THE TAX OUTLOOK FOR SMALL BUSINESSES:
WHAT'S ON THE HORIZON?

HEARING
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES
ONE HUNDRED TWELFTH CONGRESS
SECOND SESSION

HEARING HELD
APRIL 18, 2012

Small Business Committee Document Number 112–063
Available via the GPO Website: www.fdsys.gov
CONTENTS

OPENING STATEMENTS

Hon. Sam Graves ................................................................. 1
Hon. Nydia Velazquez .......................................................... 1

WITNESSES

Aparna Mathur, Ph.D., Resident Scholar, American Enterprise Institute, Washington, DC ......................................................... 3
Leonard Steinberg, Principal, Steinberg Enterprises, LLC, West Windsor, NJ ............................................................... 4
Margot Dorfman, CEO, U.S. Women’s Chamber of Commerce, Washington, DC ........................................................... 6
Martin J. Mitchell, Vice CEO, Mitchell & Best Homebuilders LLC, Rockville, MD ............................................................. 8

APPENDIX

Prepared Statements:

Aparna Mathur, Ph.D., Resident Scholar, American Enterprise Institute, Washington, DC ................................................................. 18
Leonard Steinberg, Principal, Steinberg Enterprises, LLC, West Windsor, NJ ............................................................... 31
Margot Dorfman, CEO, U.S. Women’s Chamber of Commerce, Washington, DC ........................................................... 39
Martin J. Mitchell, Vice CEO, Mitchell & Best Homebuilders LLC, Rockville, MD ............................................................. 41

Additional Materials for the Record:

Associated Builders and Contractors, Inc. Letter for the Record ........ 48
Statement of the National Grocers Association .................................. 49
Comments from the Small Business Committee “Open Mic” Website .... 53
THE TAX OUTLOOK FOR SMALL BUSINESSES: WHAT’S ON THE HORIZON?

WEDNESDAY, APRIL 18, 2012

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

The Committee met, pursuant to call, at 1 p.m., in room 2360, Rayburn House Office Building. Hon. Sam Graves (chairman of the Committee) presiding.

Present: Representatives Graves, Mulvaney, West, Landry, Schilling, Velázquez, Schrader, Cicilline.

Chairman Graves. Good afternoon, everybody. And we will call this hearing to order. I want to thank our witnesses for being here today and I will look forward to everybody's testimony.

This week, as small business owners across the country are filing their taxes, we consider the tax burden on them. According to the National Federation of Independent Business, federal taxes consistently rank among the top five problems that small business owners face. And a Small Business Administration study found costs small and medium-sized businesses 36 percent more per employee to comply with the regulations than larger businesses.

Small business owners face other obstacles, too. Many will be hit with new taxes and tax increases in the health care law, such as the increase in the Medicare payroll tax and an unprecedented Medicare tax on nonpayroll income. And if the 2001 and 2003 tax policies are not extended, many small business owners may see their tax bills increase. Already facing rising energy costs and scarce capital, they do not need tax increases in this struggling economy, too.

We should be fostering an environment where people are rewarded for investment, and that is why we encourage investment in entrepreneurship. But if we are going to penalize those investments by raising taxes on them, then our small businesses will find it even more difficult to access capital. I agree with the Ways and Means Committee chairman, Dave Camp, that we need comprehensive tax reform. In the meantime, we must do all we can to create an environment in which small businesses can thrive.

And again I want to thank all of our witnesses for being here and for your participation. Some of you have come a long way. And I now yield to Ranking Member Velázquez.

Ms. Velázquez. Thank you. Thank you, Mr. Chairman. Welcome everyone.

In recent months, our economy has shown steady signs of recovery. In the last quarter of 2011, gross domestic product grew at an
annual rate of 3 percent. Consumer spending is on the rebound, increasing by the most in seven months in February despite stagnant wages and rising gas prices. Most importantly, the U.S. economy is adding jobs—245,000 a month between December and February.

While this news is promising, the recovery remains fragile, making it vital that our tax policy promote small business job growth and does not hinder it. Now more than ever, small firms need stability and incentives to grow. But after filing taxes yesterday, the challenge is created by the current tax code and the uncertainties that lie ahead are on the minds of every small business owner. Tax law has been used to encourage business investment through the use of deductions, credits, and favorable tax rates. Yet, as this Committee is well aware, it has become riddled with unnecessary complexities which have created additional burden on small firms. With many expiration dates looming and ACA tax provisions going into effect in the coming years, these complications are compounded for millions of firms.

In that vein, it is my hope that today’s hearing will offer insight on both current and future tax obstacles while also generating potential solutions. In doing so, we will seek ways to ensure effective tax efforts are maintained and ineffective ones are either allowed to expire or modified to encourage growth and competition. Failure to take any action, however, could create greater uncertainty in the marketplace and dampen the recovery for small businesses.

At a time when the economy is starting to exhibit sustained job creation, small firms cannot have new obstacles to expansion. Tax policies can disadvantage small businesses as they seek to compete both domestically and abroad. Small firms now spend up to 67 percent more on tax compliance than their corporate competitors and face constant changes to the tax code creating further confusion and hindering job creation. A fitter and simpler tax code can encourage entrepreneurship, promote investment, and yield hiring. After all, as we look at policies to promote growth, tax reform should be a top priority.

Given that the last major reform of the code took place in 1986, it is clear changes are long overdue and that we cannot go forward without input from small business owners and entrepreneurs. Yet, comprehensive tax reform poses its own challenges. However, many discussions have focused on a corporate-only approach which disregards the importance of individual tax rates. Devoting reform efforts on a complete overhaul of the code supports our nation’s job creators by allowing them to continue hiring and expanding without worrying about tax increases. Comprehensive reform will have immediate benefits for small businesses while also serving our nation’s economic objectives of promoting job growth policies.

With that I look forward to today’s testimony and thank the witnesses for your participation. Thank you, Mr. Chairman.

Chairman Graves. Thank you. Unfortunately, it looks like we are going to have a series of votes that are coming up within the half hour. So what we will do is at that point in time we will recess and go vote and then we will come back. I apologize for that. Ms. Velázquez and I do not get to make the schedule. If we did, we would do it a little bit different unfortunately.
But we are going to start out with our first witness and you each have five minutes. And please try to adhere to that if you possibly can.

STATEMENTS OF APARNA MATHUR, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE; LEONARD STEINBERG, PRINCIPAL, STEINBERG ENTERPRISES, LLC, ON BEHALF OF THE SMALL BUSINESS AND ENTREPRENEURSHIP COUNCIL; MARGOT DORFMAN, CEO, U.S. WOMEN’S CHAMBER OF COMMERCE; MARTIN J. MITCHELL, VICE CEO, MITCHELL AND BEST HOMEBUILDERS, TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF HOMEBUILDERS

Chairman Graves. Our first witness is Aparna Mathur, a resident scholar with the Economic Policy Study Team at the American Enterprise Institute here in Washington, D.C.

Dr. Mathur specializes in microeconomics, international finance, and econometrics. Her work has been cited in The Wall Street Journal, the Financial Times, and the Economist. She received her Ph.D. in Economics from the University of Maryland. And welcome, Dr. Mathur. I appreciate you being here.

STATEMENT OF APARNA MATHUR

Ms. MATHUR. Thank you for having me. Chairman Graves, Ranking Member Velázquez, and members of the Committee, I am honored to be invited to testify on the topic of small businesses and tax policy. This testimony documents the impact of new and higher tax rates and policy uncertainty on entrepreneurs and small businesses.

Research suggests that young small businesses are the biggest job creators. According to the Census Bureau, small firms account for about half of all private sector employment and represent more than 99 percent of all employer firms. Moreover, they pay approximately 43 percent of all private wages and salaries. However, in the current recession, small business hiring, investment, and employment is down. The start-up rate has fallen to levels below that in the 1990s and the start-ups being created are smaller than they were at that time. In other words, they are creating fewer jobs. Hence, this recession has been particularly bad for small employer firms.

Future tax increases and new taxes are likely to make the business environment even tougher for small businesses. In his budget proposal for 2013, President Obama has proposed raising the top margin income tax rates on individuals earning more than 200,000 and couples earning more than 250,000. A 2011 report from the Department of the Treasury shows that approximately 4 percent of all small businesses face the two top rates of 33 and 35 percent, but this accounts for nearly 32 percent of small business income. For employer businesses in particular within small businesses, 10 percent of business owners and 38 percent of business income was subject to the high margin rates of 33 and 35 percent. Hence, the tax increases are likely to affect a large share of small business income, particularly for employer firms.

In addition, the Affordable Care Act will impose new taxes on small business earnings. The Medicare payroll tax and self-employ-
ment earnings in excess of 250,000 will rise from 2.9 to 3.8 percent. The Affordable Care Act also imposes a 3.8 percentage point hospital insurance tax on investment income over 250,000 starting in 2013.

In addition, there are excise tax increases on businesses that fail to provide qualifying health insurance and another tax of 2.5 percent of gross income on self-employed people failing to buy qualifying health insurance.

How will these tax increases affect small businesses? Economic research suggests that raising taxes on small firms has a significant negative impact on business activity. Higher taxes lower the ability of small firms to hire workers. It also lowers their ability to make wage payments to these workers. Further, an increase in marginal tax rates reduces the gross receipts of these businesses, reduces the proportion of entrepreneurs who make new capital investments, and decreases the average level of these capital investments. These effects are more pronounced for high income small businesses which are the job creators. A paper co-authored by Glenn Hubbard of Columbia University also found that increasing the progressivity of the tax code by raising the top marginal rates discourages entrepreneurs from starting new businesses.

Finally, all the talk about future tax hikes and new regulations has created a climate of uncertainty for small businesses which makes it hard for them to make long-term decisions about hiring and investment. New research shows that an increase in policy uncertainty, such as about taxes or government spending or other policy matters leads to large and persistent declines in aggregate outcomes such as declines in real GDP, private investment, and aggregate employment. A recent Gallup poll and also a Chamber of Commerce survey found that more than 48 percent of small businesses are not hiring because of the potential costs of health care, and more than 46 percent are not hiring because of concerns over government regulations.

The above evidence clearly suggests that the proposal to raise taxes and hire entrepreneurs is exactly the wrong policy prescription for this time. To encourage job creation we need a future with lower taxes, not higher. Thank you.

Chairman GRAVES. Thank you, Dr. Mathur.

Our next witness is Leonard Steinberg, principal of Steinberg Enterprises, LLC in West Windsor, New Jersey. He is a federally licensed enrolled agent and certified management consultant. His tax practice specializes in comprehensive tax services for small businesses, including tax preparation planning and problem solving. So welcome, Mr. Steinberg. We appreciate you being here.

STATEMENT OF LEONARD STEINBERG

Mr. STEINBERG. Thank you very much. Chairman Graves, Ranking Member Velázquez, and members of the House Committee on Small Business.

Thank you for the invitation to participate in today’s hearing to examine the significant impact our tax system is having and will have on small businesses and individuals with regard to the Affordable Care Act, the expiration of the Bush administration tax cuts,
the complexity in the tax system, and the issues affecting compliance.

As a practitioner, I am responsible for the consequences of all the laws that Congress passes and helping my clients fulfill their obligations in filing their taxes. I am a member of the New Jersey IRS Practitioner Liaison Committee representing over 200 enrolled agents in the state and all of our respective clients. Since 2005, I have also represented the Small Business and Entrepreneurship Council as a member of the Small Business Advisory Committee through the Financial Accounting and Standards Board, also known as FASB. And from 2001 through 2004, I was a member of the Taxpayer Advocacy Panel and chair of the Small Business Self-employed Payroll Tax Committee.

The issues of complexity have been outlined in my written testimony and due to the time factor a lot of this will now be part of the written record. But the tax complexity deals with many, many issues, some of which I outlined, regarding depreciation, Section 179, which allows a write-off of approximately $500,000 in expenses and again, if it is due to be repealed and go back to a much lower rate which in effect becomes an automatic tax increase. I am also a member of the FASB Small Business Advisory Committee and we have the issue of the International Financial Reporting System that is currently being considered. Under the IFRS structure, small businesses would not be allowed to use the last in, first out method of inventory evaluation. The only method that is available under IFRS is FIFO, first in, first out. That, too, would be an automatic huge tax increase because of the reserves that would be automatically taxable during the first year.

The complexity of the tax law also affects employers at the state level. While this Committee is involved with federal issues only, many, if not most states follow the federal rules and regulations which all add to the cost of doing business. Many business clients have stated that the tax code is so complex and cumbersome and filled with so-called loopholes or special circumstances which make it inherently unfair. Business people sign the returns stating they are correct but they really do not know what they are signing. Many have no idea what the accountants are actually doing but pay them and the lawyers plenty of money to properly comply and find ways to reduce the tax burden. It seems that those with more money or more political influence can get more tax breaks. As an example, in 2010, Congress made 579 changes to the tax code which now numbers 3.8 million words and it has been written up in the press that it is now four times the length of William Shakespeare’s works.

Nina Olson, the national taxpayer advocate, has testified before Congress and written in her annual report that the tax code has gotten too complex for reasonable people and even trained professionals to understand, including members of the IRS. The tax courts have ruled that IRS publications are not authoritative sources. In our representation work we must use IRS revenue rulings, prestigious tax law, and other cases to boost our representation for our clients. This uncertainty and all of the other complexity takes money out of the workers’ pockets, reduces job creation, and will lead to a decline in the overall economy since there will be
fewer dollars available for disposable income and less risk-taking overall.

