses.

CLOSING REMARKS

We appreciate your efforts in examining some of the difficulties that small businesses and small tax exempt organizations face in navigating through the rules on the small employers' health insurance tax credit. The complexity of the credit has left taxpayers perplexed about how the tax law applies to them. Many small businesses spent more time or cost on the preparation of the income tax returns this year in order to calculate their potential health insurance credit only to learn they received a minimal tax benefit, if any at all.

We encourage you to review our publications AICPA's Tax Policy Concept Statement #1: Guiding Principles for Good Tax Policy, AICPA's Tax Policy Concept Statement #2: Guiding Principles for Tax Simplification and the AICPA's Tax Policy Concept Statement #3: Guiding Principles for Tax Law Transparency to assist you in testing any new proposals against the principles of good tax policy.

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The AICPA is the national professional organization of certified public accountants comprised of approximately 377,000 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. I would be happy to answer any questions you may have.

Chairman BOUSTANY. Thank you, Ms. Thompson.

Mr. McCracken, you may proceed.

STATEMENT OF TODD McCRACKEN, PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION, WASHINGTON, DC

Mr. MCCRACKEN. Thank you, Mr. Chairman. Chairman Boustany and Ranking Member Lewis, we appreciate the opportunity to be here today to speak to the Subcommittee, and we appreciate your commitment to finding ways to find workable solutions to get affordable health coverage in the hands of small companies. Again, my name is Todd McCracken, I am the president of the National Small Business Association. And we are a national small business advocacy organization that has worked on these issues for many, many years.

Our sources indicate that there is still a very high level of confusion about the health care law among the small business community that extends, I think, to this tax credit. Part of the confusion, I believe, stems from the start date of the law, 2014. I think there are still some companies that don't believe that some of these credits really begin until that timeframe.

That said, I think the IRS actually has done a pretty good job of outreach to the small business community. I think that they have engaged a lot of small business organizations in creating awareness of the tax credit. We certainly try to get information to our members, so that if there is a credit that they are able to claim, they are making sure they are doing it.

But I think there is still a huge vacuum there, because it—the overall complexity of the Tax Code plays a significant role, I think, in this as well, because there are so many aspects, so many credits, so many things we are trying to induce or incent companies to do or not do, that to a large extent it becomes sort of a white noise for them, and it becomes very difficult to get their attention on a particular provision to affect the way they do business.

And as my colleagues from the AICPA have pointed out I think very capably in their written statement, the calculation is relatively complex, especially for small companies that don't have a stable work force. They have employees that come in and out of service that work differing hourly schedules on a week-to-week basis, those that have seasonal and part-time employees. It can be relatively complex for them to calculate. And that is a lot of companies. It is more standard for many small businesses to have that kind of work force than to have a very stable, it's pretty much the same all year kind of work force. For those companies it would be relatively simple.

But I think the single biggest issue that this credit faces is that it is a credit chasing an audience that is just very, very small. If you look at the provision of health insurance in the smallest companies, most—by quite a lot—companies do not offer health insurance to their employees. If you look at the number of those very small companies—ones who would be most eligible to receive the full 35 percent tax credit that are fewer than 10, have low-wage workers, less than $25,000 a year, a very high percentage of those companies employ family members in the business. And those family members are specifically precluded from taking this tax credit if they are an employee in the business.

So, you may have a situation where a small business offers health insurance, and most of the low-wage employees who are eligible decline the coverage, because they simply cannot afford to pay their half of the premium, which is clearly understandable in that labor market. And so there is really nothing left for that company, even though they technically offer health insurance, there is nothing left for them to take a tax credit against, because they don't have that expense.

And when you look at the raw numbers that have been—that the IRS and Treasury have provided, granted, they are preliminary and they need a thorough analysis when they are all in. But if you look at the numbers, there is about 300,000 companies that have claimed the credit for about $400 million, a little above that in both cases. That works out to an average of about $1,300 per business. And $1,300 is $1,300. But in the larger scheme of how much health insurance costs, that is not even 25 percent of one employee's single coverage value.

So that leads me to believe it seems very likely that there is a whole bunch of companies who are taking it at the margins, who have more than 10 employees, have average wages more than $25,000 a year, and have—did the whole calculation, and figured out they could get a very small sliver of the tax credit. But it winds up being a very small percentage of their overall health insurance costs, which could be 80, $100,000 a year. So I suspect that may be what is happening here.

But all this being said, we have always believed that the best way to subsidize health insurance is to look at individuals, look at their own personal situation, and not to do it through businesses. And to bring down the overall cost of health insurance is the fundamental issue I think this congress needs to grapple with.

Thank you for having me today.

[The prepared statement of Mr. McCracken follows:]

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Testimony of Todd McCracken

President

On behalf of the National Small Business Association

NSBA
National Small Business Association®

House Committee on Ways and Means Subcommittee on Oversight

Hearing:

"The Implementation and Effectiveness of the Small Business Health Insurance Tax Credit."

November 15, 2011

1156 15th Street, N.W., Suite 1100
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202-293-8830

Chairman Boustany, Ranking Member Lewis and members of the Committee, on behalf of the 150,000 small-business owners represented by the National Small Business Association (NSBA), I would like to thank you for the opportunity to appear today to discuss the implementation and effectiveness of the Small Business Health Insurance Tax Credit created by the Patient Protection and Affordable Care Act (PPACA).

NSBA is the nation's oldest small-business advocacy group representing employers in every state. As a strictly non-partisan organization, we reach employers in all sectors and industries of the U.S. economy from retail to trade to technology—our members are as diverse as the economy that they fuel. NSBA's policy positions and priorities are strictly formulated through robust volunteer leadership, communicated by NSBA staff, and reflective of our nation's 29.6 million small businesses. Indeed, health care reform has dominated the member-driven legislative priority agenda at NSBA for years, and NSBA has been an outspoken leader on the topic.

In fact, according to NSBA's Mid-Year Economic Report, released late-July, the cost of health care continues to be an issue with 44 percent of small-business owners who provide health insurance experiencing a premium increase of 11 percent or more. To address these costs, small businesses have implemented the following changes: 50 percent increased the deductible, 50 percent held off on employee compensation increases, 46 percent increased the employee share of the premium, 42 percent reduced employee benefits, 28 percent switched insurance carriers, 32 percent held off on hiring a new employee, and 24 percent held off on implementing new growth strategies.

These costs are coming to a breaking point where employers have fewer and fewer benefit design options and are increasingly forced to make difficult employment decisions as a result. There also was an increase in those who reported they were forced to lay off an employee due to health care costs.

NSBA has invested in the health care reform debate for decades. NSBA's volunteer leadership, with guidance from several experts, published *Small Business Health Care Reform—A Long-Term Solution for All* in 2004. This proposal sought to achieve universal coverage, focus on individual responsibility and empowerment, create the right market-based incentives, and a relentless focus on improving quality while driving out unnecessary, wasteful, and harmful care.

While PPACA attempted to address many of these goals, it failed to sufficiently achieve the most important factor for small businesses in health care reform; that is, to bring down the cost of health care and lower insurance premiums for all individuals. Thus, despite the extraordinary needs of small businesses for a sustainable health care system, NSBA opposed PPACA. However, the flaws of PPACA do not obviate the ongoing small-business need for health care reform and cost containment.

More specifically, we are here today to discuss the effectiveness of a provision in PPACA that includes a recently implemented limited-time tax credit to encourage small businesses to provide health care coverage to employees. The Small Business Health

Insurance Tax Credit (Small Business Tax Credit) is available to certain small businesses and covers some of the cost of employee health insurance.

What Are the Tax Credits?

The tax credits are available to small businesses in two phases. To be eligible for both phases of the tax credits, employers must have 25 or less full-time equivalent employees with average wages of $50,000 or less and provide at least 50 percent of the total premium costs. In the first phase of the tax credit—tax years 2010-2013—employers meeting the criteria can receive a tax credit worth up to 35 percent of the employer's contribution toward the employee's health insurance.

The second phase begins in 2014 when the Exchange is created. The credits are available for two years once the employer purchases a group policy through the Exchange (important to note: phase II credits are available strictly through the Exchange).

Employers meeting the criteria can receive a tax credit worth up to 50 percent of the employer's contribution toward the employee's health insurance during this time. The full tax credit for both phases is available only to employers with 10 or less employees who have average salaries of $25,000 or less. The credit phases out for businesses between 10-25 full-time equivalent employees with average wages between $25,000 -- $50,000. Tax exempt employers meeting the aforementioned criteria get a 25 percent credit for tax years 2010-2013 and a 35 percent credit for the two years in the Exchange.

For-profit employers can capture the tax credits by deducting it against their federal income tax liability. The credit is not refundable, but it can be carried back one year and forward 20 years. Tax-exempt employers can deduct it against their payroll taxes.

The self-employed are not eligible because the credit is only available to those businesses with employees. The only health insurance premium self-employed individuals will qualify for are federal premium subsidies, assuming they meet the low-income criteria through the Exchange. This inequity should be remedied by allowing sole proprietors to be eligible for the tax benefits afforded to other small businesses.

NSBA Data

Since the passage of the health care reform law small-business owners have expressed significant confusion about how the new health care law will impact their business. Today, however, there appears to be a slight increase in their understanding of the new law.

According to the NSBA Mid-Year Report, nineteen percent of small businesses—up from 15 percent in December 2010—said they have a clear understanding of how the new law will impact their business. Meanwhile, 63 percent, up from 53 percent, said they have a limited understanding and 18 percent, down from 32 percent, said they do not understand at all how their business will be impacted.

Complexity of Tax Credit

Most business are not sure if they qualify primarily because it is fairly complex and the tax credit appears to be an administrative quagmire for small business owners. According to the pages and pages of questions answered on the Internal Revenue Service (IRS) website on the credit—which essentially proves the complexity of it—business owners have to calculate their average annual wage, figure out the premiums they paid for eligible employees, figure out the average premium for the small group market in which they offered health insurance coverage, deal with various phase-outs and limitations that start at 10 employees or more and figure out their full-time equivalent employees (FTEs) in order to determine eligibility **and** then seven worksheets must be completed in association with claiming the credit.

Complying with IRS rules and regulations is not a new burden for small businesses. They tend to be an easy target since unlike big corporations—which have hordes of accountants, benefits coordinators, attorneys, personnel administrators, etc. at their disposal—small businesses often are at a loss to keep up with, implement, afford, or even understand the overwhelming regulatory and paperwork demands of the federal government.

Approximately 36 percent of NSBA members have fewer than 5 employees—few, if any, of whom is a tax specialist—leaving business owners with no other choice but to hire outside help to keep track of all their additional reporting and filing requirements, which means even more paperwork.

According to the recently released Treasury Inspector General for Tax Administration (TIGTA) report titled *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements are Needed* taxpayers have been slow to claim the credit, and both taxpayers and tax practitioners are making mistakes on Form 8941 in spite of the extensive outreach and education efforts made by the IRS to inform taxpayers and the tax preparer community about the credit and how to claim it. Clearly compliance is expensive and determining eligibility and planning is proving to be extremely difficult.

Low Volume of Participation

Despite IRS efforts to inform four million employers who would be eligible for the credit, the TIGTA report states the volume of claims for the credit have been low. As of mid-May 2011, only 228,000 taxpayers took advantage of the credit for a total amount of more than $278 million.

Certainly, it seems likely that the number of small firms utilizing the credit is likely to rise somewhat as outreach efforts continue and as awareness continues to build. However, it is also not particularly surprising to NSBA that participation by small employers is much lower than had been anticipated.

As designed, the tax credit is most valuable to very small, very low-wage companies. However, very few of these companies are able to offer health benefits at all, for myriad reasons. When those companies are able to offer coverage, their low-wage employees typically decline it, since they are unable to afford their own share of the premium. In such a case, there is no employer-paid premium against which to claim the tax credit, even for a small, low-wage company identified as "offering" health insurance to its employees. A number of factors heighten this effect.

High Morbidity in Small Groups

While I am not an actuary, it is well-known in actuarial circles that morbidity (a measure of poor health) is much higher in the very small group insurance market than in the rest of the market. Of course, it is not generally the case that workers in small firms are sicker than other workers. However, it is the sicker employees who are willing to make the financial sacrifices to obtain and retain coverage in the very small group market, a fact which drives up average premiums in this sector. Those higher premiums, in turn, reduce the number of healthy low-wage workers willing to pay for health insurance, driving the premiums yet higher.

Family Members as Employees in Small Groups

In many small companies (again, especially under ten employees, where the credit in question is most valuable) multiple family members may serve as employees of the company. Small low-wage companies that employ family members are the ones most likely to offer employer-sponsored health insurance, since that plan also provides coverage for the owners own family. While there is not good available data, based on our experience, we strongly believe that these businesses account for a very substantial portion of the smallest companies that still offer health insurance to employees. However, those family employees are ineligible for this tax credit and many of the other employees may have declined the coverage because of high cost.

The Tax Credit is Non-Refundable

Because the tax credit is nonrefundable, some employers will not be able to take full advantage of it even if they meet all the criteria. If the small business has no taxable income in the year in which it wishes to receive the credit, it may carry the credit forward for 20 years or backwards one year (after 2010). Tax-exempt organizations may use the credit to offset withholding and Medicare taxes that they owe on behalf of their employees.

Cost Containment

Health care spending in the United States has increased from 12.5 percent of GDP in 1990 to 13.8 percent in 2000 to 17.6 percent in 17.6 percent in 2009. Nearly one in six dollars spent in the U.S. are spent on health care. This makes our country's health care system uniquely expensive. By almost any metric (life expectancy at birth or age 65, infant mortality, etc.), our system does not deliver materially better results than other advanced countries' health care systems.

International Comparison of Health Expenditures (Public and Private), 2008[1]

United States	16.0%
Canada	10.4%
France	11.2%
Germany	10.5%
Italy	9.1%
Netherlands	9.9%
Switzerland	10.7%
United Kingdom	8.7%

Rising health costs consume most of the real wage increases that ordinary Americans receive. They impose a huge expense on business and harm our international competitiveness. They will make our state and federal budget difficulties nearly intractable.

Restraining rising health costs will:

- Dramatically improve federal and state budgetary situation;
- Dramatically improve the cash compensation of working Americans; and
- Substantially improve the international competitiveness of U.S. businesses.

The Congressional Budget Office (CBO) projections below show this problem getting steadily worse, with total health care spending reaching an absurd 25 percent of GDP by 2035. It is a problem that simply must be addressed. And one thing is certain. Simply making adjustments around the edges of the current system will not solve the problem.

[1] Statistical Abstract of the United States, 2012, Table 1346.

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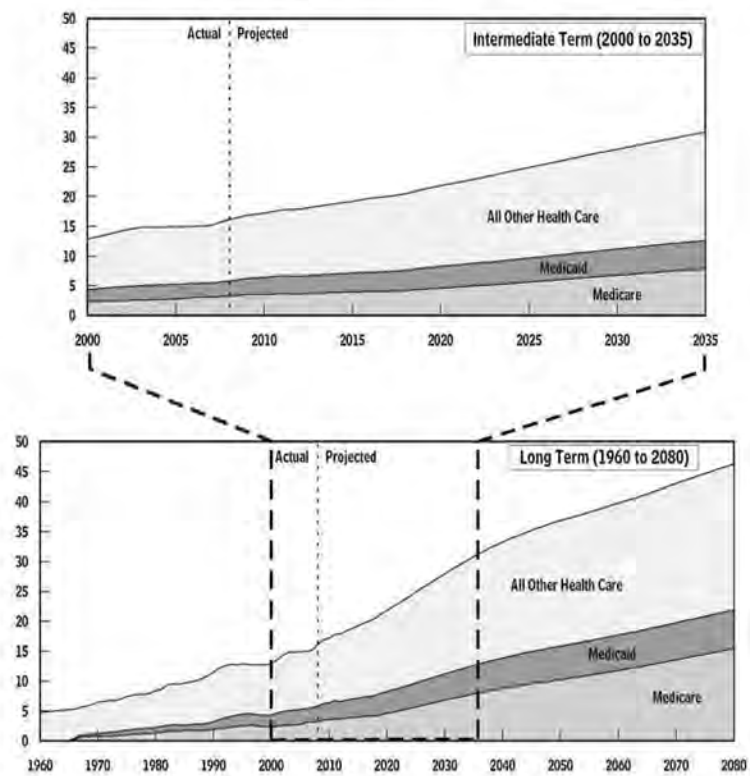
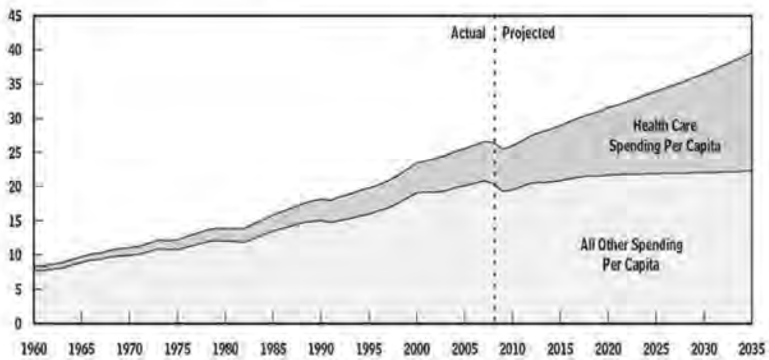
Total Spending for Health Care Under CBO's Extended-Baseline Scenario
(Percentage of Gross Domestic Product)



Source: Congressional Budget Office, Long-Term Outlook for Health Care Spending, 2009.

Total Health and Nonhealth Spending Per Capita
Under CBO's Extended-Baseline Scenario
(Thousands of 2009 dollars)



Source: Congressional Budget Office, 2009

Principles of Health Care Cost Constraint

The current health care marketplace is thoroughly broken and bears no resemblance to a normal market. There is virtually no competition on the basis of price. Information about quality regarding providers is very difficult to obtain. Neither providers nor consumers have a meaningful incentive to economize and a third party pays for the decisions made by consumers and providers of health services. In fact, almost all of the incentives in the current system are to spend more money.

Consumers, although they have some first dollar cost-sharing, have no incentive at the margin to economize on health care costs. Generally, the marginal cost to consumers under private insurance and under Medicare and Medicaid is zero. This must change. We must move the private and government health systems toward positive marginal costs to consumers. As has been almost universally understood by economists since the 1870s, it is at the margin that decisions are made. If there is a marginal cost to the consumer of ordering an additional test or choosing a more expensive treatment, then consumers will have some incentive to economize. The current flat deductive and flat co-pay system means that there is no marginal costs to consumers for electing more expensive health care.

Another reason for high hospital costs are mandates on hospitals to treat those that arrive at the emergency room for free if necessary. By this mechanism, a large number of uninsured persons received free medical care. Providing this care, however, is not free and the hospitals recover it in the end by higher bills to paying patients.

Moreover, the employer-provision of health insurance (driven by the tax exclusion for employer provided health insurance) further breaks the link between health care expenditures by consumers and the cost of providing those expenditures. Generally, a consumer's health care costs consist of a deductible (which is so low it is almost always exceeded) and minor co-payments. There is little to no variance in a consumer's health care costs depending on the degree to which health care services are used.

Providers, meanwhile, have every incentive to provide more health care because by providing more services they make more money. They are under no pressure to compete on the basis of price because the health care consumer generally faces a zero marginal cost. Very little information is available or provided regarding quality. Artificial limits are placed on the number of newly minted doctors each year. Medicare, Medicaid and private insurers are under tremendous pressure to simply pay the medical bills presented to them and are treated as pariahs by politicians and the media if they attempt to push back on health care provider costs.

There is one obvious exception to the forgoing analysis: the case of elective procedures such as corrective eye laser surgery or cosmetic surgery. In these medical fields, competition on the basis of price and quality is commonplace. The reason, of course, is that the consumer is footing the bill.

Neither does the current system possess the cost containment features of a government run system. The government is not in a position to dictate prices and salaries to health care providers. It cannot use monopoly power to dictate to suppliers.

In short, we have the worst of both worlds. A private market without any of the normal market mechanisms that lead to efficiency, cost control and quality gains. A government insurance system that has almost none of the cost containment features that a single-payer, monopoly, socialized system would have. Thus, we have the most expensive health care system in the world. We cannot afford it.

The health care system must be changed so that:

- Consumers have substantial marginal costs when consuming health care services;
- Consumers benefit financially when they economize on health care services;
- Health care providers compete on the basis of price;
- Health care providers compete on the basis of quality and outcomes;
- Health care providers have a substantial incentive to economize; and
- Genuinely unwarranted medical malpractice claims or excessive awards are limited.

Maintaining the present system will accomplish none of these goals. Both President Obama's PPACA and Rep. Paul Ryan's Medicare reform proposal move towards a premium support system (where government subsidizes the purchase of private insurance). They retain the basic structure of the current health care system with no meaningful consumer costs at the margin and little incentive for consumers or providers to economize. In Rep. Ryan's case, the plan may succeed in shifting costs from government onto private citizens, but it can be expected to do little to reduce overall health care costs.

Ensuring that consumers bear meaningful marginal costs and that therefore providers in competing for those consumers have a reason to compete on the basis of price and quality can be accomplished without harming the poor or lower middle class. Instead, however, of subsidizing insurance premiums, government funds could be used to provide individuals with a stipend for health care expenses that if not used for health care expenses because the consumer effective economized can eventually be used by the consumer for whatever they want. In this way, there is a real incentive for everyone involved in the system to economize.

Tort reform can also contribute to health care cost containment. The CBO estimates that a modest medical malpractice reform law would save over $50 billion through 10 years. However, those savings would continue to increase as the cost of medical malpractice litigation in the U.S. continues to grow, steadily increasing at almost 12 percent annually since 1975. Moreover, according to the Harvard School of Public Health, 40 percent of malpractice suits filed in the U.S. are "without merit." In general, studies place the direct and indirect costs of malpractice between 5 percent and 10 percent of total US medical costs.

Beyond traditional medical malpractice laws, NSBA supports some kind of safe harbor for physicians, as well as the use of health courts. Any safe harbor rule would have to be in conjunction with federally-defined, evidence-based medical procedures. Physicians, who abide by those standards and report outcomes, would be allowed a certain level of protection from medical liability. Health courts would allow for the establishment of specialized courts for dealing with medical malpractice claims. NSBA surveys show 83 percent of small businesses support monetary caps in medical malpractice cases. That survey also found that a majority support addressing the issue federally. Tort reform traditionally has been dealt with at the state level; however, the National Conference of State Legislatures cites 17 states where there are no stipulations whatsoever on medical malpractice lawsuit caps. The broad variance in states' laws encourages attorneys to forum shop, which simply increases the need for a federal solution.

Conclusion

This tax credit is only temporary—it expires after five years—and given the failure of PPACA to contain costs even those few small-businesses able to utilize this credit will be left without any kind of support and a very expensive benefit that is difficult to take away once they offer it to employees. Tax credits are neither the cure-all for small businesses' health insurance woes nor a replacement for good policies on cost-containment that make health care more affordable.

The number of uninsured in the United States is a big problem that needs to be addressed, but the uninsured are not a homogeneous group and they are uninsured for several different reasons. However, one common element that runs through the entire health care system, for those insured or not, is the cost of health care. In fact, the impetus for health care reform was sold on the need to address spiraling cost by altering the increasing health care cost trend.

Unfortunately, this founding tenet of reform has been lost through deliberations. The CBO has reported that PPACA does not alter the unsustainable long-term health inflation trends to the level needed to make a significant enough difference in premiums five, 10 or 15 years down the road.

I would like to thank Chairman Boustany for holding this hearing, and appreciate the opportunity to provide a small-business perspective to the Small Business Health Insurance Tax Credit. We hope to continue to work with you and your staff as a constructive participant as the implementation of this proposal continues to be at the forefront, and will gladly provide additional information or insight into the health care challenges faced by our nation's small businesses.

Chairman BOUSTANY. Thank you.
Mr. Hisel, you may proceed.

STATEMENT OF MATTHEW HISEL, CO-DIRECTOR, HOME RESOURCE, MISSOULA, MONTANA

Mr. HISEL. Chairman Boustany, Ranking Member Lewis, and Subcommittee Members, thank you for the invitation to testify today. I appreciate the opportunity to share my experiences as a small employer with the ACA health insurance tax credit. My name is Matthew Hisel. I co-direct Home Resource, a building materials reuse center in Missoula, Montana.

We collect and sell reusable building materials to reduce waste and promote a more vibrant and sustainable local economy. We also partner with a range of work training programs and offer educational classes. Home Resource, Incorporated is a non-profit under section 501(c)(3) under a special category for resource conservation. When we founded Home Resource in 2003, my co-founder and I were the only people on payroll. Now we employ between 15 and 20 people.

At Home Resource we believe our employees work best when they are healthy. We also know our health care benefit is key to attracting and retaining great employees. We have offered health insurance to employees who work more than 30 hours a week since 2004, and we pay 100 percent of the premiums.

Skyrocketing costs have made this difficult to sustain. We face double-digit increases practically every year, sometimes as high as 39 percent. We have had to shop around for a new plan almost every year, and we have had to increase our deductibles and reduce benefits. We now have a $5,200 deductible. It is the kind of insurance that works fine until something goes wrong, as I can attest to personally from an emergency hospital stay that left me with bills totaling around $4,000. I had just barely been able to achieve the American dream of homeownership a few years before, and these bills forced me to sell my home.