I would like to conclude by saying that every large businesses started as a small business. It is the dream of every small business owner to become the next large business. When money is taken out of the economy it also affects charitable giving. Many small businesses support local causes which are adversely affected by any decrease in the financial support that they would receive. And let the example of the Reagan era tax overhaul be a guide for future discussions, when the tax code was simplified in 1986—I apologize. The result was the longest continuous period of economic boom in this country's history and more jobs were created than at any other time.

The members of this important Committee have the influence in their respective congressional districts, their state delegations, and with fellow congressional members to significantly impact and reignite the most successful economic engine in the free world. That is the U.S. small business community. I respectfully request that you make the necessary changes for the future economic growth of our great nation and as part of your public service legacy. Thank you.

Chairman GRAVES. Thank you, Mr. Steinberg.

We are going to recess for three votes. It will not be too long and then we will come back and we will start with you, Ms. Dorfman. But with that we will stand in recess until right after the last vote.

[Recess.]

Chairman GRAVES. Thanks everybody for bearing with us on the vote series. I will now turn to Ranking Member Velázquez for an introduction.

Ms. VELÁZQUEZ. Thank you, Mr. Chairman. It is my pleasure to introduce Ms. Margot Dorfman. Ms. Dorfman is the founder and CEO of the U.S. Women's Chamber of Commerce. The Women's Chamber of Commerce represents 500,000 members, three-quarters of whom are small business owners and federal contractors. Through her leadership, this organization has championed opportunities to increase women business and career and leadership advancement. Additionally, Ms. Dorfman has an extensive background in business, including over 10 years in executive positions with General Mills and other Fortune 500 firms. Welcome.

STATEMENT OF MARGOT DORFMAN

Ms. DORFMAN. Ranking Member Velázquez, Chairman Graves, and Small Business Committee members, thank you very much for the opportunity to speak today on behalf of the U.S. Women's Chamber of Commerce's 500,000 members, three-quarters of whom are American small business owners, regarding the tax outlook for small business.

In preparation for today's hearing, I listened to the views of our many small business members, and I can tell you there is a great deal of frustration amongst small business owners surrounding small and individual tax policies, revenues lost, and compliance.

This frustration centers around a few broad issues—complexity, constant change and uncertainty, the costs associated with managing the ever growing and changing complexity, the lack of fair-
ness and resulting anti-competitive outcomes, and the challenge of simply being a good employer and provider for one's family and community.

Already in today's hearing we have heard a bountiful number of references to the growing complexity of the U.S. tax code and how these changes have a great impact not only on business tax policies but also on individual taxes due to the high number of small businesses that are structured as pass-through entities.

The outcome of these challenges has been magnified by the recession. While large businesses employ armies of accountants, attorneys, and complex tax evasion strategies to avoid paying their fair share of taxes, Congress continues to pass press release ready legislation instead of taking the action needed to truly level the playing field to invigorate America's Main Street businesses.

Our small business members tell me the endless and unrelenting lack of fairness and changing landscape of business and individual taxation takes away from their focus on the things that matter to them—securing and keeping good employees, increasing business competitiveness and profitability, and investing in future business growth.

Our small business members who are active as federal contractors tell us they are doubly burdened as they must also deal with the complexities of the FAR, the EPA regulations, and state and local issues. It is not feasible or affordable for small business to employ someone to deal with the spiraling complexity Congress has created.

When our small business members see how the tax system is skewed against them and how big business gets away with schemes to avoid taxes when as a small business they cannot even access nor use many of the supposedly targeted tax break for small businesses, they become outraged. And worse, the unfair tax advantage big businesses have over small businesses decreases small business competitiveness as well as their ability to hire and retain employees and to provide good benefits.

We hear endless stories of how tax breaks cannot be used by our small businesses because of some feature or restriction that renders it impossible for many small businesses to comply with. Yet congressional leaders still manage to find a nice headline proclaiming their love and concern for small business.

For example, tax breaks for investments and equipment are nice as long as your firm needs equipment and has the cash flow up front to invest. As most of the smaller, financially challenged firms do not have cash flows available, they find this approach simply emboldens their larger competitors while discriminating against them.

Additionally, an overwhelming majority of small business members told us they very much want to provide health insurance for their employees and take advantage of incentive tax credits. Small business owners are close to their employees who are their neighbors and often their family members.

Many of our members told us they believe as the provisions of the Affordable Care Act continue to be implemented, that they will be better able to provide health care for their employees and to be better competitors when seeking to secure and retain employees.
I call upon Congress to end the piecemeal approach you have taken to tax policy and the grossly unfair tax provisions and loopholes that can only be employed by larger firms. Small business owners want to pay their fair share of taxes and they understand the need of the U.S. government to raise revenues to provide a quality and secure environment for businesses and families.

But today we do not have a level playing field. More legislation aimed at grabbing headlines will not help. What will help is real leadership in Congress, leaders who come together to truly work on behalf of small businesses. We know that small businesses are the job creators. It is imperative that we simplify tax policy and the complex codes and skew policies that benefit big business and allow business owners to focus on the important work they have as revenue generators, job creators, and community leaders. Thank you.

Chairman GRAVES. Thank you, Ms. Dorfman.

Our final witness is Martin J. Mitchell. He is the vice CEO of Mitchell and Best Homebuilders in Rockville, Maryland, where he works with his father and three siblings. In 2011, Mr. Mitchell was president of the Maryland National Capital Building Industry Association. He received his MBA from the University of Maryland and is testifying on behalf of the National Association of Homebuilders. Thanks for being here, Mr. Mitchell.

STATEMENT OF MARTIN J. MITCHELL

Mr. MITCHELL. Thank you for having me. Chairman Graves, Ranking Member Velazquez, members of the Committee. Thank you for the opportunity to testify today.

My homebuilding company, Mitchell and Best, is a family owned company and has been in operation for 37 years. After a very tough five years of the worst housing market downturn in our lifetimes, in 2012 we expect to build 25 homes, thereby creating at least 75 full-time jobs. We used to build close to 100 homes per year.

Small businesses are the heart of the residential construction sector. In 2012, nearly 80 percent of the NAHB builder members had less than 10 employees. About half had less than $1 million in gross revenues. Three-quarters built 10 or fewer homes. And 80 percent of homebuilders are organized as pass-throughs, S corporations, and LLCs. As pass-through entities, homebuilders and all other small businesses report and pay taxes at the individual rate. For this reason, NAHB strongly supports extending the 2001, 2003 income tax cuts now scheduled to expire at the end of this year.

In addition to the marginal rate cuts, it is important that the 15 percent rate on capital gains and dividends also be extended. As many homebuilding companies are family-owned like mine, the present law on the estate tax rate rules must also be extended or ideally the tax itself eliminated.

Another issue for small businesses organized as pass-through entities is the Alternative Minimum Tax. The AMT complicates business planning and has grown from a tax that affected a few taxpayers to one that could hit more than 30 million taxpayers this year absent a congressional fix.

Also, next year, several new taxes will come into force that will negatively affect small businesses. One standing from the 2010 health care reform legislation is a 3.8 percent tax on certain capital
gains that will have a harmful effect on multi-family apartment developers. Further, there is a pervasive rumor that this new 3.8 percent tax will take the form of a sales tax on homes. This incorrect information, which NAHB is fighting via educational efforts, is having a chilling effect in some housing markets.

Ultimately, a complicated federal tax system is a burden and a hindrance on small businesses. Traditionally, the job creators. For this reason, NAHB supports simplifying the tax code as part of a deliberative and thoughtful comprehensive reform effort. Such an effort should include a public process that examines necessary changes, studies transition rules, and considers economic impacts. For homebuilders, homeowners, and prospective homebuyers, a critical element of the tax code is the mortgage interest deduction, the MID.

The MID has been part of the tax system since 1913 and helps facilitate homeownership. Its beneficiaries are primarily the middle class, and in particular younger homebuyers who in the early years of mortgage are primarily paying interest. Weakening or eliminating the MID today would be economically disastrous.

It is also worth noting that any tax reform effort that would lower corporate but leave individual rates the same or even higher would have a negative impact on small businesses. Homebuilders also face a number of other tax issues, including business debt mitigation and the phantom income tax. What is hopefully clear from my testimony is how uncertain the current tax environment is for businesses. The current uncertainty and tax policy makes it difficult for businesses to plan for years ahead which may further stall economic growth. In my industry, we cannot afford further stalled growth. Homebuilding has led the economy out of almost every recession. Housing provides the momentum behind an economic recovery because the homebuilding industry employs such a wide range of workers. Housing is a key engine of job growth. It is also a key component of consumer confidence.

In terms of jobs, if we were at normal production levels for the housing industry, 3 million more people would be employed at this point in time. As Congress moves forward on the consideration of tax issues, Homebuilders want it to be a constructive partner with you in creating a better tax code. I thank you for the opportunity to testify today and look forward to your questions.

Chairman Graves. Thank you, Mr. Mitchell.

Mr. Mitchell’s testimony expressing concern about the pending tax increases is echoed by many small business owners across the country and they are making their views very well known on the Small Business Committee’s website portal. It is called Small Business Open Mic and I would ask unanimous consent that these comments be admitted as part of today’s hearing record. Without objection, that is so ordered.

We are going to start questions with Mr. West.

Mr. West. Thank you, Mr. Chairman. Also, Ranking Member. And thanks to each and every one of the members of the panel for being here. You know, we just came off of two weeks being back in our districts, and again, the recurring theme when you go out and you talk to everyone, the three top issues—access to capital, regulatory environment, and tax policy. And as you know, we just
passed a budget out of House here that said we would look at personal income tax rate, condensing those six tax brackets down to two—25 percent and 10 percent. And of course, the Ways and Means Committee will look at that cut line.

But my question to you, because as you know, if we are talking about lowering tax rates that means we have to get rid of deductions and eliminate loopholes and things of that nature and for subchapter S LLCs using the personal income tax rate. My question to you then, if we take it down to 25 percent or maybe 22, 23 percent, what are the three deductions that you see that still need to be retained for small business owners and for that personal income tax rate? Do you want me to play the Jeopardy music?

Mr. Steinberg. Number one, charitable donations. That is probably one of the best tax deductions. But I would also like to say as a practitioner, a lot of people think that when they get a deduction it is a dollar for dollar deduction on their tax. It is not. It is a reduction based upon your marginal rate. So as an example, if you give $100 in charity but you are in the 25 percent tax bracket, you only get a $25 deduction off your taxes. While it is important, a lot of people are under the misconception that that deduction is a dollar for dollar.

The other aspect which I personally take umbrage with is the term “loophole.” Congress passes the laws. There are no loopholes. Everything is in law. What a loophole is is the unintended consequences of the law that gets passed. So if you want loopholes, there are plenty of unintended consequences that are built into the tax code that I and my fellow practitioners really have to deal with on a year-to-year basis every time Congress passes new tax codes or updates the tax code. And as people say when they say to me, well, if you go to a flat tax you are going to put the accountants out of business. And my answer to that is every time Congress passes a tax act it should be subtitled “The Accountants Full Employment Act” for that particular reason, because we then have to implement and make sure all of these aspects are enforced.

So as far as the three, I would leave the charitable donations. I understand the issue of mortgage interest. I also understand the issue of real estate taxes, which is really a state issue as well as a federal issue. And, of course, that is where the states and the federal government go back and forth. And those are the three that I would definitely keep.

Mr. West. Does anyone else want to——

Mr. Mitchell. I would have to echo the keeping of the mortgage interest deduction. Right now that is keeping the homebuilding industry going. We would see a devastating effect as I indicated in my testimony in that there has been a lot of misperceptions about the mortgage interest deduction and who gets the advantages to that deduction. But housing production would fall off significantly. But what you would also find is that not only do we create three jobs for every house that is built, there is tens of thousands of dollars that go back into the local community, the state, and the federal government from the taxes and impact fees that are created for every home that is built. So the more we can incentivize home ownership to a reasonable level and a sustainable level, we think that is appropriate.
Mr. West. Anyone else? I only got two.

Ms. Dorfman. I will have to defer to my accountant.

Mr. West. Last question then. Do we really need to have the death tax? Especially when we consider the fact that we are about to take from 35 percent up to 55 percent and we are about to bring that minimum qualifying amount from 5 million down to 1 million. Is this something that will absolutely crush the small businesses? And if we look into the future—three, five, further down the road—do we really need to have the death tax when it comes to small businesses?

Mr. Steinberg. As a practitioner, and I do not mean to monopolize the conversation, but this is what I do for a living. As a practitioner, the inheritance tax, that money has already been taxed twice. It has been taxed once as income and it has been taxed also on the dividends and interest that result from the investment of that. Now you are going to pass that burden onto the next generation and there are tax avoidance schemes that are looked at all the time to try and avoid paying the estate tax. It is interesting that you bring that up at this point in time because I am working on an estate right now where the estate, the owner had passed away and his wife now may have to sell the house in order to pay the state taxes. Where is she going to live? What is she going to do? She is 65 years old. She cannot work. She does not have any means of employment. She was going to use the assets from her inheritance to be able to live comfortably for the remainder of her life. You tax that, where is she going to go? Where is she going to live? So as far as the estate tax is concerned, I think it is confiscatory and I think it serves a negative purpose regarding the amount of money that is generated to the government.

Mr. West. So that is a no. Yes or no?