In the past year the ACA has changed our situation significantly, and for the better. This is thanks to both the tax credit and also other parts of the law. In 2010 we paid close to $11,000 for our employees' health insurance. The tax credit cut our costs by over $2,000. For a small business struggling to keep health coverage, that makes all the difference. We were actually considering dropping our insurance in June of 2011, but knowing we would get the tax credit for 2010 tipped the balance and helped us maintain coverage.

I found the credit pretty straightforward. I prepared the worksheet to determine if we qualified myself. It took me less than 10 minutes. Our accountant spent a little over an hour preparing the final forms, at a cost of $195 to Home Resource. That is $195 to get more than $2,000 back. A small business like mine cannot ask for a better return on investment than that.

While I was aware of the credit from following the debate over health care reform, and my accountant was aware when I asked her about it, I do believe there would be value in a broader education effort to ensure that all small business owners and their accountants are aware of the opportunity to claim it. If utilization of the credit is lower than expected, I would encourage you to consider building on it to help more businesses benefit. This could be done by raising the thresholds for FTEs to 50 and wages to $75,000. Since the Congressional Budget Office scored the credit at 38 billion, I believe Congress should make sure all of these resources are getting to small businesses to help us with our health care costs.

The tax credit isn't the only piece of the health law that is helping us. There is the requirement that insurers cover free preventative care. There is the end to denying coverage for kids with preexisting conditions. I lost one of my best employees before this provision went into effect, because our insurer wouldn't cover his kid, who was a cancer survivor with Downs Syndrome.

And finally, after years of steep increases between 19 and 39 percent a year, this year's increase was only 9 percent. Combine this with the tax credit, and we will see our effective health insurance costs go down by double digits this year.

There are other benefits we are looking forward to in the health care reform, as well: the state insurance exchange, which will give small businesses more transparency, better choices, and more bargaining power; stronger rate review to protect us from unreasonable rate hikes; the minimum medical loss ratio requirement, which will ensure a basic standard of value for premiums; and reduced cost shifting, as more people get health insurance and start paying into the system.

Based on the improvements we are already seeing, I believe it is critical that we keep moving forward on implementing the health law. You have an opportunity to build on the tax credit to help more businesses benefit. This credit is a bridge to a reformed insurance marketplace in 2014. If not enough businesses are making it across the bridge, let's build the bridge wider, not blow it up.

Helping small businesses get affordable health coverage is one of the most important things you can do to help us succeed, grow, and create jobs. Thank you.

[The prepared statement of Mr. Hisel follows:]

Statement of Matthew Hisel
Co-director of Home ReSource
Missoula, Montana

Subcommittee on Oversight of the
House Committee on Ways & Means

Hearing on Small Business Health Insurance Tax Credit

November 15, 2011

Chairman Boustany, Ranking Member Lewis, and members of the Subcommittee on Oversight,

Thank you for the invitation to testify today about the health insurance tax credit enacted as part of the Affordable Care Act. I appreciate the opportunity to share my experiences with health care and with this tax credit as a small employer.

My name is Matthew Hisel, and I am the co-director of Home ReSource, a building materials reuse center in Missoula, Montana. We collect and sell re-usable building materials to reduce waste, build healthier communities, and promote a more vibrant and sustainable local economy. We also partner with a range of work training programs and offer educational classes.

Home ReSource is incorporated as a non-profit under Section 501(c)(3) of the Internal Revenue Code, under a special category for organizations that support resource conservation. Nearly all of our income, about 85 percent, comes from business operations – our building materials store and building dismantling service. Those operations are generally self-sustaining and provide additional revenues to support educational and charitable activities.

I co-founded our business in 2003. When we opened our doors, my co-founder and I were the only people on payroll. Now, we employ between 15 and 20 people.

Health Care at Home ReSource

At Home ReSource, we believe our employees work best when they and their families are healthy, able to access needed health care, and not worrying about medical bankruptcy. Caring about the health of your employees is a small business value we take seriously. For that reason, we've offered health insurance to employees who work more than 30 hours per week since we could first afford to pay for it in 2004, and we pay 100 percent of the premiums for covered employees.

Skyrocketing health care costs have made that increasingly difficult, however. Over the last seven years, we've been hit with double digit rate increases practically every year, sometimes in excess of 30 percent. We've had to shop around for a new plan every year because we just couldn't absorb the unrelenting increases. We've had to increase our deductibles and other out-of-pocket costs and reduce benefits in order to continue coverage. When we've brought the issue to our employees and explained we'd either need to stop paying the premiums in full or increase the deductible, they chose to increase the deductible.

It's reached the point that the best plan we could afford for the current year has a $5,200 deductible. It's the kind of insurance that seems to work just fine until something goes wrong – as I can attest to personally from an emergency hospital stay this spring that left me with bills totaling around $4,000. I had just barely been able to achieve the "American Dream" of home ownership a few years before, and these bills forced me to sell my home.

The ACA Small Employer Tax Credit

In the past year and a half, health care reform has changed our situation significantly – for the better. This is thanks in part to the new health care tax credit, and also to other provisions of the Affordable Care Act that are helping with costs and improving our quality of coverage.

Home ReSource qualifies for the small employer health premium tax credit. For 2010, when we paid $10,782 for health insurance, this credit cuts our costs by more than $2,000. For a small business struggling to maintain decent health coverage, that makes all the difference. We were actually considering dropping our health insurance this year, but the tax credit tipped the balance and helped us maintain our coverage. And we anticipate receiving the credit for the next several years as a bridge to a reformed insurance marketplace in 2014.

To questions about whether the credit is too complicated, I can say from experience that I found it quite straightforward. I prepared the worksheet myself to determine if we qualified and it took me less than 10 minutes. All the information I needed was already in our Quickbooks software. Our accountants spent a little over an hour preparing the final forms, at a cost of $195 to Home ReSource. So we paid $195 to get more than $2,000 back. A small business like mine can't ask for a better return on investment than that.

While I was aware of the credit from following the debate over health care reform, I do believe there would be value in a broader education effort to ensure that all small business owners, and their accountants, are aware of the opportunity to claim it.

Also, if utilization of this credit is lower than anticipated, I would encourage you to consider ways to build on the credit and help more businesses benefit. This could be done by raising the top end of the employee threshold to 50 FTEs and the top end of the wage scale to $75,000. This would ensure that more businesses can benefit from this valuable assistance while other components of the health law that will increase competition and reduce costs phase in over time.

Since the Congressional Budget Office scored this piece of the health law at $38 billion, I would suggest the responsible thing for Congress to do would be to build on the credit to make sure all of the allocated resources are getting to small businesses to help us with our health care costs, rather than spending time undermining the credit or threatening to take it away from those of us that are benefiting and using it to maintain health coverage for our employees.

Other Immediate Benefits of the ACA to Small Businesses

The tax credit is not the only provision of the Affordable Care Act that's helping us. There are a number of other parts of the law that we're seeing benefits from already. I will highlight three here.

First, there is the required coverage of preventive care with no cost-sharing. Our insurance covered preventive care back in 2004, but we had to drop it the very next year when the renewal was going to cost 39 percent more. I'm glad we have preventive coverage again. Making prevention a priority is good for our employees' health, workplace productivity, and long-term savings in the health care system.

Second, our employees' kids with pre-existing conditions can no longer be denied coverage. I lost one of my best employees before this provision went into effect because he had a child who had Down Syndrome and cancer, and the insurance company refused to cover his child. If the health reform law had been in effect four years ago, we would have been able to promote this employee to full-time and provide health insurance for him and his child.

And third, our greatest surprise came this spring at renewal time. After years of outrageous rate increases – between 19 and 39 percent, year after year – this year's increase was only 9 percent. It's hard to imagine this would be the case without the downward pressure on rates and increased scrutiny of rate increases created by the Affordable Care Act. Combining this with the tax credit, which cut our effective health care costs by more than 20 percent, we're actually seeing our insurance costs go down by double digits.

Looking Forward to Upcoming Benefits of the ACA

Looking forward, whether you get the tax credit or not, I believe there's a lot for small business owners to look forward to as more elements of the health law phase in.

Key elements that will help small businesses with better coverage and lower costs include:

State insurance exchanges: In 2014, the opening of the state health insurance exchanges will give small businesses more transparency, better choices, broader risk pooling and more bargaining power by allowing us to band together to shop for coverage. This bargaining power and increased competition are critical to bringing costs under control.

Stronger rate review: The law gives states new tools and resources to strengthen review of insurance rate increases and protect small businesses from unjustified rate hikes. Given the high level of market concentration in the health insurance industry (especially in rural states like Montana) and its negative effects on competition, we need this stronger rate review to protect us from unreasonable and unjustified rate increases.

Minimum medical loss ratio: The minimum medical loss ratio requirement will ensure that small businesses are getting good value for our premium dollars. By requiring insurance companies to spend at least 80 percent of premiums collected from small group and individual customers on actual health costs or pay a rebate if they fail to meet the requirement, we will increase the value of insurance or decrease its cost – or both.

Reducing cost-shifting: As these provisions help more small businesses get health insurance and pay into the system, businesses that are already providing coverage should see the "hidden tax" we pay now to cover cost-shifting from uncompensated care decrease, lowering our costs overall.

Conclusion

Based on the challenges I've experienced with health insurance over the last several years trying to maintain a decent small group plan for my employees, and based on the improvements we're already seeing thanks to the Affordable Care Act, I believe it is critical that we keep moving forward on health reform with measures like strong rate review, the value for premiums requirement, and the state insurance exchanges.

I also believe we have an opportunity to build on the ACA's small business tax credit to help more small businesses benefit. This credit serves as a bridge to help us afford coverage as we move toward the exchanges and a reformed marketplace for health insurance. If not enough businesses are making it across the bridge because it's too narrow, let's build the bridge wider, not blow it up.

Spiraling health care and insurance costs are one of the major forces driving income disparity to further and further extremes in recent decades. I experienced this force directly when I had to choose between paying medical bills and paying a barely-affordable mortgage. I believe in free enterprise, entrepreneurship and hard work. But the free market only works when there is adequate competition, when consumers have enough choices and influence over prices, and when economic growth occurs across the income spectrum, not just in the top percentiles.

The current health care system allows big insurance companies to have monopoly control over prices, and the rest of us have no choice but to fork over our hard-earned dollars to cover essential health care. Reforming our health care system is one important step toward improving the overall economy, because more hard-earned dollars will remain in the hands of working Americans who will circulate them, not hoard them.

Helping small business owners and our employees get decent health coverage we can afford is one of the most important things we can do to position small businesses to succeed, grow, and create jobs. For the health of Americans and our economy, it is imperative that we keep moving forward, not backward, on health care reform.

Thank you.

Chairman BOUSTANY. Thank you, Mr. Hisel. We have heard a lot about the complexity of this tax credit this morning, both with the first panel and, Ms. Thompson and Mr. McCracken, your testimony both sort of corroborate that. And you know, we have heard about Form 8941 and the instructions, 8 pages, complex calculations that need to be done.

What kind of feedback have small businesses been giving you on the value of this credit?

Ms. THOMPSON. For my clients that are able to take advantage of the credit, they find that it is very helpful, because it does reduce the health insurance costs. And so the complexities that we are going through, to them it is worth it.

Chairman BOUSTANY. Okay. Mr. McCracken.

Mr. MCCRACKEN. I would say it is a mixed bag. I mean there certainly are companies that, as we just heard from the last example, that fit the definitions nicely, and can take a rather large share of the credit. My point is that there are very few of those companies in the larger scheme of the American economy. And so, you just have to factor that factor in.

So I do think there are some companies who have gone through the exercise—and I have heard from some of these folks—who went through the exercise of doing the calculation, having their outside CPA firm do a lot of work for them to figure out what the credit would be, and at the end of the day claiming the credit, yes, because they had done the work, but it being a relatively small credit. And there was a frustration that they had gone through all the trouble. And if they had known the outcome, they probably wouldn't have paid the CPA and done all the hassle to figure out the credit, because they only got a few hundred dollars or a thousand or two, which, in the scheme of a company that might have 15, 20, 25 employees, would be a relatively small percentage of the credit.

So, it is—it really depends very much on the specifics of the individual business. They really run the gamut between those two.

Chairman BOUSTANY. Mr. McCracken, do you have any information on the actual cost to a small business to get this credit?

Mr. MCCRACKEN. I don't. And again, that is going to also vary greatly, depending upon the type of workforce that company has, because it is going to be much more difficult for a small company to have a highly seasonal, highly—lots of variations in its work force over the course of the year, sort of week by week and month by month.

I should also point out that the smaller those companies are—which are the ones that stand to get the biggest credit, potentially—are the ones that have least automation in those processes, or the ones who are least likely—most of them don't use a payroll service, just for example, in the below 10 market.

So, for them to then go back and collect that data often is a time-consuming manual process than to go back and figure out how many hours did each person work each week to figure out what the FTEs—so—but if you are a company that has a stable, 5-person work force and they all work 35 hours a week every week and that doesn't change, it would be relatively simple. So——

Chairman BOUSTANY. Ms. Thompson, do you have information on cost, maybe average cost for a small business?

Ms. THOMPSON. We don't really have the information on the cost of preparing the credit, because it depends on the size of the firm that is preparing the credit. It could be a small CPA firm, it could be a large, or it could be mid-sized. So you can't really generalize on what the cost is going to be to prepare the credit calculations.

Chairman BOUSTANY. Ballpark?

Ms. THOMPSON. You can't really ballpark it.

Chairman BOUSTANY. Not even a ballpark figure?

Ms. THOMPSON. Uh-uh.

Chairman BOUSTANY. Okay. Well, the IRS has mentioned their outreach efforts. And Inspector General George gave them a B on it, not a bad mark. So it sounds as if they have really made significant efforts to move forward, to get the information out to tax preparers and—as well as to small businesses about the—their awareness of this credit. Yet, with all of this, participation still seems to be below what was predicted, and seems to be low, by most standards, even at this early stage.

Ms. Thompson, is that because of insufficient outreach, insufficient information being put out to small business? Or is it because the credit is just complex, and small businesses have not availed themselves of that because of the complexity and cost?

Ms. THOMPSON. I think at this point it is really too early to make a conclusion as to the effectiveness of the credit. Because, as we had heard, the information is not in for all of the tax returns that were on extension, which was as late as October 15th. And for those that were located in disaster areas, it could have even been October 31st. And as someone had mentioned, the tax-exempt organizations are due today. So, without having a full year of information, it is really too early to answer that question.

Chairman BOUSTANY. Okay. Fair enough. Mr. McCracken.

Mr. MCCRACKEN. I think a big issue, as I said before, is that there is a relatively small population of these firms who can maximize the credit. Most companies that offer health insurance that are below 10 employees are not low-wage firms. So they are limited on that end.

So, when you drill down to how many companies are truly low-wage firms, have fewer than 10 employees, have been able to offer health insurance nevertheless, and have an uptake rate for their employees for the offer, you are just looking at a very small slice of the small business community. And I think a lot of the low uptake comes down from that fundamental point.

And a lot of the companies that do offer health insurance in that market that might have been assumed to be taking the credit, when you dig deeper you find out that they are often employing family members who are specifically precluded from using the credit.

Chairman BOUSTANY. And Ms. Thompson and Mr. McCracken, both of you mentioned that small businesses are often disproportionately hurt by the complexity of the Tax Code, because they are unable to hire or they don't have the resources to hire the number of tax preparers and accountants, lawyers, and so forth, advisors to navigate through the Code.

And I am concerned about these different definitions of a small business that are out there. I think it was your testimony that highlighted some of that, your written testimony. For example, the research credit defines "small business" as one with 500 or fewer employees. But for the purposes of an Archer Medical savings account, it could be a business with fewer than 51 employees. And then there are all these various definitions.

So, comment on how the Tax Code's complexity affects these small employers, however they are defined, and hone in on the impact of this particular tax credit and its complexity, and the impact it is having.

Ms. THOMPSON. Well, the AICPA is definitely in favor of simplifying the Tax Code. There is no such thing as a simple code, because the world is just very complex. So you really need to make it simpler than it is. And as you pointed out, something as basic as the definition of a small business, depending on which particular provision you are looking at, you are going to get a different answer.

But we also understand that there may be reasons why they are different, depending on what you are trying to accomplish as your goal in passing legislation.

So we can understand why it is different. We would like to see it a little bit more consistent, and for example, on this one, when we are talking about having to use current information, on all those other provisions that I had identified they were all using prior years, which is very helpful to that small business, because that is information that is going to be readily available to them, and it may not be as much of a stretch for them to go on the prior year, rather than the current year.

So, it is more challenging for a small business. But I would have to say that the small businesses do need a professional to prepare their tax returns. And we do find that if they do hire the professional, they are going to be done correctly, and they may find that they are going to be saving more in taxes than they would otherwise, because they are going to be aware of these incentives.

And the tax professional is doing these calculations all the time. So if it was a one-off, where one person was just preparing it, yes, it is going to sound very complicated. But if a CPA firm is doing it, they are doing it multiple times for multiple employers, and it is going to become a lot less complex for them.

Chairman BOUSTANY. Mr. McCracken, briefly, would you like to respond?

Mr. MCCRACKEN. Yes. Your basic question was about the definition of small companies. And there aren't very many other instances for the tax law—usually there is other ways of defining smaller entities, rather than necessarily employee size.

But I also would warn against creating sort of a cliff effect by, for all purposes, defining small business exactly the same way. Because if you sort of define it at 25 employees, or wherever you pick that number, whether it is for good things below that or bad things above that, you are going to create a significant disincentive. So there does need to be some variation, to some degree, so that you don't wind up with one place where people don't want to cross.

Chairman BOUSTANY. Thank you. Ranking Member Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. I want to thank each of you for being here this morning.

I would like for each one of you to respond to this question by saying yes or no. Do you support repeal of the small business health care tax credit in the Affordable Care Act?

Ms. THOMPSON. I know you said that was supposed to be a yes or no answer.

Mr. LEWIS. Yes?

Ms. THOMPSON. Except the AICPA doesn't have a position either for or against, so I can't really answer that question.

Mr. LEWIS. Yes, would you want to speak for yourself as individual? You don't want to get in trouble?

Ms. THOMPSON. I am not going to get in trouble today.

[Laughter.]

Mr. LEWIS. Oh, just take a chance.

Ms. THOMPSON. No, I think I am going to pass.

[Laughter.]

Mr. LEWIS. Oh, you will pass?

Ms. THOMPSON. Yes, sorry.

Mr. LEWIS. That is all right.

Mr. MCCRACKEN. I would say no.

Mr. HISEL. No.

Mr. LEWIS. Thank you. Mr. Hisel, what role did the health care credit play in your decision to provide health insurance for your employees? Did it play any role?

Mr. HISEL. We were already providing health insurance. But as I said, we were considering dropping it at the beginning of this year, 2011. I spent a lot of time trying to balance my budget for a year, looking a year in advance. And you know, this year we were really struggling with a challenging economy through the winter, and I was working very hard to get the number at the end of the day to remain positive.

And it ultimately made a big difference to us, because I really was looking at health insurance this year. And ultimately, knowing that we would get the credit for 2010, and then again in 2011, that tipped the balance. It was a deciding factor, and we decided to keep our health insurance.

Mr. LEWIS. So you would be a strong supporter of the health care tax credit?

Mr. HISEL. Absolutely.

Mr. LEWIS. So you are saying as for my house, for your house, could you say to other small businesspeople, "You should take a look at it?"

Mr. HISEL. Absolutely. And I know a lot of people have. And I do agree that it should be expanded to include more small businesses. Those thresholds should be increased and perhaps brought in line with other definitions, 50 FTEs and wages.

I would also like to say that we are a very seasonal business. We fluctuate with the construction season quite a bit. And I completed this qualifying worksheet myself. It is six simple fill-in-the-blanks. I had all the information in QuickBooks. It was not that challenging. I don't quite understand what the problem was. And then, you know, to just hand it over to our accounting service, they did not seem to have a huge problem with it.

And I think it just needs to be expanded.

Mr. LEWIS. Well, you traveled a great distance to be here today.

Mr. HISEL. Yes.

Mr. LEWIS. Further than anyone.

Mr. HISEL. I am sorry?

Mr. LEWIS. I said you traveled a great distance to come and testify today. And I just want to thank you for coming.

Mr. HISEL. You are welcome, thank you for having me.

Mr. LEWIS. Thank you. Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman. Ms. Black.

Ms. BLACK. Thank you, Mr. Chairman. Again, thank you, panelists, for being here today. It is very helpful.

It has been suggested that what we see here was just a political stunt. And yet I continue to hear that there is complexity. And the complexity includes things like definitions that are confusing, that it is also confusing with the other parts of the tax code. And yet, there—has been suggested that it could be done in three simple steps.

I would like to hear—and Mr. Hisel, I probably want to come back to you, but I would like to hear, first of all, from Ms. Thompson and Mr. McCracken about what they are hearing and what their experience are with dealing with the small businesses. If it is just three simple steps, then why is it that there are folks that are saying that it is more complex than that? So help me understand that.

Ms. THOMPSON. I think that the provision does require a lot of questions to be answered. And the first one is starting off with whether or not they do qualify as a small business. And it is not as easy as just looking to the prior year's gross receipts, or the prior year's employee count. It is really based on the current year information.

And when you look at the definition of "employee," as one of the other panels had mentioned, it is not just your employee count on the W–2s that were issued during the year, it needs a little bit more analysis to look at those employees, to see whether or not there is any family members that have to be excluded. If you have seasonal workers, how many—whether those seasonal workers can be included or not. And so, there is a lot of definitions or analysis that goes into whether or not that person is an employee that is going to be eligible for that credit.

And then, if you talk about the hours, the hours are going to be based on the payroll records, again. But you do have to look at it, because if somebody went over 2,080 hours, you don't include the excess over that level, so you would include only that amount. If the people aren't being compensated on an hourly basis, then they may have other methods of determining what—the hours works.

So, it is those type of definitions and analysis each step of the way that adds to the amount of work that is being done for that credit. And so that is why we were suggesting that if you change the definition away from the way it is right now, and base it on something like the prior year, it does away with a lot of the complexity that is there.

Ms. BLACK. Mr. McCracken.

Mr. MCCRACKEN. Actually, I don't have a lot to add to that. But I would also point out that, you know, for a lot of these companies, they will see that and realize they need to go through lots of steps, and they have to change their procedures to simplify how they can gather that data in order to claim the credit. And if the credit they are able to claim they think will be at a relatively low level, and it is temporary, they might not want to go through that trouble of change the way they do it.

Again, that is more likely for the companies that have more than 10 or 15 employees, that are sort of reaching the upper size of the availability of the credit. But my sense is those are the companies that are far more likely to be offering health insurance to the employees. So it is going to affect a greater variety of actual—of people.

Ms. BLACK. So I think what I hear you saying is that it is all across the board. And maybe Mr. Hisel has a little bit more stability there, where he is not having to figure quite as many of these different categories that I am seeing to not be well defined, or that there is a lot of variations in the employees, the number of employees, the hours worked, and that kind of thing.

Obviously, we all want to get to the same point, where we can let small businesses take advantage of something that is there to incentivize them to provide insurance for their employees. So I appreciate your recommendations there.

The next question I wanted to ask is the piece on the family members. Is there a reason why you believe that—and I wasn't here when this was passed, so I don't know—why family members would be excluded? Because it seems that that is very typical in small businesses, that small businesses are very family-oriented. And to exclude family members doesn't seem like it is really going to be beneficial. Is there a reason, Ms. Thompson or Mr. McCracken, that you could enlighten me on that piece?

Ms. THOMPSON. I really didn't look into the committee reports as to why the family members were excluded from the definition of "employee," so I can't really answer that question.

Ms. BLACK. Okay. Okay. Mr. McCracken, any idea——

Mr. MCCRACKEN. I don't—wasn't privy to those conversations, of course, but I have to believe it is because the congress at the time was concerned about, you know, potential abuse, that you might hire an employee—a family member who is not really an employee, that kind of thing, and so they sought to prevent that.

Ms. BLACK. Well——

Mr. MCCRACKEN. I should also point out, though, that it does work both ways. Because in companies where you have family members who are working in the company, more often than not they are in a kind of a management position. So not only are they not eligible for the tax credit, but they also aren't counted in the calculation of whether you are low wage.

And so, if you added them back in to that calculation, probably the average wage of the company would go up, but your tax credit would go down for the employees you can claim it for.

So, if you are going to think about a system that allows the business owner who works as an employee and the family members who work as employees to participate, you might need to sort of think through the levels, because you will wind up allowing some businesses to claim a credit for some of the individuals' health insurance, but you might actually reduce the credit available to other companies.

Ms. BLACK. Good point. And I just think that it is something we need to take a look at, Mr. Chairman, in particular. I don't know the reason for it initially, but my experience with small businesses, of which our family is a small business, and that many of those that we know do have a lot of family members that are involved in the business. Thank you.