Ms. Mathur. I think it should be, you know, done away with. I think there is a lot of—a lot of businesses will be affected negatively by the tax.

Mr. West. Ms. Dorfman.

Ms. Dorfman. In even looking I believe there was the challenge originally with the farmers and the land that they inherited. It was passed down to the generations and the family farm having to be sold. You know, it is a small business. So.

Mr. West. Yes or no?

Ms. Dorfman. I forget how you crafted the question.

Mr. West. Should the death tax be, you know, maintained or should we do away with it?

Ms. Dorfman. No tax. No death tax. That is the way to say it.

Mr. Steinberg. We agree. It should be eliminated.

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

Ms. Velázquez. How do you balance that with deficit reduction and balancing the budget? Mr. Steinberg.

Mr. Steinberg. Okay, thank you. I appreciate the opportunity. Well, one of the ways to do it is Congress does not have an income problem; Congress has got a spending problem.


Mr. Steinberg. No, it is not a revenue problem. There is enough revenue coming in. What I suggest is that if Congress really wants
to get their act in order, why do you not make a recommendation that every federal agency cut their budget by 1 percent? You will have more than enough money to offset all of these taxes.

Ms. VELÁZQUEZ. Dr. Mathur, the Ryan budget includes extending the Bush era tax rate cuts, reducing corporate tax rates, and moving to only two tax brackets. Yet, in order to ensure the estimated $10 trillion in cuts are paid for, many popular tax expenditures must be completely eliminated, possibly having a disproportionate impact on small firms. The Ryan budget did not include any details on what expenditures should be caught. Since we are talking about ways to stimulate the economy and control deficits without burdening small firms and the middle class, can you please give us specific credits or deductions that will make up the trillions in tax cuts without imposing such burdens on small businesses?

Ms. MATHUR. I think the assumption that just reducing corporate income taxes or reducing personal income taxes will actually lead to long-term deficits is wrong. I think there is a lot of, you know, the research suggests that if you actually cut corporate income taxes or you cut personal income taxes you could actually see higher taxable incomes being reported. You could actually see more corporate tax revenues coming into the system.

Ms. VELÁZQUEZ. Let us say that it does not happen the way that you are describing it. Can you give me specific tax credits that could be—or deductions that will make up for the trillions of dollars in tax cuts without burdening small businesses?

Ms. MATHUR. I think we will have to go through the list. I am not sure, you know, which ones are actually working.

Ms. VELÁZQUEZ. Thank you. Mr. Mitchell, in your recent testimony you spoke about a Recovery Act tax change that not only helped your business but made the system a little fairer to small firms with debt. Can you please elaborate a little more on the debt exclusion from the stimulus bill and where your business would be today if that exclusion had not been enacted into law?

Mr. MITCHELL. Yes, I would be happy to.

Under the Stimulus Act there was a deferral policy where if you had forgiveness of debt, cancelation of debt that created phantom income, you could defer that out to a period of up to 10 years. Unfortunately, in an industry such as we are in, we turn our product over. We are not like an apartment builder where we hold an asset for a long period of time. So even though that was beneficial and it allowed us to defer, it really only created a deferral for maybe a year or two because once you sell the underlying asset that was a part of that debt you then have to take that phantom income tax. It has helped us to move things forward for another year or two but we had situations where Weyerhaeuser Realty Investors was our largest mezzanine debt holder. They closed down that operation. The value of land dropped significantly. And we have tens of millions of dollars of COD which is phantom income. It could be devastating to us if there is not an adjustment made to that. And we ask Congress to take a serious look at that.

Ms. VELÁZQUEZ. So you are telling me that what you are describing is how one targeted provision in the tax code could be beneficial to small business.
Mr. MITCHELL. I believe it can be for those businesses that saw, you know, reductions in the value of their assets over the last five or six years during this downturn.

Ms. VELÁZQUEZ. Thank you. Thank you, Mr. Chairman.

Chairman GRAVES. Mr. Schilling.

Mr. SCHILLING. Thank you, Chairman. I would like to thank the panel for being here today.

I am a small business owner. I have a pizzeria in Moline, Illinois. And you know, the one thing that I understand is that our business is down. We are off about 35 percent and the gas prices continue to just crush our business. And a lot of the business folks that I have spoken with recently are very concerned about the Bush-Obama tax cuts expiring because as this downturn economy is here and then now they take on another hit with a 35 percent or, you know, most of the folks I talk to are anywhere from 20 to 40 percent off, once those expire, basically what is going to happen is it is going to put a lot of these companies out of business.

And I think it is really, really imperative to understand, I believe, is that we have to stop spending money that we do not have. And that is the thing. Because as we continue to spend it, you know, we are $16 billion in debt, it is a huge burden on our kids and our grandkids. And, you know, once we stop the ridiculous spending—the Tunnels for Turtles and all of the other things that we have been doing for years—then we can look at revenue increases. But until then we have got to really stay focused in on that type of stuff.

What I would like to do is just, Mr. Steinberg and Mr. Mitchell, the new health care law creates much uncertainty for our small businesses through mandates, regulations, and tax increases that do not take effect until 2014. One specific tax, the Small Business Health Insurance Tax, will increase premiums by two and a half percent in the year 2016 alone. According to the Joint Committee on Taxation is what they are telling us, do you think that this tax increase will make it more difficult for employers to provide health care which is the overall goal of the president’s health care law after all and then predict health insurance costs in the future by giving us that increase? Just kind of a basic.

Mr. MITCHELL. Well, from our aspect, despite maybe what is thought about in the public, we are now operating at razor thin margins if we are on the black side of the ledger at this point in time. So any type of an increase, even a 2.5 percent, which may not sound like a significant amount but on your overall employee base it will be a significant burden. So right now it will be difficult for us. We are an industry that has been hit with several code changes in the last 10 changes, significant ones that have changed our cost structure. But any additional cost item that is placed on us such as that will make it difficult for us to continue and survive.

Mr. STEINBERG. There are consequences through having that tax passed and number one would be whether the IRS has the resources to be able to enforce it. Right now the IRS is operating razor thin as it is with their budget. They do not have the resources to enforce the current tax law. How are they going to have the resources to enforce additional mandates that are being passed through the Affordable Care Act? And the other aspect is that you
are really taking money out of the owners’ pockets. And I happen
to know Ms. Velázquez’ district. I grew up in Brooklyn so I
know—and Queens. And I know the area. Sunnyside Avenue. You
have got bodegas. You have got laundromats. You have got hair sa-
lons. You raise the amount of tax that they are going to pay, those
small businesses are not going to be able to employ the local peo-
ple. So how are they going to stay in business if you take more
money from them?

Ms. VELAZQUEZ. I do not think they are making over $250,000.
Mr. STEINBERG. That is not the issue. That is not the issue, Con-
gresswoman. The issue is you are taking money away from them
that they cannot give to hire somebody else. Or let us say a young
high school student wants to come in for a job after school and is
looking for a job and they want to be able to give them a job to
be able to do it. If they do not have the money, that high school
kid—I worked high school jobs after high school. They want to be
able to work. If they do not have the money, what is a high school
kid supposed to do? Where are they going to get the experience and
learn how to do it if the money is being taken out of the economy
and being sent to Washington? There is a disconnect there between
what is happening in Washington and what is happening on Sun-
nyside Avenue.

Ms. VELAZQUEZ. I totally disagree with you.
Mr. STEINBERG. I respectfully accept that.
Mr. SCHILLING. Can I reclaim my time? You guys can do this
later.
Just one quickly, Mr. Steinberg and Mr. Martin (sic) because you
guys have experience in this, how much would you say your com-
pany or members spent preparing and comply with the tax code or
the regulations each and every year? Because I see this as money
that we could be expanding and hiring people. But can you give me
a ballpark of some of your clients and then maybe what your busi-
ness does in complying?

Mr. STEINBERG. The average tax return for an S corporation for
me takes about three hours. That is just doing the tax return. That
is not doing all the due diligence behind it. So when you factor in
all of the work behind it you are looking at approximately 6 to 10
hours worth of work before the tax return is completed.

Mr. SCHILLING. So basically you are able to hire another worker
to do all of this extra work. Right?

Mr. STEINBERG. But then have to pass that cost on to the client.

Mr. SCHILLING. That is right. Okay.

Mr. STEINBERG. So the client, in effect, is paying for compliance
one way or the other. So therefore, I am taking more money out
of the client’s pocket rather than having the client be able to put
that money back into the business.

Mr. SCHILLING. Very good. Thank you.

Mr. MITCHELL. From our standpoint we have never been a large
enough firm to be required to do audited financial statements. We
have always done different levels below that. The complexity of our
tax returns in our type of business going back from the downturn
of the early 90s is that we basically have to put every project into
a separate LLC and then we have to compile those up and roll
those up to one LLC. As a business that is not operating profitably
for the last couple of years, we are still having to put out $30,000 to $40,000 a year to have our tax returns done. That is not our financial statements. We have our financial statements done internally. We get some input and feedback from our accountants but we do not have them do that. That does make it even more difficult to obtain equity and debt, but it is just one of those things we have to look at every penny that we are spending these days. It is a significant number for a firm like us.

Mr. SCHILLING. Very good. I thank you for your time and yield back.

Chairman GRAVES. Mr. Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

Dr. Mathur, the data I have seen would indicate that our tax revenues, federal tax revenues are pretty much at an all-time low since World War II. Would you agree to that?

Ms. MATHUR. Yes.

Mr. SCHRADER. So how would you describe the state of our economy right now with our revenues, tax revenues at an all-time low, taxing of businesses is, you know, at the lowest point it has ever been.

Ms. MATHUR. I do not agree with that the taxing of businesses is at its lowest point it has ever been. I think, I mean, if you look at the corporate tax rate, we have one of the highest corporate tax rates now amongst——

Mr. SCHRADER. With LLCs. Most of your small business folks as I understood, we are talking about LLC.

Ms. MATHUR. A lot of small business folks will also face high tax rates of 33 and 35 percent.

Mr. SCHRADER. But you just testified a minute ago that the federal average is at an all-time low. Our taxes——

Ms. MATHUR. The revenues are low because——

Mr. SCHRADER. Let me finish my comment, please.

Ms. MATHUR. Sure.

Mr. SCHRADER. I will ask you a question; you can answer. Okay?

Ms. MATHUR. Okay.

Mr. SCHRADER. So what I am saying here is that our revenues are at an all-time low. Our taxes are at an all-time low overall. I will grant you a point, it depends on what business you are in or what part of the world you come from. But they are at an all-time low. If taxes alone determine the health of our economy, we should be booming right now and we are not booming. So while I share everyone’s concern on, you know, tax policy, I think it is completely inaccurate and hyperbolic to say that, you know, low taxes equal great economy. We are not seeing that right now in the United States of America.

Second point, Mr. Steinberg, you are absolutely ill informed on the American—or excuse me, the Affordable Care Act. Congresswoman Velázquez is absolutely correct. The revenues in that bill are for larger businesses. Businesses 50 employees or under are completely exempt. Those are truly the small, small—I am a veterinarian. I am like Representative Schilling. I have got a small, small business. And I am very appreciative of the fact that that is recognized in the Affordable Care Act. Health care right now is totally unaffordable. As we have heard testified here today, the ef-
fects of that act do not occur until 2014 and already businesses are
shedding, you know, their health care plans. So the system now is
broken. We have to do something. And I respect the fact that the
bill is imperfect. Every bill we pass is probably imperfect and we
have got a long way to go. But I would suggest respectfully we do
not throw the baby out with the bathwater.

My question, Mr. Chairman, sir, to the panel, you have all testi-
fied, at least all agreed I think, that our tax code is too complex
and comprehensive tax reform is probably a good idea. There are
several proposals out there. Congressman Ryan has given an at-
tempt at that and I appreciate that actually. There is another one
out there that the president put together through his Debt Com-
mission, sometimes commonly called the Simpson-Bowles Report.
And there has been a recognition that certain deductions are very,
very important. They call out the primary interest deduction
through the Gang of Six work. They talk about the charitable de-
duction that Mr. Steinberg talked about. The real world is, you
know, for every junction we save, I am a big one to say that, prime
interest mortgage deduction, that is a big cost. That is one of the
bigger deductions we have. And that will affect how much we can
lower the rate going forward.

But I guess I would just like a general from each of you, do you
think that the Simpson-Bowles framework of comprehensive tax re-
form with certain critical tax deductions to make sure our economy,
and the housing industry in particular, recovers is maybe a decent
template at least for this Congress to work off of? There were 38
members of Congress that agreed to that. I am curious where you
all stand.

Mr. MITCHELL. Well, I have to admit I do not know all the details
of the Simpson-Bowles, but we are supportive of a reform of the tax
code and supportive of the simplification as you talked about and
we think that it was mentioned here earlier, if you go back to 1986
when some of the reforms were made, there were certain protec-
tions for important items such as the mortgage interest deduction
and other housing. But there were other housing changes that
made severe impacts that were negative to the housing industry.
So I think that, you know, while we support the overall goals, I
cannot get into the details. I apologize. I can go back and talk
about that.

Mr. SCHRADER. Ms. Dorfman.

Ms. DORFMAN. I would have to say I am not familiar with all the
details either but our members definitely would like to have a sim-
plified code. We also think that the unfair tax advantages that the
large corporations are enjoying should be re-examined and perhaps
removed so that there is a level playing field. Trying to compete as
a small business when the corporations, obviously the large cor-
porations have that advantage, it is hard to go ahead and, you
know, grow in a market space with that competitive disadvantage.

Mr. SCHEIDER. Mr. Steinberg.

Mr. STEINBERG. Any framework that the Congress can begin to
look at that is going to significantly improve the tax structure is
definitely welcome. And, of course, with the CBO and the other
panels, the American Enterprise Institute and some of the other
think tanks in the city, as they do the analysis of it as you begin
to progress, it is a start. It took us 40 to 50 years to get to this point. We are not going to solve it in one or two years. It has got to be a phased implementation. And each Congress can change it as they change—as the Congress changes every two years, then they can do away with what the previous Congress has done. What you need to do is you need to codify it and say this is permanent so that businesses have a way to plan. They have certain certainty. Right now there is no certainty among the small business owners. You know that. And Mr. Schilling knows that. There is no certainty in the tax code. So once you have that certainty, if you are going to use Simpson-Bowles, that is a good framework to start. And just let the statistics tell you where it goes from year to year.

Mr. SCHRADER. Good.

Ms. MATHUR. I agree that we need tax simplification. We need a process where, you know, if you are thinking of cutting down rates then, you know, we also care about effective rates. I think what matters when we think about actually getting revenues, that was the point I was trying to make earlier. You can have high rates but that does not always translate into high revenue. We know that with the corporate tax rate. We have one of the highest rates and we have one of the lowest revenue collections in all of the Western countries. So we should aim for simplification but I think we need to care about where we stand in terms of the effective rates as well.

Mr. SCHRADER. I am actually over my time. Mr. Chairman, thank you very much. I just want to say I appreciate the comments particularly on the last question and ask you to do a little more homework if possible and give me a little more feedback based on Simpson-Bowles, Gang of Six type of changes because it is the only bipartisan game we have in town. It is not perfect but at least it is a starting point for finally a productive discussion that I think America is craving right now. Thank you. And I yield back, sir.

Chairman GRAVES. Mr. Mulvaney.

Mr. MULVANEY. I am all right.

Chairman GRAVES. Are you sure?

Mr. MULVANEY. Yes. I yield back.

Chairman GRAVES. I want to thank you all for participating today. And I think we should all be concerned about the burden of taxation on our nation’s small businesses, the effect of these pending tax increases, the fact that the administration seems to be willing to let that happen, and the impact that is going to have on our economic recovery.

I would ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record. Without objection that is so ordered. This hearing is adjourned.

[Whereupon, at 2:35 p.m., the Committee was adjourned.]
Testimony before the House Committee on Small Business
The Tax Outlook for Small Businesses: What's on the Horizon?

Aparna Mathur
Resident Scholar
American Enterprise Institute
April 18, 2012

The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.
Chairman Graves, Ranking Member Velazquez and Members of the Committee, I am honored to be invited to testify on the topic of small businesses and tax policy. This testimony documents the impact of higher tax rates, higher health care costs and policy uncertainty on entrepreneurs and small businesses. The academic literature suggests that higher taxes and new taxes (such as those outlined in the Patient Protection and Affordable Care Act) not only affect the formation of new businesses, but also adversely impact the growth and survival of existing businesses. Moreover, uncertainty in policies relating to government spending and taxes further constrains business activity. This policy lesson is particularly relevant in the current economic climate when we have seen limited hiring and capital investments by not just small businesses, but also large businesses. Raising taxes on these businesses will negatively affect the weak economic recovery. To get the economy on the path to sustainable growth, we need to understand that raising taxes and health care costs on these businesses is the wrong policy prescription for these times.

1. The Importance of Small Businesses to the Macroeconomy

I would like to begin my testimony by stressing the importance of small businesses in the U.S. economy. Small businesses, typically defined as firms with fewer than 500 employees, contribute almost 50 percent of U.S. GDP. According to the Census Bureau, they account for about half of all private sector employment and represent more than 99 percent of all employer firms. In terms of job creation, they account for 65 percent of net new jobs over the previous 17 years, and they pay approximately 43 percent of all private wages and salaries.

The topic of job creation by small businesses has generated heated debate among academic economists. Much of the previous literature, and even some recent papers such as by Neumark, Wall and Zhang (2009), finds an inverse relationship between firm size and job creation rates. In other words, small firms contribute disproportionately to net job growth. Haltiwanger et al. (2010) further qualify this argument by suggesting that firm size is a proxy for firm age. Young firms, or new start-ups, contribute substantially to both gross and net job

---

2. http://www.census.gov/econ/smallbus.html. In 2009, there were 27.5 million businesses in the United States. Of these, 5.9 million were employer firms and the rest were non-employers. Small firms represented 99.7 percent of all employer and non-employer firms. Further, of the 120.9 million nonfarm private sector workers in 2008, small firms employed 59.7 million and large firms employed 61.2 million.
creation. Since young firms tend to be small, the inverse relationship between firm size and job creation is in fact, an inverse relationship between firm age and job creation. Business startups account for roughly 3 percent of U.S. total employment in any given year. While this is a reasonably small share of the stock, it is large relative to the net flow which averages around 2.2 percent per year.

However, as per the Small Business Administration, Office of Advocacy, the current recession has had a negative impact on small businesses. Between 2007 and 2010, employer establishment births dropped 12 percent from 844,000 to 742,000.³ Of the total number of firm births, about 85 percent are new employer firms, or start-ups, that are small businesses, while the remaining 15 percent tend to be new locations for existing businesses that expanded their operations. In the second quarter of 2008, the establishment start-up rate fell below 3 percent for the first time since figures were recorded in the early 1990s. The latest startup rate for which data is available is 2.7 percent in the second quarter of 2011. Moreover, the start-ups being created now are smaller on average than they were in 1999. In other words, they are creating fewer jobs. Given the important role that start-ups play in job creation, this recession has been particularly bad for small employer firms.

When considering these statistics, we need to question what role policy can play in helping small businesses recover from the effects of the recession and get them hiring again.

II. Demographic Characteristics of Small Businesses

Although policy debates often focus on “small business owners”, there is little consensus about what distinguishes a small business from other businesses. Previously, any individual who reported receiving flow-through business income would count as a small business owner. However, a 2011 report issued by the Office of Tax Analysis at the Department of Treasury, provides a clearer picture of who exactly is a small business owner. The OTA (2011) report looks at six tax forms and schedules filed by individuals or firms that could potentially represent business activity. Using various criteria, they find that 54 percent of taxpayers who file one of the six forms or schedules would qualify as small businesses for the tax year 2007. Further, these businesses represented 17 percent of total and net business income. Slightly more than 20

³ http://www.sba.gov/sites/default/files/Startup%20Rates.pdf
percent of these small businesses are employer firms. In the aggregate, there are 20 million filers who qualify as small businesses and they report $376 billion in net business income.

In terms of the marginal tax rates that apply to these businesses, the OTA report shows that 11 percent of small business owners have adjusted gross incomes higher than $200,000 and these businesses reported 64 percent of the total small business income.

The income distribution within small businesses is as follows: Slightly more than 50 percent of firms reported less than $50,000 in total income, 30 percent earned between $50,000-$250,000 and the rest earned between $250,000-$10 million. Only 6 percent of small businesses reported more than $1 million in income and less than 1 percent earned between $5 million-$10 million. Hence the distribution is highly skewed.

In terms of employment, employer firms were considerably larger than non-employers with employer firms reporting average total income of $922,100 compared to $99,000 for non-employers. Employer firms paid a total of $945 billion to workers, an average of $174,200 per small business that reported any wage expense. Relative to all business entities regardless of size, small businesses reported 23 percent of total labor payments made to employees who were not owners/officers of the firm.

Conducting the analysis in terms of adjusted gross income, 11 percent of small business tax returns reporting 64 percent of all small business income had AGIs over $200,000. This represents 1.6 percent of all taxpayers and 50 percent of all taxpayers with AGIs above $200,000. Moreover, this represents about 8.5 percent of all income in the brackets above $200,000. Within employer businesses, the distribution of business owners and income is more concentrated in the upper income ranges. For instance, nearly 24 percent of all owners are above the $200,000 AGI cutoff and they reported 76 percent of all income from these businesses.

This has implications for the marginal tax rates faced by small businesses. As per the report, approximately 4 percent of small businesses in 2007 faced the high marginal tax rates of 33 and 35 percent. However, nearly 32 percent of small business income was subject to this tax. If we include the businesses subject to the AMT, another 12 percent of returns reported paying AMT rates of 26 and 28 percent, and the income subject to AMT was 26 percent. For employer businesses in particular, 10 percent of returns and 38 percent of income was subjected to the high marginal rates of 33 and 35 percent. For those subject to AMT, the corresponding numbers were 21 percent and 30 percent, respectively.
Therefore, these numbers are important to keep in mind when considering the impact of proposed tax changes on taxpayers and particularly small business owners. Future tax policy changes (discussed in the next section) will result in increases in marginal tax rates on small businesses at the higher income ranges, and employer businesses in particular. Further, new taxes and tax increases under health care reform will impact all small businesses more generally.

III. Policy Challenges for Small Businesses

The National Survey of Small Business Finances is a survey of U.S. small businesses conducted by the Board of Governors of the Federal Reserve. The survey collects information on firm and owner characteristics, an inventory of small businesses' use of financial services and of their financial service suppliers, and income and balance sheet information. A part of the survey is questions relating to typical problems faced by small business owners. In every year of the survey, small business owners listed taxes and health care costs as the two major problems facing businesses.

Tax policy is perhaps one of the first factors to consider when discussing the issues of concern to small businesses. Entrepreneurs face a complex and ever-changing web of federal, state, and local (and sometimes international) tax rules and burdens. However, even aside from the complexity, one of the major issues facing businesses today is the impending tax hike as a result of the expiration of the Bush tax cuts for individuals earning more than $200,000 (families earning more than $250,000) as well as the taxes imposed as part of the Patient Protection And Affordable Care Act (PPACA). In his budget proposal for 2013, President Obama has proposed raising the top marginal income tax rate on individuals earning more than $200,000 (and couples earning more than $250,000) from 35 to 39.6 percent. Many small employers pay taxes using the individual tax brackets, and as we explained above, a large share of small employer profits are taxed in the top bracket.

Under PPACA, the first tax increase on small employers is a Medicare payroll tax hike. The Medicare payroll tax for wages and self-employment earnings in excess of $250,000 for couples ($200,000 for singles) will rise from 2.9 percent to 3.8 percent. This is a direct tax hike in the marginal income tax rate paid by the self-employed and general partners.

The Affordable Care Act also imposes a 3.8 percentage point hospital insurance tax on investment income over $250,000 starting in 2013. Some of this so-called “investment income”
is actually small business profits. Notably, investors in small businesses (limited partners and passive shareholders in Subchapter-S corporations) will face this tax. Active trade or business income is excluded, but of course most of that will face the higher Medicare tax described above. This provision will make it harder for employers to raise capital in order to create jobs and expand business operations.

Next is the employer mandate. The employer mandate, which takes effect in 2014, will apply to all firms with 50 or more employees. If an employer fails to provide "qualifying health insurance", these employers will have to pay a per-employee excise tax fine. The tax is $2,000 per employee ($3,000 if an employee receives coverage through an exchange). If the employer has a waiting period to get into the plan, there is an additional tax of $400-$600. A small employer with 100 employees could easily find himself paying a tax of $300,000 per year. Even if an employer provides health insurance, it can be deemed "unqualified" by HHS.

Finally, we again turn to the individual mandate. Many self-employed people choose not to have health insurance — because either they would rather self-insure, they have a mini-med plan or they want to retain capital in their small businesses. This choice is stripped of them by the Affordable Care Act. Starting in 2014, everyone must obtain "qualifying" health insurance or face an excise tax of at least 2.5 percent of adjusted gross income. If they are an employee of their own firm which has at least 50 employees, the firm would also be subject to the employer mandate excise tax described above.

In the next section, I will present the academic literature on the topic of taxes, health care costs and entrepreneurship. Following that discussion, I will also emphasize the effect of policy uncertainty on the business decisions of small firms.

IV. Taxes and Entrepreneurship

What are the effects of high taxes on entrepreneurship? There is a vast academic literature studying this topic. Many papers have studied transitions from wage and salary employment to entrepreneurship as a function of the different tax rates faced by individuals and firms. This option is valuable to the extent that personal income is taxed at a higher rate than corporate income. In recent years in the U.S., the corporate tax rate for a small firm could be as low as 15%, which is below the marginal personal (plus payroll) tax rate faced by effectively all individuals. As a result, a firm generating tax losses will prefer to be noncorporate so that the
entrepreneur can deduct these losses against other personal income, saving on personal income taxes. When and if the firm generates profits, in contrast, for tax purposes the entrepreneur will prefer to incorporate so that these profits are taxed at the lower corporate tax rate. The paper by Cullen and Gordon (2002) shows that reducing the minimum corporate income tax by 5 percentage points leads to a doubling of entrepreneurial activity in different quintiles and in the aggregate. If personal income tax rates were cut by 5 percentage points, this would lead to a nearly 30 percent drop in entrepreneurial activity, with larger percentage drops in the highest earning quantiles. Finally, a flat tax of 20 percent would increase self-employment activity by 15 percent. Such a tax cut reduces the taxes saved from deducting business losses, while profits remain largely taxed at the corporate tax rate. As a result, risk taking is discouraged. In addition, as emphasized by Domar and Musgrave (1944), a lower personal tax rate implies less risk-sharing with the government, in itself making self-employment less attractive to risk-averse individuals. The potential tax savings from going into business simply to reclassify earnings as corporate rather than personal income for tax purposes also falls when personal tax rates fall.