Chairman BOUSTANY. Dr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. Mr. Hisel, I feel an affinity for you. I worked for a gypo logger one summer. I see that you have been to the University of Montana and got a master's degree and then you took an entrepreneurship course in the Montana Community Development Corporation. Did they have a course in there to figure out how to fill out government forms, in the master's degree program or in the entrepreneurship?

Mr. HISEL. I do not recall such a course, specifically.

Mr. MCDERMOTT. So, the skills that you used were skills that you learned in maybe common public schools and eighth grade, where you learned to multiply fractions and add and subtract?

Mr. HISEL. And divide, yes. That is correct. In fact, there is an addition symbol right here, and a division symbol. It is pretty basic.

Mr. MCDERMOTT. And so, my feeling then is—why do you think people are complaining about this form? I mean did you get that card in the mail? Is that how you figured out about this?

Mr. HISEL. No. I was aware of it from following the health care debate, that it would be coming. And I was quite anxious to be aware of it. But my accountant did know about it from receiving some type of communication from the IRS, I believe. So——

Mr. MCDERMOTT. And so why are we hearing all these complaints? I mean you are just an ordinary guy who learned eighth grade math and figured out this thing, and figured it out, and handed it to your accountant and said, "I think this will work for us," and your accountant said, "Yep, you're right," and it cost you $195. Why are other people finding it so complicated?

Mr. HISEL. I don't know.

Mr. MCDERMOTT. All your people work every day, 8 hours a day, 50 weeks a year?

Mr. HISEL. No, we have—in fact, we have three full-time employees—that is one of the blanks—and then the full-time equivalent of part-time employees is simply a matter of finding the total number of hours worked by part-time employees, which is reporting QuickBooks, and you divide by 2,080, and you get the number of full-time equivalents.

Mr. MCDERMOTT. So, it is not that complicated.

Mr. HISEL. Doesn't seem to be, to me.

Mr. MCDERMOTT. And why, then, Ms. Thompson—I mean you got these accountants. I mean I got an accountant. Everybody here on the dais has an accountant, I will bet. Bet there is nobody up here that doesn't use one. They fill out a million forms every year. Months of February, March, and April are absolutely crazy at Bader Martin in Seattle.

So, when they have done 100 of these, or 1,000 of them, what is the complexity then?

Ms. THOMPSON. You made a very good point. It is the tax professional that is preparing the form. And to them, it is not complex. But it is to the individual small business owner that is accumulating that information that it may not be as straightforward for everybody as it is for my fellow panelist here.

And so, that is where the complexity comes in. The complexity is when the small business owner has to accumulate the information that they don't readily have available. Yes, they have it available, but it is not just picking up one number from here and dropping it there. They have to analyze it in a little bit more detail. But you are absolutely right——

Mr. MCDERMOTT. If you are running a business—if I could interrupt you just a second—if you are running a business, how can you run it without knowing how many people you are paying how much per hour times hours to give them a paycheck at the end of the week? How could you not know that information, to just hand it to your accountant and say, "Here is what I do"?

Ms. THOMPSON. You are absolutely right. There are payroll records that have annual amounts on them. But it is not as easy as just picking up that annual amount, because you have to know if the person had more than 2,080 hours because that person—you are not picking up the total hours. Maybe they worked 3,000 hours. But in your calculations you are not picking up 3,000, you are picking up 2,080. And then you have to look at whether or not you have part-time employees. And so those have to get special attention. If you have seasonal workers that work less than 120 days, they are handled one way. But if you have seasonal workers that are more than—you handle them a different way.

So, it is every situation for the small business owners themself that is where the complexity is. But you are absolutely right. For the tax professional that is preparing that form, it is not complex for them at all.

Mr. MCDERMOTT. So, if I want a deduction, I bring into my tax preparer the information about my contributions, and about my business expenses, and all that kind of stuff. If I don't give it to him or her, I don't get the deduction, right? So it is up to me?

Ms. THOMPSON. No, it would be up to the tax professional to make sure you, as a small business owner, were aware of the credit. And if you didn't provide it to the tax professional, the tax professional should be asking you the questions to get the information in.

Mr. MCDERMOTT. So in the second year we will have some better data.

Ms. THOMPSON. Second year it is going to be a lot better than the first year. And I think that is true of any tax law, the first year is always a little bit more challenging than the second year.

Mr. MCDERMOTT. Exactly. Thank you.

Chairman BOUSTANY. Ms. Jenkins.

Ms. JENKINS. Thank you, Mr. Chairman. Thank you all for being here.

Ms. Thompson, in your written testimony you explained how small business—the small business tax credit did not provide an incentive for small business to provide health insurance. If the employer is even aware of the credit, you said they are not likely to know whether their business is eligible for the credit—and if so, the size of the credit—until after the end of the year.

I would be curious for both you and Mr. McCracken to comment or elaborate on the challenges that a small business faces when planning its expenses, including health benefits for employees, and perhaps elaborate specifically on the effects of the temporary nature of this tax credit, which will expire after 2015, and how this affects a business owner's calculations when they are deciding whether to offer insurance, given that the health insurance law has not reduced the cost to provide the health insurance.

Ms. THOMPSON. I think I was answering the question from the perspective that the small business owner didn't know at any point during the year whether or not they were going to be eligible for the credit. There are those situations that they would absolutely be aware of it.

If there are less than 10 employees, and they know their compensation is—average compensation is less than $25,000, that is really very clear, very straightforward. They know they are going to be eligible for the credit. And so they would be able to calculate the credit, or the professional would be able to calculate the credit, and let them know how much they would be able to save, if they did have or purchase the insurance for those employees.

So, that is the perspective I was coming from. It is that they didn't—weren't able to plan for it during the current year to know whether or not they were going to be eligible for the credit. And that is why we say, okay, it would be so much better for them to do that look-back to the prior year, because then they can plan and make a really good business decision as to whether or not to purchase that insurance.

When you talk about the temporary nature of it, I don't think a small business owner is going to be that concerned with something that is going to be happening 7 years from now. If it is going to be very helpful for them in the short term to be able to pick up this insurance and be able to take advantage of the credit, that is probably what they are looking for.

As you know, tax laws change all the time. So maybe by the time this credit is scheduled to be repealed, maybe it won't be. And so there is a lot of things that go on when people are talking about whether or not to take advantage of the credit.

But our answer was perspective from planning for the current year, and whether or not to buy the insurance.

Ms. JENKINS. Okay. Mr. McCracken.

Mr. MCCRACKEN. I agree with part of that. I think that the temporary nature of the tax credit doesn't have—play a significant role in determining whether someone is going to use the tax credit. But I do think it plays a significant role if you are trying to incent a company that doesn't currently offer health insurance to begin offering health insurance.

Because small business owners are very reluctant to start doing something—an employee benefit—that they don't feel confident that they are going to be able to sustain. That is one of the biggest issues, I think, that played into health care reform for small companies, is newer companies simply were not starting to offer health insurance the way companies had in the past. And as older companies have gone away, newer small businesses are much less likely to offer health insurance, because they have seen this cost trajectory, and they are very concerned that they won't be able to keep offering it.

And it is a very different conversation with your employees if they came into your company because you offered health insurance, and now you have to get rid of it. That is a much more difficult conversation than if they came into your company knowing that you didn't provide health insurance, and being able to deal with that.

So it is just a really different situation. So I do think the temporary nature makes it very difficult to incent different behavior on the part of the small business.

Ms. JENKINS. Thank you. I yield back.

Chairman BOUSTANY. Mr. Paulsen.

Mr. PAULSEN. Thank you, Mr. Chairman. And, you know, the last panel, as well, talked about some of the complexity issues that are obviously out there when you have less than an 8 percent compliance rate, or an 8 percent participation rate, I should say, as a part of this tax credit. And it goes back to a little bit of that definition perspective of what is a small business, right? It is 25 employees, 15 employees.

I just remember in the health care debate and when that law was being first debated, I talked to one small business owner. I said, "Well, how many small—employees do you have, as a small business?" He said, "Under 50, and I am going to stay that way." And to me, that really sort of struck home. And now we are talking about a certain tax credit to help small businesses like Mr. Hisel's and others, where you have a 25-employee limit.

And Mr. McCracken, let me ask you this, because you testified about the difficulties that a small business faces in figuring out whether they are eligible for the credit, and if so, then calculating the amount of what that credit is. But moving beyond just those two hurdles, what effect do the employee and average wage limitations have on hiring or wage increases?

So you got seasonal employees, you got family members, you have wage restrictions, you have FTE restrictions. I mean do you believe that this complexity—this could actually prevent small businesses from hiring additional employees, or increasing wages?

Mr. MCCRACKEN. Do you mean the tax credit itself?

Mr. PAULSEN. Just in terms of the complexity component of it, yes.

Mr. MCCRACKEN. It could. I mean that is one of our concerns about having a long-term policy that provides incentives to small companies directly to provide health insurance. Because while the temporary doesn't have much effect on their behavior, a long-term tax credit or incentive could have effects on their behavior. But they might not be what you expect.

So, for instance, if you offer low-wage companies a significant tax credit for offering health insurance, you are essentially encouraging low wages. You are subsidizing low wages for the long term. And I think you would have a very real effect, in that regard.

If you are going to—and there are other ways you could define. If you subsidize small companies exclusively and have a cliff, you are giving them significant incentives to stay small, and to think about that growth, as you point out.

I think on the—with this credit being a temporary credit, those kind of effects are more muted than they would be if this was a permanent policy, going forward.

Mr. PAULSEN. Yes. And, Ms. Thompson, want to expand at all? Any comment?

Ms. THOMPSON. [No response.]

Mr. PAULSEN. I will just mention this, too, is I think that is fairly accurate, from the perspective of Congress is always thinking in short-term cycles. Is this certain tax credit going to get renewed for another 6 months? I mean this is actually a fairly unique credit. It is out there for a few years, and then it is going to be set to expire.

And so at some point Congress is going to be asked to come back and say, “Well, do we want to keep it going? Do we want to renew it? Do we want to extend it to other categories, for instance?” And it does create the uncertainty out there from those in the business community that want to allocate capital as a part of just the overall Tax Code. I mean that is a factor.

And I hope that, Mr. Chairman, we are going to continue to have these conversations. This is just one credit we are talking about, but it is an issue across the board, large companies and small. So I yield back.

Chairman BOUSTANY. And next we will go to Mr. Reed.

Mr. REED. Mr. Chairman, I am going to yield back. I am all set today. Thank you.

Chairman BOUSTANY. Mr. Crowley.

Mr. CROWLEY. Thank you, Doctor. Thank you for letting me participate today. I am pleased you are having this hearing today. And, my colleagues, if the worst thing you can say today about the health care law that we passed, also known as the Affordable Care Act, is that it only provided 228,000 small businesses with a tax cut, averaging $1,220, then it is clear to me that we have much larger problems on our hands. Because, in my book, tax cuts for 228,000 small businesses is a pretty good start. Furthermore, even more small businesses will receive this small business tax cut. That is clear from the testimony that you have offered.

But I am happy to use this hearing as an opportunity to spread the good word about this tax cut, and ensure we educate even more small businesses about the range of benefits available to them through health reform, so they can afford health coverage for their employees.

So I am thrilled to have this hearing today to allow us to trumpet the health care law, and reiterate that we are all in agreement on two points today: the Democratic health care law expands private health insurance coverage, and cuts taxes on job creators, small business men and women.

So welcome, Mr. Hisel, to the Ways and Means Committee, and please give my regards back to Montana when you go. My wife is from Billings, Montana, and her brother lives just outside Missoula in Clinton, Montana. So, maybe a neighbor of yours? So welcome here today.

So, you are a small business man who employs 17 folks, correct?

Mr. HISEL. We are at——

Mr. CROWLEY. Or less?

Mr. HISEL [continuing]. Nineteen right now.

Mr. CROWLEY. Nineteen? Good for you. Was this tax credit for small businesses in the Democratic health care law helpful to you? And I know you may have already answered this question, but I don't think we can hear it enough. Was it helpful to you?

Mr. HISEL. Yes. It continues to be helpful to us.

Mr. CROWLEY. So how much did you see refunded from your taxes because of the small business tax cut in the Affordable Care Act?

Mr. HISEL. Over $2,000.

Mr. CROWLEY. Over $2,000. So is it safe to say that this tax credit made it more affordable for you to provide health insurance to your workers, and without it you might have had to give it up, or give up on providing the private health coverage you give your employees today?

Mr. HISEL. Yes. It was on the chopping block this year.

Mr. CROWLEY. So we are hearing from a few people that not enough qualified small businesses are applying for this tax credit, and that it may not be worth it as it may be too complicated. What do you think, again? Is this tax credit worth it or not?

Mr. HISEL. It is absolutely worth it. Not too complicated, in our experience.