In another paper, Gentry and Hubbard (2000) show that the less progressive is the income tax schedule, the greater the incentive to entrepreneurial entry. Gentry and Hubbard (2000) emphasize a different effect of the tax system on risk-taking that arises even if investors are risk-neutral. If the marginal tax rate under the personal income tax is an increasing function of taxable income, then entrepreneurs are able to save little in taxes on any losses they incur but can owe substantial taxes on any profits. The more progressive the tax schedule, therefore, the more risk-taking lowers the expected after-tax return from the project. As a result, a progressive rate schedule discourages risk-taking.

Bruce (1998) similarly finds that taxes have significant effects on the probability that an individual will leave a wage and salary job to become self-employed. Estimates indicate that a five percentage point increase in the difference between an individual’s expected marginal tax rates in wage and salary employment and self-employment reduces his transition probability by about 2.4 percentage points.

A different strand of literature focuses on the effect of the entrepreneur’s own taxes on their ability to hire workers and expand investment. Carroll et al. (1998) analyze the income tax returns of a large number of sole proprietors before and after the Tax Reform Act of 1986 and determine how the substantial reductions in marginal tax rates associated with that law affected
their decision to hire labor and the size of their wage bills. The authors find that raising the entrepreneur’s “tax price” (one minus the marginal tax rate) by 10 percent raises the probability of hiring workers by about 12 percent. Further, conditional on hiring employees, taxes also influence total wage payments to workers. A 10 percent increase in the tax price would increase the median wage bills of entrepreneurs by 3 to 4 percent. These effects are more pronounced for high income sole proprietors. Therefore, raising tax rates on high income entrepreneurs could result in lower wages for workers employed at these firms.

Using a similar dataset, Carroll et al. (1998) also study capital investment decisions by entrepreneurs. Taxes affect the demand for investment through their impact on the user cost of capital. An increase in the personal tax rate raises the user cost and negatively affects investment. Another channel through which taxes affect investment is liquidity constraints. An increase in taxes reduces the entrepreneur’s cash flow. To the extent that liquidity constraints are present, this leads to a reduction in the demand for capital. The authors investigate both channels and find that the substantial reductions in marginal tax rates for the relatively affluent had quantitatively significant influences on their investment decisions. A 5 percentage point increase in marginal tax rates reduced the proportion of entrepreneurs who made new capital investments by 10.4 percent, and decreased mean expenditures by 9.9 percent.

In another closely related paper, the authors find that income taxes exert a statistically and quantitatively significant influence on firm growth rates. Raising the proprietor’s tax price by 10 percent increases gross receipts by about 8.4 percent. This finding is consistent with the view that raising income tax rates discourages the growth of small businesses.

V. Health Care Costs and Entrepreneurship

A number of papers have focused on the effect of health care costs on entrepreneurship. Gruber (1992) finds that health insurance mandates reduce coverage of employees in small firms by as little as 1%. This is similar to the finding by Gabel and Jensen (1989), though in a 1992 survey, they showed that 19% of sampled small firms did not offer coverage due to state mandated benefits. Of the papers linking health insurance and entrepreneurship, Gruber and Poterba (1994) analyze the impact of the Tax Reform Act of 1986 which allowed self-employed individuals to deduct a certain percentage of their cost of health insurance from their taxable
income, thus bringing them closer to the tax treatment afforded to employer provided health insurance. The results of their paper suggest that a 1% increase in the cost of health insurance coverage would reduce the probability for coverage for self-employed households by 1.8%. Perry and Rosen (2001) find a statistically negative effect of self-employment on the probability of being insured.

A paper that I published (Mathur, 2009) focused specifically on state health insurance mandates and their impact on job creation by small firms. Health insurance is regulated at the state level by the use of state mandated health benefits. These are regulations issued by the state that mandate minimum levels of certain benefits as part of policies offered, e.g. chiropractic services, mental illnesses etc. The cost effect of mandates varies due to differences in state laws. For example, Virginia’s mandated benefits accounted for about 12 percent of claims costs in 1993, 22 percent of claims in Maryland in 1988 and 5 percent in Iowa in 1987. The studies that reported the highest costs were those for Maryland and Massachusetts, which have more mandated benefits than most states. The study focuses on the period of the 1990s when there was a tremendous increase in the number of mandates passed by states, unlike a lot of earlier studies which focused on the 1980s. The number of states with six or more mandated benefits increased dramatically between 1988 and 1997. The evidence strongly suggests that while some mandates matter more than others in the job creation decision of small firms, the most significant impact on small firms is simply in terms of the total number of mandates in a state. The larger the number of mandates, the lower is the probability of employment generation. Studying the predicted probabilities for different levels of mandated benefits, the data shows a clear negative relationship between the size of the firm and the total mandated benefits. The predicted probability of owning a business with more than 1 employee goes down from 0.45 to 0.34 i.e nearly 10 percentage points as the number of mandates goes up from 0 to 16. The probability of owning a firm with more than 2 employees goes down by nearly 50 percent for the same change in mandated benefits, and by about 35 percent for firms with 6 or more employees.

From a broader perspective, this paper is particularly relevant in the context of today’s debates on employer health mandates which form the basis of many health care reform proposals.

---

4 There are mandated providers as well, but we have only included mandated benefits in our study.
5 For example, the mental health illness mandate in Montana specifies that firms must offer minimum 30 days of inpatient services.
today. Employer mandates typically stipulate that employers are required to provide health insurance coverage for their employees. If they do not, they may have to pay a penalty. In terms of the framework of our paper, these mandates would essentially force employers to provide coverage to their employees, where coverage is defined in terms of the mandated benefits for each state.

VI. Effect of Uncertainty on Economic Activity

A recent National Small Business Poll conducted by the NFIB highlighted two principal impediments to small business growth. These are business uncertainty and weak sales. There is a rapidly growing literature that is now focusing on the effect of uncertainty on business or economic activity. A new paper by Baker et al. investigates whether uncertainty about taxes, government spending and other policy matters deepened the recession of 2007 to 2009 and slowed the recovery. They develop a new index of policy-related economic uncertainty and estimate its dynamic relationship to output, investment and employment. The index averages several components that reflect the frequency of news media references to economic policy uncertainty, the number of federal tax code provisions set to expire in future years, and the extent of forecaster disagreement over future inflation and federal government purchases. VAR estimates show that an increase in policy uncertainty equal to the actual change between 2006 and 2011 foreshadows large and persistent declines in aggregate outcomes, with peak declines of 2.2% in real GDP, 13% in private investment and 2.5 million in aggregate employment.

Another recent 2010 paper by Bachmann et al. uses micro data from the Federal Reserve Bank of Philadelphia’s Business Outlook Survey and Germany’s IFO Business Climate Index to investigate how measures of business uncertainty, which are derived from manager’s business expectations, are related to economic activity. They find that increases in business uncertainty are associated with prolonged declines in economic activity.

Rodrik (1991) shows how policy uncertainty can act as a tax on investment and cause firms to forego investments until its resolution. Hassett and Metcalf (1999) analyze the effects of

\[^7\]http://www.foxnews.com/politics/2012/02/14/proposed-obama-budget-includes-surge-in-tax-hikes/
uncertainty about tax credits for new investments. They show that this type of policy uncertainty lowers average government tax collections, because firms time investments to exploit randomness in tax rates.

VII. Conclusion

This testimony documents the impact of higher tax rates, higher health care costs and policy uncertainty on entrepreneurs and small businesses. The academic literature suggests that higher taxes and costs of health care provision not only affect the formation of new businesses, but also adversely impact the growth and survival of existing businesses. Moreover, uncertainty in policies relating to government spending and taxes further constrains business activity. This policy lesson is particularly relevant in the current economic climate when we have seen limited hiring and capital investments by not just small businesses, but also large businesses. Raising taxes on these businesses will negatively affect the weak economic recovery. To get the economy on the path to sustainable growth, we need to understand that raising taxes and health care costs on these businesses is likely to further slow hiring and expansion, and is the wrong policy prescription for these times.

References


The Tax Outlook for Small Business: What’s on the Horizon

Testimony of:

Leonard Steinberg
Principal
Steinberg Enterprises, LLC
West Windsor, New Jersey

Before the
Committee on Small Business
United States House of Representatives

April 18, 2012

The Honorable Sam Graves (R-MO), Chairman
The Honorable Nydia Velazquez, (D-NY), Ranking Member

Protecting Small Business, Promoting Entrepreneurship
Chairman Graves, Ranking Member Velazquez and Members of the House Committee on Small Business, thank you for the invitation to participate in today’s hearing to examine the significant impact our tax system is having, and will have, on small businesses and individuals with regard to the Affordable Care Act, the expiration of the Bush Administration tax cuts, the complexity in the tax system, and the issues affecting compliance.

My name is Leonard Steinberg. I am an Enrolled Agent, accountant, and a Certified Management Consultant. I am the principal of Steinberg Enterprises, LLC, a West Windsor, New Jersey tax and consulting practice that concentrates in the areas of tax accounting, taxpayer representation before the Internal Revenue Service, and financial and administrative operational reviews for small businesses and nonprofit organizations. We provide comprehensive tax services including preparation, planning and problem resolution services. Our organization works with all categories of small businesses (Sole proprietorships, partnerships and S-Corporations), nonprofit organizations, and individuals, regarding tax compliance, tax planning and problem resolution services. Our work includes estates, trusts, divorce issues, bankruptcy filings, and tax court preparation. Our representation services include negotiating Installment Agreements, Offers in Compromise, Collection Due Process Hearings, Appeals, and Trust Fund Recovery Penalty abatements.

I am a member of the New Jersey IRS Practitioner Liaison Committee representing over 200 Enrolled Agents in the state and our respective clients. Since 2005, I have also represented the Small Business & Entrepreneurship Council as a member of the Small Business Advisory Committee to the Financial Accounting Standards Board (the FASB). From 2001 through 2004, I was a member of the Taxpayer Advocacy Panel (TAP) and chair of the Small Business/Self Employed Payroll Tax Committee.

My testimony today is based on my practical experience in dealing with all tax issues affecting the small business community and its individual taxpayers.

The Small Business Community:

The structure of the small business community is comprised of one of the following: Sole Proprietorships, Limited Liability Companies, which can be either
classified as partnerships or Sub-Chapter S-Corps, Partnerships, or Sub-Chapter S-Corporations.

Sole Proprietorships and sole owners of Limited Liability Companies are required to file Schedule C, with their personal income tax returns. Partnerships and Sub-Chapter S-Corps issue IRS Form K-1 which flow through to the individual’s personal income tax return. These structures are called flow-through entities.

It is quite rare that a small business would be classified as a C-Corp since this type of organization is subject to double taxation, i.e. that the corporation pays income tax and then the person(s) who own the corporation is/are taxed on their income from the corporation.

**Tax Complexity:**

Each of the above small business organizational structures are affected by the number and extent of laws, rules, regulations and compliance issues in the current tax code. As ONE example, let’s tax a look at the subject of Depreciation. The tax code lists 18 different methods to depreciate assets. However, the method must be matched to the class life of the asset. There are 11 different class lives of various types of assets. Unless the business owner is an accountant or has an accounting background, a tax advisor must provide the updated depreciation schedule each year. Since each asset can use a different depreciation method, the work required can be quite complex. Selling an asset before its completed useful life has its own set of rules, regulations, policies and procedures.

Business owners also can use Section 179 to expense capital investments. Section 179 has been in existence since 1981 with passage of the Economic Recovery Tax Act (ERTA); a major piece of tax legislation enacted during the first Reagan Administration. The purpose of the code section was to allow business owners that make capital investments in their business, to deduct the investment in the year that such investment is made; instead of having to deduct the cost basis over a longer period of time (e.g. useful life).

The purpose of the legislation was to encourage business owners, who were contemplating an investment in capital equipment to make that investment in the current year, which would stimulate growth in the economy.

The maximum deduction in 1981 was $10,000 and during the succeeding years it increased to $25,000. In 2003, The Jobs and Growth Tax Relief
Reconciliation Act (JGTRRA) was passed by Congress, during the Bush Administration. This bill increased the §179 deduction limit to $125,000.

In 2007 the deduction limit was increased to $250,000 for tax year 2008. The purpose, again, was to encourage capital investment and give a stimulus to the economy. In February of 2008 the $250,000 limit was extended through 2008 and it was again extended through 2009. It was extended through 2010 (§103 Hiring Incentives to Restore Employment Act of 2010, or HIRE Act).

For tax years 2010 and 2011, Congress passed the law that allowed the expansion of the Section 179 expense limitation to $500,000. As noted above, without further “enabling legislation”, the 2003 “Bush Tax Cuts” will expire and go back to pre-2003 rates and the §179 deduction limit will fall back to $25,000. Such uncertainty makes it more difficult for small business owners to properly plan for capital investments and diminishes the impact of the incentive.

As a member of the FASB Small Business Advisory Committee, the issue of the pending US adoption of IFRS (the International Financial Reporting System) will have significant adverse effects on the small business community. Under the IFRS structure, small businesses would not be allowed to use the Last-In-First-Out (LIFO) method of inventory valuation. The only method permitted would be the First-In-First-Out (FIFO) method. This would be an immediate tax increase for all those who use the LIFO method. Under the LIFO method, business owners must track the reserves for the FIFO method and those would become taxable in the year of conversion. This would result in an immediate tax increase.