Mr. CROWLEY. There is a charge in the House of Representatives to repeal the health care law as we know it, known as the Affordable Care Act, to eliminate all future benefits, such as this small business tax break, and to reclaim all past benefits.

And I would allude to H.R. 2, which—I would think that Mr. Cain would have no difficulty reading this bill—it is on the second page where it says the act—"Such act is repealed, and the revisions of law amended or repealed by such act are restored or revived, as if such act had not been enacted." An entire repeal to reclaim all past benefits provided, such as the money you got to keep with this tax credit for job creators like yourselves, small businesses.

How would you feel if Congress repealed the health care law? And, once again, let me quote again—"as if it never was enacted,"—which experts have said could be used to force people to repay any benefits they have received like this tax cut or the $250 check that the seniors in our country received to close the doughnut hole in 2010. How would that make you feel, if you had to pay back that $2,000?

Mr. HISEL. I would be absolutely livid. It would be——

Mr. CROWLEY. How would it affect your business and your employees' well-being, having to write a much larger check to the IRS to deal with the small business tax cut that my colleagues on the other side of the aisle vehemently oppose?

Mr. HISEL. That would be absolutely infuriating. It is going in absolutely the wrong direction. I believe that the ACA is an actual stimulus to small businesses. It has helped me. It has reduced my premiums. And I would be absolutely infuriated if we went backward.

Mr. CROWLEY. I thank the witness for his testimony. I am pleased we got the opportunity to hear from a hard-working small business man like yourself.

Let me just for the record really point out other benefits. No mandates on any employer with under 50 employees to comply with this. No more health care decisions will be made by HMO employees on the phone, but rather by patients and their doctors. Children can no longer be denied coverage on their parents' private health insurance because of a previously existing condition, like asthma. Children can stay on their parents' private health insurance until 26. And the list of benefits goes on and on and on.

I thank you all for your testimony today.

Chairman BOUSTANY. I want to remind the gentleman that he did raise prospective legislation, which has been under consideration, and that is not the purview of the Oversight Subcommittee. And at the same time, I would also remind the gentleman that the—Mr. Hisel has a non-profit entity, so that some of the tax considerations you proposed would not apply.

Mr. CROWLEY. If the chairman would just yield for a moment?

Chairman BOUSTANY. I will yield.

Mr. CROWLEY. I was just taking the opportunity to point out the benefits of the law that we passed. So I thank the chairman for yielding.

Chairman BOUSTANY. And we have better proposals going down the line.

So I want to thank the witnesses for being here today, for your testimony, and I want to remind you all that—please be advised that Members may have written questions that they will submit, and your answers to those would be made part of the official hearing record.

Again, thank you. And this hearing is now adjourned.

[Whereupon, at 12:45 p.m., the Subcommittee was adjourned.]

[Questions for the Record follow:]

House Committee on Ways and Means, Subcommittee on Oversight
Questions for the Record from Chairman Boustany and Response from
Ms. Patricia Thompson, Chair AICPA Tax Executive Committee
American Institute of CPAs

1. **Your written testimony highlighted the complexity of determining eligibility for the small business tax credit. In fact, the IRS instructions to Form 8941 alone are eight pages long.**

   What kind of feedback have small businesses been giving you on the value of this credit? Also, please comment on the costs small businesses incur to determine and maintain eligibility for the credit? As a percentage of time spent by a paid professional on the return?

As I stated at the hearing, for the taxpayers who perfectly fit within the narrow constraints of the law, the credit is helpful. However, for many small employers, tax compliance costs were created without an offsetting benefit. As stated by one of my colleagues, "many times there was a lot of work for not a lot of return."

The AICPA does not gather any specific data with regard to the costs small businesses incur to determine and maintain eligibility for the credit. However, our members have told me that it was not uncommon this year for tax preparers to have spent up to 20% of the time necessary to prepare an entire small business return just on the credit calculation, only to learn that the client did not even qualify for the credit. As such, many small employers felt the entire process was a fruitless effort or wasted expense.

2. **In her written testimony, Ms. Ingram mentioned IRS outreach efforts such as mailings, webcasts, and town halls. IRS has made significant efforts to move forward to get information out to tax preparers and small businesses to raise awareness about the credit. Yet, with all this, participation seems too low at this early stage.**

   Is this attributable to insufficient outreach and information being given to small businesses, or is it because the credit is just too complex and small businesses have not taken the credit because of the complexity and cost?

Our members thought the IRS should be complimented on providing guidance on the application of the credit and also on informing taxpayers and tax professionals on the availability of the credit. We do not think the low participation is due to insufficient outreach or insufficient information.

Many small businesses had not filed their tax returns through this period so it is too early to tell if the actual participation for 2010 will be low. However, our members found that the credit's application was narrowly defined resulting in many of their clients not being able to take advantage of the credit. Other reasons for not claiming the credit may include that the small business owner did not seek professional assistance to understand the impact of the credit on their particular situation or may have decided that the cost of preparing the calculations outweighed the benefit to be received from the credit. Others may not have purchased health insurance because they would not be certain until after the end of the year that they would be eligible for the credit. The credit is complex and the AICPA's Tax Policy Concept on Guiding Principles for Tax Simplification states that complexity may lower levels of voluntary compliance.

3. In your written testimony you mentioned that small businesses are often disproportionately hurt by the complexity of the tax code, because they are unable to hire or they do not have the resources to hire the number of tax preparers, accountants, lawyers, and advisors to navigate through the code.

Also, the tax code is not even consistent in defining a small business. For example, the research credit defines "small business" as one with 500 or fewer employees, but for the purposes of an Archer Medical savings account, a business with fewer than 51 employees is a small business.

Please comment on how the tax code's complexity affects small employers, and how the small business tax credit adds to that complexity.

Many small businesses find tax compliance challenging as they lack the resources to comply with the rules. Unlike larger businesses that have dedicated staff to handle payroll, accounting, and tax issues – many small business owners handle all of these functions in addition to running the business.

The small business tax credit clearly adds complexity to the Code. For example, the definitions of eligible small employer, full-time equivalent employees, average annual wages, and employee are not straightforward or consistent with other provisions of the Code. Additional complexity results from the phase out of the credit based on the number of employees and average annual wages. Calculating the employee hours of service also made the credit difficult to apply as the number of annual hours worked by employee is often not readily available. Furthermore, the use of current year information did not provide an incentive for the small business owner to purchase health insurance during the year since they did not know until after the end of the year whether or not they would receive the benefit of the credit.

There is also no quick method for small businesses with more than ten employees to determine if they are eligible. Instead, small businesses sometimes incurred significant time in gathering information. Then, the CPAs had to spend time on analyzing the data and performing the calculations.

If the credit were made simpler, many small businesses could spend less time gathering data. More importantly, the ability to determine eligibility early in the year would provide an incentive for small businesses to purchase health insurance for employees.

4. In your written testimony you explained how the small business tax credit did not provide an incentive for small businesses to provide health insurance. If the employer is even aware of the credit, you mentioned that they are not likely to know whether their business is eligible for the credit and if so, the size of the credit until after the end of the year. Please elaborate on this point.

The primary problem is that employers cannot determine whether they will be eligible for the credit until the end of the year, after they have already made the decision whether to purchase health insurance. As previously mentioned, there is no quick method for small businesses with more than ten employees to determine if they are eligible. These small businesses generally must wait until after the end of the year in order to know their number of employees, the exact number of hours worked per employee, and the actual wages per employee. All of this information is necessary to determine eligibility for the small business health insurance credit.

One simple step to help achieve simplicity would be to use prior year data instead of current year data. In addition, the AICPA recommends that you consider basing the definition of small business on gross receipts. Instead of gathering information on its number of full-time equivalent employees or its average annual wages, the small employer could use the gross receipts amount reported on its prior year tax return.

[Submissions for the Record follow:]

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Statement for the Record
Ways and Means Oversight Subcommittee Hearing
On the
Small Business Health Insurance Tax Credit

Submitted by the National Association of Professional Employer Organizations

November 15, 2011

The National Association of Professional Employer Organizations (NAPEO) submits the following statement for the record.

NAPEO is the national trade association for the professional employer organization (PEO) industry and the voice of the PEO industry. NAPEO has more than 300 PEO members operating in all 50 states, representing more than 85 percent of the industry's $81 billion in revenues. NAPEO's PEO members range in size from start-up PEOs to large publicly held companies.

PEOs help small- and medium-sized businesses with human resources, compensation, and employee benefits issues through a co-employment arrangement whereby the PEOs assume W-2 employer status for the client's worksite employees. Employer responsibilities for those worksite employees are shared or allocated between the client and the PEO. Through economies of scale, PEOs improve compliance with federal and state tax and benefits laws and often provide retirement and health benefits that were not available to the workers prior to the PEO arrangement. PEOs collect employment taxes from their clients and remit the taxes to the federal government under the PEO's Employer Identification Number (EIN). This facilitates tax administration by reducing the number of returns processed and by reducing errors in calculating employment taxes. In addition, compliance is improved by accelerating the timing of collection of employment taxes because PEOs deposit taxes more quickly than their small business clients.

The hearing today is to examine the findings of a report (2011-40-103) issued on September 19, 2011, by the Treasury Inspector General for Tax Administration (TIGTA), on the implementation of the Small Business Health Care Tax Credit by the IRS. One of the findings of the report is that small business clients of PEOs may find they are targets of IRS enforcement efforts designed to address employers who do not pay employment taxes. Because these small businesses do not file employment tax returns, TIGTA stated that this problem is caused in part by the inability of the IRS to link a small business client to the PEO with which it contracts.

In 2007, TIGTA issued another report, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done*, (2007-30-169) that recognized that PEO clients and the IRS are vulnerable to non-payment of federal employment taxes by PEOs, because under the regulations, the IRS's only recourse in the event of PEO failure to remit employment taxes is to collect the amounts due from the PEO's clients. TIGTA also reported that several states have laws that require bonding and independent audits for PEOs that do business in their states.

Fortunately, there is legislation that would address many of the concerns raised by TIGTA. Representatives Kevin Brady (R-TX) and Mike Thompson (D-CA) have introduced The Small Business Efficiency Act of 2011 (H.R. 2466) to create a voluntary certification program for PEOs within the IRS.[1] To become IRS-certified, a PEO would have to meet financial standards (including bonding and independent financial audit requirements) and satisfy reporting obligations and other appropriate standards set by the IRS. These reporting requirements could include reporting of the EINs of a PEO's clients as recommended by the TIGTA report.

Under H.R. 2466, certified PEOs would take on sole liability for the collection of federal employment taxes for worksite employees performing services for their PEO clients. Small- and medium-sized business clients that contract with certified PEOs would be assured that they would not be liable for employment taxes when the PEO has accepted that responsibility. This provision would help address one of the findings in the TIGTA report being discussed in today's hearing. TIGTA found that small businesses using PEOs were "unnecessarily" falling into an IRS compliance program designed to identify and audit employers who are not paying their employment taxes. TIGTA called this "a waste of IRS resources" and "an increased burden on those affected taxpayers"—meaning the small and midsized business clients of PEOs. H.R. 2466 would afford protection to businesses that use IRS-certified PEOs from such enforcement.

NAPEO strongly supports H.R. 2466. Enactment of this legislation would result in improved compliance with federal tax law, grant legal status within the IRS for PEOs, and create a safe harbor from IRS enforcement on the payment of employment taxes for small businesses that use certified PEOs. It addresses several of the problems raised by TIGTA in its report in 2007 and the report that is the focus of today's hearing. For these reasons, we ask that the Ways and Means Committee move forward on consideration of H.R. 2466.

[1] Comparable bipartisan legislation has passed the Senate in a previous Congress and a bill identical to the one passed previously by the Senate (S. 1908) has been reintroduced in this Session of Congress by Senators Charles Grassley (R-IA) and Bill Nelson (D-FL).

NFIB
The Voice of Small Business.

November 29, 2011

The Honorable Charles Boustany
Chairman
Ways & Means Subcommittee on Oversight
U.S. House of Representatives
1431 Longworth House Office Building
Washington, D.C. 20515

The Honorable John Lewis
Ranking Member
Ways & Means Subcommittee on Oversight
U.S. House of Representatives
343 Cannon House Office Building
Washington, D.C. 20515

Dear Chairman Boustany and Ranking Member Lewis:

On behalf of the National Federation of Independent Business (NFIB), the nation's leading small business advocacy organization, we write today to report the findings of a July 2011 NFIB Research Foundation survey regarding the Patient Protection and Affordable Care Act (PPACA) small business tax credit's impact on small business and their ability to offer health insurance coverage. We believe the survey, *Small Business and Health Insurance: One Year After Enactment of PPACA*, accurately demonstrates small business owner reaction to the PPACA small business tax credit and is verified by two recent government analyses.