The issue of complexity continues with payroll and employee benefit plans. Even for the small employer, those with 50 or fewer employees, the rules and regulations at the federal level require the use of paid professionals to ensure proper compliance.

This complexity also affects employers on the state level. While this Committee is involved with federal issues only, many, if not most states, follow the federal rules, and regulations which all add to the costs of doing business.

Complexity of the tax laws and compliance only increases the amount of time small business employers must expend valuable resources. According to the Small Business Administration’s analysis, small firms with fewer than 20 employees spend 60 percent more per employee than larger firms to comply with federal
regulations. Small firms spend twice as much in dollars on tax compliance as their larger counterparts.

Many business clients have stated that the tax code is too complex, cumbersome and filled with so-called “loopholes” or special circumstances which make it inherently unfair. Business people sign the returns stating they are correct, but they do not truly know. Many have no idea what the accountants are actually doing, but pay them and the lawyers plenty of money to properly comply and find ways to reduce the tax burden. It seems that those with more money or more political influence can get more tax breaks.

As a member of the IRS Practitioner Liaison Committee in New Jersey, our panel works with IRS personnel in trying to resolve complex client issues. We use the IRS Issue Management Resolution System (IMRS) to monitor local and national tax complexity and compliance issues. Over the years, as the tax code has become more complex, the issues take longer to resolve and many outstanding issues are referred for possible Congressional action.

In 2010, Congress made 579 changes to the tax code which now numbers 3.8 million words which as recently reported is 4 times the length of Shakespeare’s entire works.

**Affordable Care Act:**

Regardless of how the U.S. Supreme Court rules on the constitutionality of the Affordable Care Act, many small business entrepreneurs are concerned with the new taxes and regulations that the law imposes. Some employers have expressed concerns that they may not be able to afford to keep their employees. One of the alternatives some have considered is to re-classify their workers as independent contractors and thereby avoid the issue altogether. However, the reclassification of these workers poses additional risks for the employer and the former employee. A question is whether the business owners will accept the risk. If enough small business owners engage in this practice, the IRS and the states will be unable to monitor these actions. Some business owners will get caught while others will escape. This scenario is inherently unfair in its application.

The proposed tax increases in the Affordable Care Act will alter the way small businesses view each expenditure and cause them to be risk averse. Businesses will stagnate since business owners will be unsure of what additional rules and regulations will be promulgated by the U.S. Secretary of Health and Human
Services. This uncertainty takes money out of the worker’s pockets, reduces job creation and will lead to a decline in the overall economy since there will be fewer dollars available for disposable income and less risk-taking overall.

Expiration of the Bush Administration Tax Cuts:

If no extensions of the tax relief enacted by the Bush Administration are signed into law, the pre-2001 higher tax rates will go back into effect. The 10% bracket would disappear and those taxpayers would move up to the 15% bracket, which would apply to all income below $34,550. This increase would have a negative impact on those at the bottom of the economic ladder. Obviously, increases up the ladder will impact small business owners at all income levels.

The Child Tax Credit would revert back to $500 per child from the current $1,000 per child. Again this tax increase would disproportionately affect those in the middle class who struggle to make ends meet during this prolonged recession.

The capital gains tax and the qualified dividends tax were both reduced to the 15% rate and were at a zero rate for lower income filers. Capital gains would revert back to 20% and qualified dividends would revert back to the higher tax rate of the filer up to the maximum rate of 39.6%. Itemized deductions would also revert back to the pre-2001 higher tax rates. This provision will have a chilling effect on future investments, especially for those with lower incomes who try to supplement their incomes and to provide for a larger retirement fund. In addition, current retirees who rely on their IRA, SEP, or 401(k) distributions will be adversely affected by having their income reduced because of higher taxes on the Required Minimum Distributions.

The marriage penalty used to equalize the standard deduction to twice that of a single filer would also revert back. Personal exemptions and phase outs of itemized deductions would also revert back to the pre-2001 rates.

Let us also include the impact of the Alternative Minimum Tax (AMT). This additional tax has never been indexed for inflation.

Small business owners, who have flow-through entities, are impacted twice should the tax cuts expire. They are impacted at the company level when net operating revenue is decreased and also on the personal level when their individual taxes are raised. Unlike employees, many small business owners are involved with their respective businesses 7 days a week. Their comparable hourly rates of pay will be
reduced as they struggle to allocate fewer resource dollars thereby putting a significant strain on their ability to continue to prosper and grow.

Every small business strives to emulate the successes of other small business entrepreneurs as Will Hewlett and Dave Packard, Michael Dell, Steve Jobs, Sam Walton, and numerous others.

**Conclusion:**

In 1980, the year the Paperwork Reduction Act was passed into law, the number of instruction booklet pages for the individual form 1040 was approximately 45 pages and the form itself contained 68 lines. In 2004, the number of instruction booklet pages for the individual form 1040 was 128 pages and the form itself contained 75 lines. As of the 2011 filing year, the number of instruction booklet pages for the individual form 1040 was 189 pages and the form itself contained 77 lines. Burden and complexity have significantly increased in the last 25 years. This is just for regular 1040 filers.

Business returns have also grown more complex. In the year 2000, the IRS instruction booklet for Partnerships, IRS Form 1065 consisted of 35 pages; for tax year 2011, for the same return, the booklet now consists of 45 pages. In the year 2000, the IRS instruction booklet for S-Corps, IRS Form 1120S consisted of 32 pages; for tax year 2001, for the same return, the booklet now consists of 42 pages.

The constant uncertainty in the tax code from year to year causes business owners to be reluctant to take actions which would enhance their respective firms. Business owners cannot effectively plan for the future. When Congress passes tax credits, these only take effect when the tax return is filed, which is at least 12 to 18 months later. The tax credits do not put money directly into the workers’ pockets. At best, tax credits have a delayed effect and usually provide little substance to the business owners.

Whenever money is taken out of the economy from the small business community, the consequences have multiple effects. Business owners cannot afford to give their employees timely raises, profit sharing and other fringe benefits are cut or withdrawn, business owners defer capital expenditures affecting their suppliers and the supplier workers, worker disposable income is reduced affecting vacations, restaurants, entertainment, and other activities. The workers who work in these industries also suffer due to the cutback. The Las Vegas economy is a prime example.
Tax increases also disproportionately affect minority populations and their communities since small businesses usually operate in their own neighborhoods.

Let the example of the Reagan era tax overhaul be a guide for future discussions. When the tax code was simplified in 1986, the result was the longest continuous period of economic boom in this county’s history. More jobs were created than at any other time.

The issue of tax complexity, compliance, lack of tax certainty, and burden on small businesses falls squarely within the domain of the Congress. The IRS can only implement the will of the Congress. The members of this important Committee have the influence in their respective congressional districts, their state delegations, and with the fellow congressional members to significantly impact and re-ignite the most successful economic engine in the free world, that is the U.S. small business community. I respectfully request that you make the necessary changes for the future economic growth of our great nation and as part of your public service legacy.

I sincerely thank you for the opportunity to address this Committee. Chairman Graves and members of the Committee, I look forward to our dialog and your questions on these issues.

Thank you.

STEINBERG ENTERPRISES, LLC
Testimony of
Margot Dorfman, CEO
U.S. Women's Chamber of Commerce

Before the House Small Business Committee
for the Hearing
"The Tax Outlook for Small Businesses: What's on the Horizon?"
Thursday, April 18, 2012 at 1:00 pm
Rayburn House Office Building, Room 2360

Ranking Member Velázquez, Chairman Graves. I am here today on behalf of the U.S. Women's Chamber of Commerce representing our 500,000 members, three-quarters of whom are American small business owners.

Thank you for the opportunity to speak today on behalf of our members regarding the tax outlook for small business. In preparation for today's hearing, I listened to the views of many of our small business members. As you can imagine, especially at this time of year, most of what I heard was not positive.

There is a great deal of frustration among small business owners surrounding small and individual tax policies, revenues lost and compliance. This frustration centers around a few broad issues: complexity, constant change and uncertainty, the costs associated with managing the ever growing and changing complexity, the lack of fairness and resulting anti-competitive outcomes, and the challenge in simply being a good employer and provider for one's family and community.

Already, in today's hearing, we have heard a bountiful number of references to the growing complexity of the U.S. tax code, and how these changes have a great impact not only on business tax policies, but also on individual taxes due to the high number of small businesses that are structured as pass-through entities.

The outcome of these challenges has been magnified by the recession. While large businesses employ armies of accountants, attorneys, and complex tax evasion strategies to avoid paying their fair share of tax, Congress continues to pass press-release-ready legislation instead of taking the action needed to truly level the playing field to invigorate America's Main Street businesses.

Our small business members tell me the endless and unrelenting lack of fairness and changing landscape of business and individual taxation takes away from their focus on the things that matter to them — securing and keeping good employees, increasing business competitiveness and profitability, and investing in future growth.
Our small business members who are active as federal contractors tell us they are doubly burdened, as they must also deal with the complexities of the FAR, EPA regulations, and state and local issues. It is not feasible or affordable for small businesses to employ someone to deal with the spiraling complexity Congress has created and seems determined to continue and expand.

Our members are proud of the role they play in their communities, as small business owners and as drivers of the U.S. economy. But, when they see how the tax system is skewed against them, when they see how big business gets away with schemes to avoid taxes when they cannot even access or use many of the supposedly targeted tax breaks for small business, they become very angry and resentful. And, worse, the unfair tax advantage big businesses have over small businesses decreases small business competitiveness, as well as their ability to hire new employees, and to provide the types of benefits they would like to have in place for their employees.

We hear story after story of how tax breaks cannot be used by our small businesses because of some feature or restriction that renders it impossible for many small businesses to comply. Yet, Congressional leaders still manage to find a nice headline proclaiming their love and concern for small business. For example, tax breaks for investments in equipment are nice as long as your firm really needs equipment and has the cash flow up front to make the investment. As most of the smaller, most financially challenged firms don’t have cash flows available, they find this approach simply emboldens their larger competitors and frustrates small business owners because they see how U.S. tax policies discriminate against them.

Additionally, an overwhelming majority of the small business members who responded to our request for input prior to this meeting told us they very much want to provide health insurance for their employees and to take advantage of incentive tax credits. We hope you will remember how close small business owners are to their employees. Their employees are their neighbors and often their family members. Small business owners embrace their leadership role within the community and look forward to the ongoing implementation of the Affordable Care Act. Many of our members told us they believe, as the provisions of the ACA continue to be implemented, that they will be better able to provide healthcare for their employees and to be better competitors when seeking to secure and retain employees.

I call upon Congress to end the piece meal approach you have taken to tax policy, and to end the grossly unfair tax provisions and loopholes that can only be employed by larger firms. Small business owners want to pay their fair share of taxes, and they understand the need of the U.S. government to raise revenues to provide a quality and secure environment for businesses and families. But, today, we do not have a level playing field. More legislation aimed at grabbing headlines won’t help. What will help is real leadership in Congress — leaders who come together to truly work on behalf of small business.

We know that small businesses are the job creators. It is imperative that we simplify tax policy, end the complex codes and skewed policies that benefit big business, and allow business owners to focus on the important work they have as revenue generators, job creators and community leaders.
Statement Submitted

By

The National Association of Home Builders

Committee on Small Business
Hearing on the Tax Outlook for Small Business:
What’s on the Horizon

April 18, 2012
Introduction

The National Association of Home Builders is a Washington, DC-based trade association representing more than 140,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting, design, housing finance, building product manufacturing and other aspects of residential and light commercial construction. NAHB is affiliated with 800 state and local home builder associations around the country. NAHB’s builder members will construct about 80 percent of the new housing units this year.

Small businesses and pass-thru entities, such as S Corporations and Limited Liability Corporations, play a critical role in the U.S. economy and are the dominant players for the U.S. home building and construction sectors. The home building industry has been hit hard by the impacts of the Great Recession, with the construction sector currently experiencing a 17% unemployment rate and nearly 1.5 million jobs lost in the residential construction sector, which includes single-family and multifamily construction, land development and remodeling. In normal economic times, housing constitutes approximately 17% to 18% of Gross Domestic Product and is an important source of job creation.

As the economy emerges from the Great Recession, NAHB strongly urges Congress to extend the 2001/2003 tax reductions. Small businesses organized as pass-thru entities pay individual income tax rates on their net business income. Thus, for small businesses, traditionally the nation’s foremost job creators, individual income tax rates are business tax rates.

Importance of Small Businesses for the Residential Construction Sector

Small businesses are the heart of the residential construction sector, which includes single family and multifamily construction, land development and home remodeling. NAHB Census of Membership data for 2010 reveals that 80% of businesses that belong to NAHB are organized as pass-thru entities or sole proprietorships. In particular, 47% of businesses are organized as S Corporations and 25% are LLCs.

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

As measured by workers, 79% of NAHB builder members have less than ten employees, with the average member supporting approximately 12 employees. Only 2% of NAHB builder members have more than 100 employees. For NAHB’s associate members, 87% of such members have less than 50 employees.

Approximately 52% of NAHB builder members have less than $1 million in gross receipts, and 84% have less than $5 million in gross receipts. Approximately 76% of NAHB builder members built 10 or fewer homes in 2010. NAHB’s associated members are very similar to its builder members with respect to dollar size of business, with 77% having less than $5 million in gross receipts.
Statistics of income data from the Internal Revenue Service provide a similar story for the construction sector as a whole. Data for tax year 2008, the most recent complete data available, indicate that there were about 767,000 corporations in the construction business. Of this total, approximately 571,000 were S Corporations. Additionally, there were 203,000 partnerships and 2.8 million sole proprietorships in the sector. All of these non-C Corporation taxpayers in the construction industry pay their business income taxes on individual income tax forms. They also face certain restrictions and complications that C Corporations do not face, including but not limited to, certain passive loss restrictions and AMT issues that arise from reporting business tax items on an individual income tax return.

Role of Housing and Home Building for the Economy

NAHB analysis shows that the construction of an average single-family home creates three jobs, $90,000 in federal, state and local taxes, $145,000 in wage income, and $86,000 in business income. In normal periods, housing’s share of Gross Domestic Product stands at 17% to 18%. As of the end of 2011, housing’s share of the economy was only 14.9%. The direct impact of home building, which typically stands at 5%, is now at 2.5%.

Home building typically leads the economy out of recessions, but clearly the housing sector today remains at very low levels of economic activity. Housing starts in February 2012 were reported at a nearly 700,000 seasonally-adjusted annualized rate. This is a significant reduction from annualized rates of more than 2 million housing units just a few years ago. Based on growth in population and need for replacement of housing stock, the normal level of production for housing starts should be 1.5 million to 1.8 million starts a year.

There is some local improvement. For example, the NAHB/First American Improving Markets Index now stands at 101. That is, 101 metropolitan areas, representing one-quarter of all metropolitan areas, are now ranked as improving under a conservative evaluation of local job markets, home prices and housing construction permit activity. To make the list, a metropolitan area must show 6 consecutive months of improvement in each of the above listed categories.

But until more of the nation’s housing markets recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry. Due to declines in housing prices of more than 30%, households have had to deleverage or repair balance sheets. To do so, savings have had to increase, which results in reduced spending. This is one cause of the weak recovery we are experiencing.

NAHB is forecasting improvement for single-family and multifamily starts. The multifamily sector has improved already. Multifamily starts were up 55% in 2011 over 2010 totals. NAHB is forecasting an additional 22% increase in 2012. Single-family starts will follow the improvement in the multifamily sector.

1 The Direct Impact and Remodeling on the U.S. Economy. NAHB. 2007. (http://www.nahb.org/generic.aspx?sectionId=734&genericContentId=1035538&channelId=311)
sector. NAHB is forecasting a 17% increase in single-family starts for 2012 and an additional 30% growth in 2013.

In the meantime, business conditions for the nation’s home builders remain challenging. Access to lending, even in markets where housing demand is recovering, is tight. Many builders cannot get access to lending for Acquisition, Development and Construction (AD&C) purposes. In fact, according to FDIC data, lending for AD&C for home building is down 77% from levels of a few years ago. However, over the same period, the dollar value of permitted housing construction is down 58%. This means a lending gap has opened for home builders between available business lending and available credit. Tight conditions for mortgage lending for responsible homebuyers are also holding back a robust recovery for the nation’s housing markets.

NAHB survey data of builder’s financial status reveals what these economic conditions have caused. On average, single-family builders in fiscal year 2010 made $7.1 million in revenue, had $6.0 million go towards cost of sales, and slightly over $1 million towards operating expenses, which left them with an average net profit of $39,000 before taxes. In terms of percentages of revenue, cost of sales represented 84.7% of total revenue, which translates into a gross profit margin of 15.3%. Operating expenses ate up another 14.7%, leaving builders with a net profit margin of only 0.5%.

**Tax Policy Considerations**

With these economic issues in mind, it is clear that tax policy can have a dramatic impact for a sector like home building that is dominated by small businesses. Because most home builders pay income tax on their business income through the individual side of the Internal Revenue Code, individual income tax rates are business tax rates for the residential construction sector. And because profit margins are so low, even small tax increases can have serious consequences for an enterprise. The following discusses several tax issues of concern for the nation’s home builders.

**2001/2003 Tax Law**

NAHB strongly supports extending the 2001/2003 income tax reductions, now scheduled to expire at the end of 2012. This includes extending the present set of marginal income tax rates, with a top rate of 35%. Absent extension, the top rate will rise to 39.6% along with rate increases at the lower brackets. Absent extension, these scheduled changes will result in income tax increases for those home builders in markets that are now recovering.

NAHB also supports extension of the 15% dividends and capital gains tax rate, which is important for small business owners. A higher capital gains tax rate could also affect the multifamily sector as the sale of apartment buildings can give rise to capital gains as part of the development and operation process.
Many home building companies are family-owned, thus NAHB also supports extension of the reduced rates and higher exemption amounts for the federal estate tax. The 2003 tax legislation also temporarily fixed the marriage penalty.

**Tax Issues Related to the Patient Protection and Affordable Care Act**

It is worth noting that several tax issues arose as a result of enactment of the 2010 health care legislation. Beginning in 2013, a new 3.8% capital gains tax will be added to the existing capital gains tax system for certain taxpayers. This will have a negative effect on small businesses, particularly multifamily developers for whom capital gains may arise from developing and operating residential rental property. Furthermore, the new 0.9% Medicare payroll tax will also add to tax burdens in 2013.

The 2013 tax increases has also had an unintended but important negative effect on the nation’s housing markets as it is commonly, but incorrectly, believed that the 3.8% sales tax is a sales tax on home sales. This is not correct, but unfortunately due to the complexity of the new law, many participants in the housing market believe it to be true. NAHB along with other stakeholders in the housing industry have been attempting to educate homebuyers, home sellers and businesses in the real estate industry the facts concerning this tax.²

**Tax Reform Principles**

NAHB supports simplifying the tax code as part of a comprehensive tax reform process. Comprehensive tax reform should only occur after a thoughtful and deliberate vetting process that examines proposed changes, necessary transition rules, and economic impacts.

This process should involve making many temporary features of the income tax permanent, including the 2001/2003 income tax rates. It would also involve permanently patching or repealing the Alternative Minimum Tax (AMT). The AMT is a particular administrative burden for small business organized as pass-thru entities because it both raises tax liability and disallows certain tax incentives that business may claim. For example, in the home building sector, businesses caught in the AMT may not be able to claim the new energy efficient home tax credit (section 45L). This complicates tax and business planning, as well as increasing the tax administrative burden on small firms.

NAHB believes that the 1986 Tax Reform Act should act as a guide for tax reform. The 1986 Act reduced rates while protecting long-standing provisions of the tax code. For home builders, homeowners, and prospective homebuyers, it is critical that the mortgage interest deduction (MID) not be curtailed or eliminated as part of a tax reform effort.

² [http://eyewonhousing.wordpress.com/2011/06/22/the-facts-on-that-rumored-3-8-sales-tax-on-homes/](http://eyewonhousing.wordpress.com/2011/06/22/the-facts-on-that-rumored-3-8-sales-tax-on-homes/)
Weakening or eliminating the MID would hurt the housing market, just as signs are beginning to appear that the housing market is once again contributing to economic growth. Unfortunately, many tax reform plans would severely weaken the MID. Such changes would serve as a tax increase on the more than 30 million taxpayers who benefit from the MID, and who made home financing decisions based on long-standing tax rules. It would be unfair and economically destructive to make changes to the MID.

Additionally, tax reform plans that would reduce corporate tax rates and leave individual income tax rates the same would place small businesses at a competitive disadvantage to their larger peers. This would be harmful to the small business sector, which traditionally has been a robust source of job creation. Any reduction in corporate tax rates must be accompanied by similar reductions in rates for small businesses that pay income taxes through the individual side of the tax code.

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

**Tax Issues Concerning Business Debt**

As noted above with respect to AD&C lending, small businesses, and home builders in particular, also rely on debt proportionally more than their publicly-traded corporate peers. Access to affordable credit is the lynchpin to the success of small business. In general, the tax code currently allows businesses to deduct interest as a necessary and ordinary business expense.

Some tax reform proponents have suggested that the tax code carries a bias in favor of debt rather than equity, and this bias should be eliminated. NAHB urges the committee to consider that small businesses lack the access to equity capital that corporations often have. If Congress eliminates the present-law tax treatment for debt, small businesses will face significantly higher costs to raise capital, placing them at a distinct disadvantage to large, corporate entities.

It is worth noting that as the economy emerges from the Great Recession, many home builders are dealing with tax issues arising from prior or ongoing debt mitigation efforts. Small business may be working with lenders to restructure debt due to (and home price declines in recent years. These efforts may result in interest rate reductions, term extensions, or even principal reduction. Under present law (section 108), these market-based workouts can give rise to tax liability. In 2009, the American Recovery and Reinvestment Act (ARRA) allowed an up to 10-year deferral for such events occurring in 2009 and 2010. NAHB recommends that the committee examine extending this deferral to tax years after 2010 and making the deferral an exclusion. Absent such action, many small businesses will be forced to declare bankruptcy to avoid a tax bill that cannot be paid.
Tax Accounting Issues

Finally, for home builders, an important tax accounting rule is the Section 460(e) home construction contract rule. The tax code’s long-term tax accounting rules require pre-payment of some expected tax revenue for contracts that spillover from one tax year to another. Home construction can last months or a year or more. Hence, the 460(e) rule allows home builders to pay taxes on the home only once the home is sold, rather than during the construction period, which would require additional up-front financing.

Conclusion

Putting the federal government on a sustainable fiscal path is critical, especially for an interest-rate sensitive industry like home building that depends on debt finance for business and homebuyers. The federal government should strive to constrain the growth of government spending so that tax increases – particularly tax increases that disproportionately affect particular sectors of the economy – are not required. And policymakers should be certain to not increase taxes on certain businesses, like small businesses organized as pass-thru entities, in order to achieve other policy goals. Absent extension of expiring tax rules, most prominently the 2001/2003 tax cuts, many small businesses will be facing tax increases just as the economy is once again showing hopeful signs of growth.
April 18, 2012

The Honorable Nan Graves  The Honorable Nydia Velázquez
Chairman Ranking Member
House Committee on Small Business House Committee on Small Business
2361 Rayburn House Office Building B 343-C Rayburn House Office Building
Washington, D.C. 20515 Washington, D.C. 20515

Dear Chairman Graves and Ranking Member Velázquez:

On behalf of Associated Builders and Contractors (ABC), a national association with 74 chapters representing 22,000 merit shop construction and construction-related firms, I am writing in regard to the Small Business Committee hearing, "The Tax Outlook for Small Businesses: What’s on the Horizon?"

This month, as millions of small business owners struggle with the increasingly onerous burden of tax compliance, the U.S. corporate tax rate rises to the highest in the industrialized world and American taxpayers stand less than 270 days away from the largest tax increase in history. The need for fundamental reform of the tax code is greater than ever. With more than 17 percent unemployment in the construction industry, tax relief is critical for these businesses to spur reinvestment, create jobs and grow.

Among ABC’s top priorities for reforming the tax system are simplicity, parity and certainty. Simplicity in the sense of moving toward a less complex structure with minimal brackets and fewer loopholes; parity in terms of keeping rates low and similar for both corporations and individuals through the extension of the 2001 and 2003 tax rates and, ultimately, comprehensive reform; and certainty by way of long-term tax policy, elimination of temporary gimmicks and permanent extension of worthy tax expenditures.

One immediate way for Congress to relieve the significant compliance challenges within the construction industry is to enact the American Job Builders Tax Reform Act of 2011 (H.R. 993), a bipartisan bill that would allow the overwhelming majority of commercial construction firms to use the Completed Contract Method (CCM) of accounting on multi-year contracts. As an historical accident of the 1986 overhaul, new limits on this traditionally favored method of accounting were not indexed for inflation. In the 25 year interim, tens of thousands of Small Business Administration-defined small businesses have fallen into the administrative trap of “look-back” accounting required by the Percentage of Completion Method. By raising the current $10 million CCM eligibility threshold to a more contemporary $40 million per year level, these small and mid-sized companies would be spared the many hours and thousands of dollars per job spent on look-back calculations, with no net change in the contractor’s liability to the Treasury.

We appreciate the committee’s attention to the impact of tax rates and compliance challenges on small businesses, and look forward to working with you on reform efforts that will grow the economy and create jobs.

Sincerely,

Liam P. Donovan
Director, Legislative Affairs
Statement
of the
National Grocers Association
Submitted to
The House Small Business Committee
On
The Tax Outlook for Small Businesses: What’s on the Horizon
By
Peter Larkin, President & CEO
May 3, 2012

The National Grocers Association (N.G.A.) wishes to express its appreciation to Chairman Graves and members of the Committee for holding the hearing on April 18, 2012 on "The Tax Outlook for Small Businesses: What’s on the Horizon" and for affording N.G.A. the opportunity to submit this statement for the hearing record.

N.G.A. is the national trade association representing the retail and wholesale grocers that comprise the independent sector of the food distribution industry. An independent retailer is a privately owned or controlled food retail company operating a variety of formats. Most independent operators are serviced by wholesale distributors, while others may be partially or fully self-distributing. Some are publicly traded but with controlling shares held by the family and others are employee owned. Independents are the true "entrepreneurs" of the grocery industry and dedicated to their customers, associates, and communities. Approximately 50 percent of N.G.A.’s members operate one to three stores. N.G.A. members include retail and wholesale grocers, state grocers associations, as well as manufacturers and service suppliers. For more information about N.G.A. and the independent sector of the industry, see the N.G.A. website: www.NationalGrocers.org.