The high cost of health insurance remains a top problem for small employers and will likely remain so for a long time. However, PPACA's extraordinarily complex small business tax credit offered little incentive to purchase health insurance for small firms currently not offering coverage. Instead, it serves almost exclusively as a windfall for small businesses who currently offer coverage to employees.

Eligibility versus Actual Claims

The President's Council of Economic Advisors estimated over four million small businesses would be eligible for the PPACA small business tax credit. However, our survey found that far fewer than four million small employers are eligible for the tax credit. We estimated that 245,000 small businesses, or less than 5 percent of the small business population, are eligible for the full PPACA small business tax credit. Another 1.165 million, or a little over 20 percent of that population, are eligible for a partial credit. The estimate of far fewer than four million was verified by a September 2011 Small Business Administration (SBA) Office of Advocacy report titled *Health Insurance in the Small Business Market: Availability, Coverage, and the Effect of Tax Incentives* that estimated 2.6 million firms will be eligible for the partial benefit.

The lower estimates by our Research Foundation and the SBA Office of Advocacy report occurred for multiple reasons. Eligibility for the credit is based on a complicated combination of four tests: (1) the offer of employee health insurance, (2) fewer than 11 employees for the full credit phasing out and capped at 25 employees, (3) average annual employee wages of $25,000 or less phasing out and capped at $50,000 and, (4) employer payment of at least 50 percent of the employee's health insurance premium. The Administration's estimate may have been high because the IRS did not have ready access to data that allowed it to determine which businesses that fit the size and average wage parameters actually offer health insurance, offer the right kind of health insurance, or employ family members that would disqualify them from credit eligibility.

Despite an aggressive education and outreach campaign by the Administration, the actual results have been even more underwhelming than estimated, with 309,000 taxpayers claiming the credit as of mid-October 2011, according to the Treasury Inspector General for Tax Administration (TIGTA) testimony. The low volume of claims depends on a variety of factors – the complexity of calculating the credit, the temporary nature of the credit, and the uncertain future of the health insurance market after the passage of PPACA.

Complexity

Small employers cannot easily determine the value of the credit, according to our survey. The amount of the credit is often unknown until a complex calculation is made. Our survey found more small business owners had interest in pursuing a hypothetical, simply structured $1,500 credit per full-time employee than pursuing the PPACA small business tax credit. Our survey results are verified by the TIGTA report's findings that (1) taxpayers are unclear on the specifics of the credit and (2) the credit is not worth the time and effort to claim as multiple steps are required to calculate it and seven worksheets must be completed in order to claim it.

Temporary, Targeted Nature

The temporary credit will erode over time. Because it is temporary in nature, expiring in four to six years, depending on certain circumstances, it does not appeal to employers who do not offer insurance. The rising cost of providing insurance is a deterrent for many small businesses to begin offering insurance. A temporary, targeted tax credit does little to offset the high cost of beginning to provide health insurance and the expiration of the credit will result in a significant increase in health insurance costs. The SBA Office of Advocacy wrote, "It remains to be seen whether the provisions in Federal health care reform will be sufficient to overcome the barriers to small businesses offering health insurance to their employees… the unpredictable costs associated with providing health insurance may continue to deter small businesses from offering health insurance to their employees." This result is consistent with the SBA Office of Advocacy's findings on state tax incentives for offering health insurance, which have generally not lead to increases in offering rates because the level of incentives have been small compared to the cost of offering coverage.

Uncertain Future

Further, the SBA Office of Advocacy reported that small employers may be reluctant to offer health insurance to their employees because of uncertainty about the effects of PPACA. Small employers may "wait and see" whether exchanges are created and viable. Other small firms may not offer new employee benefits due to an uncertain economy and tax and regulatory environment. Uncertainty about future costs of health insurance with the development of exchanges and costs of the essential health benefit package is preventing non-offering firms from beginning to offer the benefit.

Conclusion

According to our survey, for those offering, the PPACA tax credit serves almost exclusively as a windfall since recipients receive a credit for what they were already doing. It provides virtually no incentive for non-offering firms to purchase health insurance. Similarly, the SBA Office of Advocacy reported that the credit will primarily benefit small businesses that currently offer insurance to their employees. This windfall is contrary to the advertised goal of incentivizing small businesses who do not currently offer health insurance to do so.

Thank you for holding this Ways and Means Oversight Subcommittee hearing on Small Business Health Insurance Tax Credit and permitting the opportunity to share NFIB Research Foundation's survey results on the topic.

Sincerely,

Susan Eckerly

Susan Eckerly
Senior Vice President
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SMALL BUSINESS MAJORITY

STATEMENT FOR THE RECORD

BEFORE HOUSE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS

ON

SMALL BUSINESS HEALTH INSURANCE TAX CREDIT CREATED BY THE PATIENT PROTECTION AND AFFORDABLE CARE ACT

NOVEMBER 15, 2011

JOHN ARENSMEYER
FOUNDER AND CEO
SMALL BUSINESS MAJORITY

This testimony is submitted in support of the small business perspective on the Patient Protection and Affordable Care Act and, specifically, the impact of the small employer healthcare tax credit provision on small businesses, our nation's chief job creators.

Small Business Majority is a national nonpartisan small business advocacy organization founded and run by small business owners and focused on solving the biggest problems facing small businesses today. We represent the 28 million Americans who are self-employed or own businesses of up to 100 employees. Our organization uses scientific opinion and economic research to understand and represent the interests of small businesses.

The Affordable Care Act will help reduce the cost of insurance and medical care while making coverage affordable, fair and accessible. The small business healthcare tax credit is an important provision within the act that will help lower costs for small employers. Granted, the tax credit is not a panacea for high health insurance costs. It alone will not give all small business owners the relief they need. However, it is one weapon small business owners should include in their arsenal to fight ever-rising premium costs.

Passage of the Affordable Care Act was critical for small businesses; they are in desperate need of relief from the high costs of health insurance. Our research shows that reforming our broken healthcare system has been and still is one of small business owners' top concerns, and that the majority of small employers believe reform is needed to fix the US economy. It also shows that small businesses support key provisions in the law, specifically ones that help them better afford insurance, such as tax credits and insurance exchanges, and those that contain costs. Controlling skyrocketing costs is essential to ensuring small businesses' ability to obtain high-quality, affordable healthcare for themselves, their families and their employees. Our research also shows that absent reform, these costs would continue to escalate, undermining small businesses' success and our economic recovery. The new law goes a long way toward fixing our broken system and stemming these spiraling costs, while helping to create jobs and stimulate the economy.

Our research, which is discussed in more detail below, shows the impact this legislation and the tax credit provision in particular will have on small businesses. In July 2010, Small Business Majority partnered with Families USA to determine the number of small businesses eligible for a tax credit on their 2010 tax returns, one of the key provisions of the Affordable Care Act.

- We found that more than 4 million small businesses would be eligible to receive a tax credit for the purchase of employee health insurance in 2010. [1]

We also commissioned a national survey of 619 small business owners to determine their views on the tax credits and insurance exchanges, another crucial provision of the Affordable Care Act for small businesses. The survey, which was released in January 2011, found that:

- Both the tax credits and the exchanges, once they take effect, make small business owners more likely to provide healthcare coverage to their employees;
- One-third of employers who don't offer insurance said they would be more likely to do so because of both the small business tax credits and the insurance exchanges;
- 31% of respondents who currently offer insurance said the tax credits and the exchanges will make them more likely to continue providing coverage. [2]

However, the poll also found that the *vast majority of small business owners don't know the tax credits or exchanges exist* to help them afford coverage.

As Congress holds hearings critical of the Affordable Care Act, it's important to understand the consequences doing nothing would have had on small businesses and our fragile economy.

- Small businesses wouldn't have $4 billion per year in healthcare tax credits and many small business protections;
- Small businesses would have no ability to pool their buying power through state insurance exchanges, and the various cost controls the ACA puts in place would not exist;
- Tough enforcement measures in the law, which are saving billions in Medicare waste, fraud and abuse, would also not exist. This would result in higher taxes for employers and employees to fund Medicare, and higher taxes mean fewer jobs.

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[1] Families USA and Small Business Majority. A Helping Hand for Small Businesses: Health Insurance Tax Credits. July 2010. http://smallbusinessmajority.org/small-business-research/tax-credit-study.php.

[2] Small Business Majority. Opinion Survey: Small Business Owners' Views on Key Provisions of the Patient Protection and Affordable Care Act, Jan. 4, 2011. http://smallbusinessmajority.org/small-business-research/small-business-healthcare-survey.php.

These are just some of the disastrous consequences our healthcare system absent the Affordable Care Act would have on small businesses—consequences that are too severe on our nation's primary job creators. Small businesses create 65% of new jobs in our country. Spending less on health insurance will help them generate larger profits, which will help speed our journey down the road to economic recovery.

This testimony highlights what we've learned both through our research about small business owners' opinions on the tax credits and the economic impact the Affordable Care Act will have on small businesses. The key issues are:

- How the Affordable Care Act is helping small business owners now;
- Educate small business owners about provisions such as the tax credits to help them thrive;
- Healthcare costs are the No. 1 problem facing small businesses; and
- The status quo was unacceptable—doing nothing would thwart economic growth and job creation.

How the Affordable Care Act Is Helping Small Business Owners Now

Our research shows that small business owners are more likely to provide insurance to their employees because of the tax credits and exchanges provided through the new healthcare law. As mentioned in the introduction, our most recent research includes a national survey of 619 small business owners that was released on Jan. 4, 2011.[3] We wanted to gauge how entrepreneurs view two critical components of the Affordable Care Act: the small business tax credits—a provision allowing businesses with fewer than 25 employees that have average annual wages under $50,000 to get a tax credit of up to 35% of their health insurance costs beginning in tax year 2010—and health insurance exchanges—online marketplaces where small businesses and individuals can band together to purchase insurance starting in 2014. The survey's key findings include:

- One-third (33%) of employers who don't offer health insurance said they would be more likely to do so because of the small business tax credits;
- 31% of respondents—including 40% of businesses with 3-9 employees—who currently offer insurance said the tax credits will make them more likely to continue providing insurance;
- One-third (33%) of respondents who currently do not offer insurance said the exchange would make them more likely to do so;
- The same is true for those who already offer insurance, with 31% responding that the exchange would make them more likely to do so;
- **However, most respondents are not familiar with the exchange or the tax credits; only 31% of respondents are familiar with the exchange and 43% are familiar with the tax credits.**

[19] Small Business Majority, Opinion Survey: Small Business Owners' Views on Key Provisions of the Patient Protection and Affordable Care Act, Jan. 4, 2011, http://smallbusinessmajority.org/small-business-research/small-business-healthcare-survey.php..

To help inform small business owners about the tax credits and other provisions in the law that affect them, Small Business Majority has been holding Listening Tours, webinars and other events across the nation. Through our conversations with small business owners at these events, we've found anecdotally exactly what our scientific opinion research found: the vast majority of small business owners don't realize the tax credits exist to help them better afford insurance, but when they learn about them they like what they hear and want to know more.

We recently spoke with a small business owner in San Francisco, CA, who had never heard of the tax credits until we informed her of them. She was very intrigued by them and upset her CPA hadn't told her about them when they filed her taxes. She recently had to drop health insurance for her employees, and if she had known she might be able to get a tax credit through the new law, it could have helped her continue providing insurance. She planned on talking to her accountant about the tax credit immediately to see if she might be able to reinstate her employees' policies.

We believe that once small business owners become more familiar with the new law and specific provisions like the small business tax credits, they will understand the financial benefits and cost savings it provides. In fact, a Kaiser Family Foundation study conducted in January 2010 found that although the public was divided overall about reform, they became more supportive when told about key provisions. After hearing that tax credits would be available to help small businesses provide coverage to employees, 73% said it made them more supportive, and 63% felt that way after learning that people could no longer be denied coverage because of preexisting conditions.[4]

The huge number of small businesses eligible for a credit on their 2010 tax returns shows how wide-ranging the benefits of the ACA are: Small Business Majority and Families USA's study on the number of small businesses eligible for a tax credit on their 2010 tax returns shows that more than 4 million small businesses are eligible.[5] That equates to 83.7% of all small businesses in the country. Perhaps even more encouraging is that more than 90% of small businesses in 11 states are eligible to receive the tax credits, with nearly 1.2 million small businesses nationally eligible to receive the maximum credit.

While the initial uptake on the credits was low, this is largely due to small business owners' overall unfamiliarity with this provision of the Affordable Care Act. What's more, opponents have spent tremendous time and resources discouraging small business owners from taking the credits for political purposes, which essentially amounts to them discouraging small business owners from taking free money. Whether it's a couple hundred dollars or thousands, any extra money helps during this unforgiving economic climate. We should be doing all we can to educate small business owners about this provision and encourage them to apply for it. It's also encouraging the IRS is taking steps to simplify the credit for small employers so more firms can reap its benefits.