Overview.

On January 6, 2012 the Congressional Joint Committee on Taxation published a long list of 60 federal tax provisions that expired at the end of 2011 and another 43 that will expire at the end of 2012. This report gives small business a realistic look at what is on the horizon. It is well known that in recent years the uncertainty of our tax laws has created a major impediment for independent retail grocers, wholesalers and other businesses to plan for the future, even more so for family owned businesses when it comes to estate taxes. N.G.A.’s retail and wholesale grocers are growing more and more concerned about the inability to make fundamental business and succession decisions because of the numerous short term changes Congress makes to the tax code and then fails to timely extend the expiring provisions. In today’s economic environment many small business and other owners are refraining from investing in a...
new store or remodel because of the expired 2011 provisions, and thus curtailing employment opportunities. The magnitude of the dilemma for independent retail and wholesale grocers will be even more significant if Congress does not act before December 31, 2012. In the longer term N.G.A. believes that tax reform must be balanced, fair and equitable. Reform of the tax code is complex and must be carefully studied before any reform changes are adopted. N.G.A. believes that this Committee can play a strong role in achieving that objective on behalf of small business.

Extension of Pro-Growth Tax Provisions.

Cost Recovery and Investment Incentives. At the end of 2011 a number of pro-growth tax provisions expired including the Work Opportunity Tax Credit (WOTC), 15 year straight-line cost recovery for qualified leasehold improvements (including qualified retail improvements), the 100% accelerated bonus depreciation, the increased expensing of up to $500,000 in equipment, and re-authorization of New Market Tax Credits. These expiring measures have been in many cases the only reasons independent retail grocers or wholesalers have been able to expand their businesses or hire new workers.

N.G.A. members feel strongly that appropriate tax policies should promote economic growth and jobs, such as the accelerated depreciation incentives that promote investment in equipment and business expansion. The resulting economic growth will not only create jobs within retail and wholesale grocery companies, but also in the communities they serve and the manufacturing, construction and supply industries.

In October 2011 the N.G.A. Tax Committee reviewed the importance of these provisions to their business growth and in creating jobs. The consensus was the 100% percent accelerated bonus depreciation, along with the increased expensing of up to $500,000 in equipment and the 15 year straight-line cost recovery for qualified leasehold improvements and New Market Tax Credits, were the key essential elements in fostering their plans for investment, and ultimately in their creation of new jobs in recent years.

Retailers and wholesalers reported during this economic recession that because credit has been so tight, or nonexistent, the 100% accelerated bonus depreciation was the key resource that made projects financially feasible. The increased expensing for equipment was an important incentive for equipment purchases and upgrades. In fact, a report prepared by Ernst and Young for the S Corporation Association entitled “The Flow-Through Business Sector and Tax Reform” illustrates that the combination of accelerated depreciation and Section 179 expensing rank at the top of largest business tax expenditures and is beneficial to both C corporations and Flow-through entities, such as Subchapter S corporations and LLCs, from 2010 through 2014. In addition, the 15 year straight-line cost recovery for qualified leasehold improvements, including retail improvements, has long been recognized as important to retail grocers due to the fact that the prior 39 year life was too long and does not reflect the economic realities of cost recovery.

The New Markets Tax Credits serve to offer retailers critical access to capital. The New Markets Tax Credit (NMTC), authorized in the Community Renewal Tax Relief Act of 2000, was designed to stimulate investment and economic growth in low-income communities that are traditionally overlooked by conventional capital markets. The NMTC program attracts capital to low income communities by
providing private investors with a 39 percent federal tax credit for investments made in businesses or economic development projects located in some of the most distressed communities in the nation—census tracts where the individual poverty rate is at least 20 percent or where median family income does not exceed 80 percent of the area median.

**Employment Incentives-Work Opportunity Tax Credit.** Since President Reagan’s Economic Recovery Tax Act of 1981 was enacted, Congress has provided private sector employers a work opportunity tax credit (WOTC) as a financial incentive to hire workers from targeted groups of the chronically unemployed. This has enabled retail grocers, wholesalers and other employers to provide job opportunities, many for the first time, to the poor, veterans, at-risk youth, and the disabled. The WOTC has been proven by several Federal and State evaluations to be an effective tool for placing hard-to-hire workers into productive, private-sector jobs.

In 2011, over 1.1 million workers found jobs through WOTC, at an average cost of approximately $1,300 based on Joint Committee on Taxation data—all other employment costs are borne by the private employer. This figure doesn’t include any offsetting savings from lower welfare, disability, and SSI payments. Congress allowed WOTC to expire last year for all but veterans, and past experience demonstrates that with unemployment still exceeding 8 percent a chance for a million jobs may be lost to disadvantaged workers if the WOTC is not extended this year.

The WOTC originated from the appeals of veterans, mayors with large at-risk youth populations, and parents of children with disabilities who wanted their child to live a normal life. Employer acceptance of WOTC is demonstrated by the fact that last year State Workforce Agencies received 3,750,000 employer requests to certify workers for WOTC and approved 1,160,000. N.G.A. strongly supports the extension of the WOTC as called for in Representative Schock’s (R-IL) and Rangel’s (D-NY) bill, H.R. 2082.

**Major Important Priority Tax Extenders For N.G.A.’s Independent Retail Grocers and Wholesalers**

There are two major current tax provisions that are of crucial importance to retail and wholesale grocers and expire at the end of 2012, the current individual tax rates and the estate taxes. As Congress considers extender measures it is also important that they be extended. The Committee’s description of the hearing has it right when it says that “Higher tax rates can mean that small firms have less capital to create jobs and invest back in their companies.”

**Extend Individual Tax Rates.**

On December 31, 2012 the individual tax rate reductions of 2001 and 2003 will expire and individuals will face average rate increases of 3 to 4%. For business entrepreneurs that operate Subchapter S, LLC’s, and other pass-through entities, these rate increases would adversely affect the financial resources that are retained for operating capital, business expansion and jobs. N.G.A.’s 2011 Independent Grocers Financial Survey reported that 51% percent were S-Corporations, 18% LLCs, and 30% C Corporations. According to the Ernst & Young report for the S Corporation Association, approximately 3.8 million flow-through entities in 2008 were in the retail and wholesale trade compared to just 235,000 C corporations. Meanwhile, flow-through entities with 100 or more employees employed 20 million employees,
suggesting that large flow-through businesses are a significant source of employment. The report observed an important finding that, “The concern over higher individual tax rates has, in part, been the result of the fact that the flow-through sector plays an important role in the U.S. economy and the recognition that higher tax rates on these firms’ owners may result in less hiring and capital investment with the flow-through sector.”

The individual income tax rates should be extended for the foreseeable future, such as through 2014, so Congress can pursue tax reform in a fair and equitable fashion and weigh the concerns of both flow-through entities and C corporations in evaluating comprehensive tax reform. The so-called Millionaire’s surtax on income over $250,000 and the “Buffet rule” should be rejected because of the adverse effects on Main Street community businesses like retail grocers.

Extend Estate Tax Provisions.

N.G.A. supports full repeal of the estate tax, however, the current economic environment may preclude repeal. In the absence of repeal, N.G.A. calls on Congress to provide meaningful relief by making permanent the current inflation adjusted exemption of $5 million per individual ($10 million per married couple with portability of any individual’s unused portion to the surviving spouse) and the maximum tax rate of 35%.

Because the estate tax falls on assets, it reduces incentives to save and invest and, ultimately, hampers growth of privately held and family owned businesses. The estate tax is especially burdensome to family-owned retail grocers and wholesalers. Well over half of the assets of a typical supermarket—the highest of any other industry sector—are not liquid, so the death of an owner creates a serious obstacle to continuation of the business. Because the estate tax is assessed on the value of a business at the owner’s death, it often forces families to borrow funds to pay the tax. As a result it reduces the ability to invest and hampers growth of the business, or forces the sale of the business.

Conclusion.

Congress should immediately include the above provisions in a comprehensive extenders bill and quickly pass it. Tax increases and uncertainty are not the answer to restoring economic growth. Congress should act now to provide American businesses with long term stability and certainty within the tax code, in part, by making permanent the current individual rates and current estate tax rates and exemption. N.G.A. also urges Congress to extend, through 2014, the Work Opportunity Tax Credit (WOTC), the 15 year straight-line cost recovery for qualified leasehold improvements (including qualified retail improvements), the 100% accelerated bonus depreciation, the increased expensing of up to $500,000 in equipment, and re-authorization of New Market Tax Credits.
Comments from the Small Business Committee “Open Mic” Website

We are hesitant to hire new employees for fear of what new tax burdens await us with the expiration of older tax law and the new health care laws coming. We are concerned that these new issues may be the ones that push us out of business. There are many, many small businesses like ours that contribute to the health of the economy of our community. If we go out of business, many more people and businesses are hurt than just our own.

Wendy Koller (Fort Smith, AR) Koller Moving and Storage
4/17/12

I am holding off hiring employees and acquiring equipment until the Supreme Court (hopefully) strikes down the Health Care Act in full. Also, the expiration of the tax cuts from the 2000’s will have a tremendously negative effect on my business, as well as many other businesses I know of. How are even small companies supposed to plan and budget for the future, when Congress and the Executive Branch cannot operate on a budget?

Jim Acher (Big Lake, AK) Northern Pioneer Helicopters
4/16/12

This administration has convinced a significant segment of voters that small business owners who “make” more than $250k per year are wealthy. But, they fail to realize that the mythical $250k in my bank account on December 31 is needed to make payroll, rent, and buy inventory on January 1. Just like it was on June 30, or August 24, or any other day of the year. Except, on December 31, the government confiscates 30%.

Will Leaman (Roanoke, VA) BCDS
4/16/12

President Obama’s latest tax proposal includes changes which will specifically harm ESOP Subchapter S companies. These changes will directly harm many middle class people. ESOP’s have been proven to be an equitable way to engage people at all levels of a company in economic success. ESOP’s have been proven to be more-resistant to layoffs than other companies. Why would we implement tax proposals that hurt the poor and middle class and which are anti-employment? Put it another way - if these proposals pass, we will likely need to lay off 10 - 15% of our workforce.

Donald Waltzer (Rochester, NY) H&C Tool Supply
4/16/12

For a small startup company to have 30% of its profits vanish in taxes does not make it easy to build a company. Taxes for property, income, sales, federal, state, local, and fuel just to name a
few. Government needs to encourage small business by eliminating taxes thereby allowing the companies to grow strong and not depend on debt alone, but grow by controlled growth.

David Warren (Avon Lake, OH) Lester Metals LLC
4/14/12

There is just way too much uncertainty in the marketplace right now. Years without a federal budget, the continuing healthcare debacle and now the potential for even higher taxes. It’s no wonder small business owners are concerned.

Jim Carroll (Norfolk, VA) Hampton Roads Chamber of Commerce
4/14/12

We are struggling to recover from the recession and the government needs to realize that small business is the ones keeping the country moving. Any additional taxes will only stop any chance of a recovery and they need to realize we need every penny to increase staff which puts people back to work!

Debbie Peacock (Mesa, AZ) Fabricating Distributor
4/14/12

As a small business owner in the construction trades I have qualified people contacting me often seeking gainful employment. However with the current economy it is very difficult to make a decent living much less try to grow a small business to the point of expanding our workforce. Government has to take control of spending before our great country winds up in another depression. Increasing the tax load on small business will only compound the problem of cash flow and undoubtedly cause many to close up shop.

David James (Okmulgee, OK) James Gang Electric
4/14/12

Higher taxes means the cost of doing business increases and the cost is passed on to the least able to pay. There is no such thing as “taxing big corporations” it all comes back to the consumer. What we need is LESS GOVERNMENT SPENDING so less money is needed.

Charles McMasters (Ridgeland, MS) Dr. Charles McMasters
4/15/12

I am a new start up business, it is extremely scary starting a business not knowing what the future will bring. We would like to hire more employees but it is hard to feel that things are stable enough that we can maintain their employment. If we are able to supply good jobs and we turn around and get hit with all these other costs, Healthcare, (which continues to escalate) taxes on small business, (which we have no clue where it could end)...all of these issues place a damper on getting to excited about following our dreams when it seems to always be taken
away from us for one reason of another. The policies implemented the past few years have precipitated this thinking.

Grant Kohler (Midway, UT) Heber Valley Artisan Cheese

Increased taxes, regulations and health care costs make it increasingly difficult to the point that there’s no sense in running a business. Whenever the economy recovers and business picks up, I’ll likely keep my staffing as low as possible by using more sophisticated software and outsourcing to Eastern European companies to keep my costs low enough to afford the software.

Barry Lewis (Mechanicsville, MD) Lewis Engineering Associates, Inc.
4/14/12

The current economic policies have just about destroyed the construction industry, including remodeling & new residential construction. New taxes & massive increases in new regulations continue to destroy the economy.

Robert Hellebuycx (Kansas City, MO) Standard Improvement Co.
4/14/12

My business requires constant capital investment to keep up with changing technology. The Obama tax increases directly affect my ability to invest in equipment and prevent me from hiring people to expand my business.

4/13/12

Nathan Wicker (Dallas, TX) Zelva Holdings

We are a small business in Pennsylvania, that would love to grow and has opportunity to do so, however, the uncertainty of Washington and the impending health care legislation has caused us to remain at our current level of operations.

2/14/12

Tammi Schaible (Souderton, PA) V-Talese Incorporated