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[4] Kaiser Family Foundation, Americans Are Divided About Health Reform Proposals Overall, But the Public, Including Critics, Becomes More Supportive When Told About Key Provisions, Jan. 22, 2010, http://www.kff.org/kaiserpolls/kaiserpolls012210nr.cfm.

[5] Families USA and Small Business Majority, A Helping Hand for Small Businesses: Health Insurance Tax Credits, July 2010, http://smallbusinessmajority.org/small-business-research/tax-credit-study.php.

Educate Small Businesses about the Law to Help them Thrive

Critics of the new law have wasted no time in attempting to tear it down, yet have offered no pragmatic solutions on how to address the core problem—the excessive cost of health insurance. As mentioned above, they've also spent considerable time attacking the tax credits. The recent release of data showing how many small employers received the tax credit should be a wake-up call for everyone invested in small businesses and our economy. Small business owners are the backbone of this country. They will help pull the economy out of its slump. But they can't do it without help. All stakeholders should be educating small businesses about provisions that will put money back in their pockets now, which will help them grow their businesses and with it the economy. The small business tax credit is one of those provisions.

Thanks to the tax credits, small businesses received $278 million back on their health insurance premiums this year. One of those small business owners is Mark Hodesh, owner of Downtown Home & Garden in Ann Arbor, Michigan. For Mark, 2010 was a good year. His best ever, in fact. Mark saw his business blossom, was able to offer health insurance to his 12 full-time employees and even managed to grow by adding a person to his staff.

While business savvy undoubtedly contributed to his bustling shop's bottom line, it was the small business tax credits that allowed him to hire another person. Mark, who pays 75% of his employees' healthcare premiums—$60,000 a year—was able to claim $15,000 on his tax return this year. Knowing that money was coming back gave Mark, who had been on the fence about hiring another person, the confidence he needed to make his move. His new employee has become a tremendous asset to the store and a big part of its success in 2010. What's more, his new worker was unemployed before going to work for Mark. Now she's paying taxes and contributing to improving the economy.

Healthcare Costs are the No. 1 Problem Facing Small Businesses

National surveys of small business owners consistently show that the cost of health insurance is one of their biggest overall problems. Small businesses are at a disadvantage in the marketplace largely because their small numbers make rates higher. According to research supported by the Commonwealth Fund, on average they pay 18% more than big businesses for coverage.[6] Small businesses, including the self-employed, need a level playing field to succeed and continue as the job generators for the U.S. economy.

We hear stories every day from small business owners who can't get coverage because they've been sick in the past or the health plans they are offered are outrageously priced. Many other businesses maintain coverage for employees, but the cost is taking a bigger and bigger chunk out of their operating budgets. It's common to hear about double-digit premium increases each year, eating into profits and sometimes forcing staff reductions. This is where the small business tax credits can provide some relief. If every small business owner eligible for a credit applied for it, it could help lower a significant number

[6] J Gabel et al. Generosity and Adjusted Premiums in Job-Based Insurance: Hawaii is Up, Wyoming is Down. *Health Affairs*. May/June 2006. http://content.healthaffairs.org/content/25/3/832.full.

of employers' costs—even if it's just by a couple hundred dollars. As a small business owner myself, I know every little bit counts for small firms.

We know small business owners want to offer health coverage, and our surveys show that most of them feel they have a responsibility to do so. They need to know about any provision available to help them do so. Small Business Majority conducted surveys of small business owners in 17 states between December 2008 and August 2009.[7] Our key findings included:

- An average of 67% of respondents said reforming healthcare was urgently needed to fix the U.S. economy;
- An average of 86% of small business owners who don't offer health coverage to their employees said they can't afford to provide it, and an average of 72% of those who do offer it said they are struggling to afford it.

It should be noted that respondents to these surveys included an average of 15% more Republicans (39%) than Democrats (24%), while 27% identified as independent.

The exorbitant cost of insurance means that many small businesses are forced to drop coverage altogether. According to the Kaiser Family Foundation, 54% of businesses with fewer than 10 employees don't offer insurance.[8]

This makes small business employees a significant portion of the uninsured population. Of the 45 million Americans without health insurance in 2007, nearly 23 million were small business owners, employees or their dependents, according to Employee Benefit Research Institute estimates.[9] And nearly one-third of the uninsured—13 million people—are employees of firms with less than 100 workers.[10]

With staffs of 5, 10 or even 20 people, small businesses are tight-knit organizations. Owners know their employees well and depend on each employee for their businesses' success. They don't want to see their valuable employees wiped out financially by a health problem, or ignore illnesses because they can't afford to go to the doctor.

The Affordable Care Act addresses all these issues and more. Without reform, we will impede our overall economic growth. Small businesses with fewer than 100 employees employ 42% of American workers.[11] Traditionally, small businesses lead the way out of recessions. Continuing to address the healthcare crisis by implementing the Affordable Care Act and educating our primary job creators about provisions that can help them is essential to our vitality as a nation. Trying to tear down or intentionally obfuscate

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[7] Small Business Majority, State Surveys Highlight Small Business Support for Healthcare Reform, August 2009, http://www.smallbusinessmajority.org/small-business-research/opinion-research.php.
[8] Kaiser Family Foundation/HRET, Employer Health Benefits Annual Survey, 2008, http://ehbs.kff.org/2008.html.
[9] Employee Benefit Research Institute. Sources of Health Insurance and Characteristics of the Uninsured: Analysis of the March 2008 Current Population. http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=3975.
[10] Center for American Progress, What Will Happen to Small Business if Health Care Is Repealed, July 23, 2010, http://www.americanprogress.org/issues/2010/07/small_biz_reform.html.
[11] U.S. Bureau of Census, 2006 County Business Patterns

important provisions of this legislation would send small businesses back into in a broken system that threatens their competitiveness, discourages entrepreneurism and jeopardizes our economic recovery.

Conclusion

Healthcare reform is not an ideological issue; it's an economic one. Small business owners know this, which is why they overwhelmingly support reforming our broken system and containing the skyrocketing cost of insurance.

Without reforms like the tax credits in the ACA, small businesses will once again be mired in a system that drains their coffers and stunts their growth—disabling them from playing their vitally important role as the nation's jobs creators. But it's imperative they are educated about the provisions that will help lower their costs so they can in turn grow the economy. We hope Congress will spend its time focusing on ways to make implementation of the Affordable Care Act as smooth as possible, and on ways of strengthening its provisions. Our small businesses and our economic recovery depend on it.

Comments for the Record

House Committee on Ways and Means

Subcommittee on Oversight

Hearing: Small Business Health Insurance Tax Credit

November 15, 2011, 10:30 AM

by Michael G. Bindner

The Center for Fiscal Equity

Chairman Boustany and Ranking Member Lewis, thank you for the opportunity to submit my comments on this topic. We will leave reporting on the effects of this program to the Administration witnesses and will confine our testimony to alternative ways to that small businesses may offer health care more effectively in the future, although we will first offer our assessment of the possibilities of reform under the *Affordable Care and Patient Protection Act.*

The Affordable Care Act works toward increasing funds for Medicaid providers, which is necessary to get people out of emergency rooms. The same act, however, counted on assuming that Medicare provider cuts would be implemented – a heroic assumption – in order to pass according to budget rules. Now that the Act is passed, however, the fiction that current law will be maintained can be dispensed with. Parity between Medicare and Medicaid is desirable, although without mandatory sick leave, it will not keep poor people from having to use emergency room care, limiting the likely effectiveness of the Act for the purpose of decreasing costs and keeping premiums low for small business.

More dangerous to the success of the Act, however, is the possibility of the failure of private insurance generally. The key issue for the future of health care consolidation is the impact of pre-existing condition reforms on the market for health insurance. Mandates under the Affordable Care Act (ACA) may be inadequate to keep people from dropping insurance - and will certainly not work if the mandate is rejected altogether for constitutional reasons.

If people start dropping insurance until they get sick – which is rational given the weakness of mandates – then private health insurance will require a bailout into an effective single payer system. The only way to stop this from happening is to enact a subsidized public option for those with pre-existing conditions while repealing mandates and pre-existing condition reforms.

One option is single-payer catastrophic insurance with health savings accounts. This would not work as advertised, as health care is not a normal good. People will obtain health care upon doctor recommendations, regardless of their ability to pay. Providers will then shoulder the burden of waiting for health savings account balances to accumulate – further encouraging provider consolidation. Existing trends toward provider consolidation will exacerbate these problems, because patients will lack options once they are in a network, giving funders little option other than paying up as demanded.

Shifting to more public funding of health care in response to future events is neither good nor bad. Rather, the success of such funding depends upon its adequacy and its impact on the quality of care – with inadequate funding and quality being related. For example, Medicare provider cuts under current law have been suspended for over a decade, the consequence of which is adequate care. By way of comparison, Medicaid provider cuts have been strictly enforced, which has caused most providers to no longer see Medicaid patients, driving them to hospital emergency rooms and free clinics with long waiting periods to get care.

Ultimately, fixing health care reform will require more funding, probably some kind of employer payroll or net business receipts tax – which would also fund the shortfall in Medicare and Medicaid (and take over most of their public revenue funding). We will now move to an analysis of funding options and their impact on patient care and cost control.

The committee well understands the ins and outs of increasing the payroll tax, so I will confine my remarks to a fuller explanation of Net Business Receipts Taxes (NBRT). Its base is similar to a Value Added Tax (VAT), but not identical.

Unlike a VAT, an NBRT would not be visible on receipts and should not be zero rated at the border – nor should it be applied to imports. While both collect from consumers, the unit of analysis for the NBRT should be the business rather than the transaction. As such, its application should be universal – covering both public companies who currently file business income taxes and private companies who currently file their business expenses on individual returns.

The key difference between the two taxes is that the NBRT should be the vehicle for distributing tax benefits for families, particularly the Child Tax Credit, the Dependent Care Credit and the Health Insurance Exclusion, as well as any recently enacted credits or subsidies under the ACA. In the event the ACA is reformed, any additional subsidies or taxes should be taken against this tax (to pay for a public option or provide for catastrophic care and Health Savings Accounts and/or Flexible Spending Accounts).

This option would be particularly attractive to small businesses. It would essentially broaden the tax credit in the ACA. The current tax regime does not serve to encourage use of the Small Business Tax Credit, which in any case should be merged with the health insurance exclusion as part of an NBRT collected on all businesses, regardless of filing status.

The key to utilization is to increase the tax rate enough to encourage use and requiring such tax benefits for health care and our proposed expanded and refundable Child Tax Credit before any other exclusion are taken, including any zero rating of exports (which is why zero rating is not recommended for this tax).

The NBRT can provide an incentive for cost savings if we allow employers to offer services privately to both employees and retirees in exchange for a substantial tax benefit, either by providing insurance or hiring health care workers directly and building their own facilities, although we expect that only larger businesses will go to those lengths. Employers who fund catastrophic care or operate nursing care facilities would get an even higher benefit, with the proviso that any care so provided be superior to the care available through Medicaid. Making employers responsible for most costs and for all cost savings allows them to use some market power to get lower rates, but no so much that the free market is destroyed.

This proposal is probably the most promising way to arrest health care costs from their current upward spiral – as employers who would be financially responsible for this care through taxes would have a real incentive to limit spending in a way that individual taxpayers simply do not have the means or incentive to exercise. While not all employers would participate, those who do would dramatically alter the market. In addition, a kind of beneficiary exchange could be established so that participating employers might trade credits for the funding of former employees who retired elsewhere, so that no one must pay unduly for the medical costs of workers who spent the majority of their careers in the service of other employers.

The NBRT would replace disability insurance, hospital insurance, the corporate income tax, business income taxation through the personal income tax and the mid range of personal income tax collection, effectively lowering personal income taxes by 25% in most brackets.

Note that collection of this tax would lead to a reduction of gross wages, but not necessarily net wages – although larger families would receive a large wage bump, while wealthier families and childless families would likely receive a somewhat lower net wage due to loss of some tax subsidies and because reductions in income to make up for an increased tax benefit for families will likely be skewed to higher incomes. For this reason, a higher minimum wage is necessary so that lower wage workers are compensated with more than just their child tax benefits.

The Center calculates an NBRT rate of 27% before offsets for the Child Tax Credit and Health Insurance Exclusion, or 33% after the exclusions are included. This is a "balanced budget" rate. It could be set lower if the spending categories funded receive a supplement from income taxes.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

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Subcommittee on Oversight
Small Business Health Insurance Tax Credit November 15, 10:30 AM
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