Small Businesses and Tax Reform

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Summary of considerations in small business tax reform

1. Define "small."
2. Recognize trends including the growing number of self-employed individuals (part-time and full-time) and modernize the tax law to tie to today's ways of living and doing business.
3. Use principles of good tax policy to identify weaknesses and how to address them.
4. Simplify (and don't continue to complicate such as with numerous changes and temporary provisions).
5. Consider integration of the corporate tax system before making rate changes.
6. Consider administrative improvements including use of technology.
7. Clarify worker classification rules.
8. Resolve state tax issues that need to be addressed by Congress such as because the commerce clause is involved (nexus issues).

Testimony Disclosure Information

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This testimony is submitted only on my behalf and not on the behalf of any government or non-governmental entity.

I have not received any government grant.

I do not hold any elected office.

[1] This URL is to a website maintained by Annette Nellen for the purposes of promoting modernization of tax systems and consideration of the principles of good tax policy, with opportunity for readers to post comments. Views represented at this website are Professor Nellen's views only and may not represent those of her employer or professional organizations of which she is a member.

Introduction

Small businesses face many obstacles in complying with the federal tax laws. The key one is complexity of the tax rules. This complexity comes at a price - costs of compliance plus time lost that could have been devoted to business growth and development.

Most tax rules today were written for the Industrial Age rather than the Information Age. Thus, some do not support, or may work against, the ways a small business operates today.

These two key issues underlie much of what should be the focal points in reforming tax rules pertinent to small businesses. This testimony suggests eight areas (see list above) to guide tax reform for small businesses. Specific recommendations within each area are noted below (items A through M).

I. Define "Small"

To truly address taxation of small businesses, this term should be defined. At present, the federal tax law defines small using many different parameters and they all differ from the approach used by the Small Business Administration (SBA) for its programs.

Under the current federal tax rules, a business may be considered small for one rule, but not another. Following are examples of the many different ways "small" is defined in the federal tax system (this is not an exhaustive list):[2]

- *Capital*: Section 1244, Losses on Small Business Stock, defines small as $1 million or less of capitalization.
- *Gross receipts*: Average annual receipt thresholds used to define small range from $5 million (§448 providing an exception from the required use of the accrual method) to $7,500,000 (§55(d) providing an AMT exception for corporations) to $10 million (§263A exception from the required use of the Unicap rules for retailers) to $50 million (§39 on credit carryovers).
- *Assets*: The Small Business/Self-Employed Division of the Internal Revenue Service (IRS) serves (1) individuals filing Form 1040 and (2) other business with assets totaling under $10 million. The Division alludes to the limitations of an asset measure by stating:
    - "Some businesses may meet the under $10 million asset test for SB/SE yet be more like a large or midsize business in every other way. … Other businesses may have assets over $10 million yet be more like a small business. These customers may be serviced by the Small Business/Self-Employed Division."
- *Personal property placed in service in a given year:* The §179 expensing election amounts have ranged from $10,000 in 1992 to $500,000 for 2010 and 2011. After the temporary increase to $500,000 expires after 2011, the amount will be $125,000 for 2012 and then $25,000 thereafter.
- *Number of employees*: To qualify for the full health insurance credit, an employer should have no more 25 full-time equivalent employees. In contrast, an employer must have no more than 100 employees to qualify for a SIMPLE IRA plan (§408(p)).
- *Sole proprietors or Schedule C filers*: IRS Publication 334 is entitled *Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)*, implying that small business means a sole proprietor.

In contrast, SBA rules define a "small business concern" as independently owned and operated, not dominant in its field and within the SBA's size criteria. Size criteria vary depending on the industry.

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[2] See Nellen, "The Many Sizes of "Small,"" *AICPA Corporate Taxation Insider*, 10/28/10; http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2010/CorpTax/SizesofSmall.jsp.

Generally, for each industry, as identified by North American Industry Classification System NAICS codes, a maximum gross receipts or employment number is used to define small.[3]

Recommendation:

A. Consider that the primary reason to even have special rules for "small" businesses is for administrative convenience and simplification. Review existing special rules and ones under consideration against this key criteria. For ones that do not meet this rationale, consider whether the rule is truly needed.

B. Review the current definitions of "small" in the IRC and other federal laws to determine which approach best describes the set of businesses that need the simplification benefit described in (A) above.

C. Direct reform efforts to using fewer definitions of "small" and be sure the special rules serve a rationale, such as simplification, to justify their existence.

II. Recognize Trends

A strong tax system is one that is regularly reviewed and modernized when warranted to be sure it comports with current ways of living and doing business. If this is not done, the tax system might work against positive trend,s and old incentives may no longer be needed or warranted. Some of the trends relevant to small business tax reform include:

- Growing numbers of people self-employed part-time or full-time.
- Increased likelihood that a small business has international operations.
- Decline in persons covered by retirement plans.
- Growth of capital investment in intangibles rather than tangibles.

Recommendation:

D. Obtain data on trends relevant to small businesses from government agencies, such as the Census Bureau and the SBA.

E. Review the trends against existing tax rules to see where rules might be working contrary to positive trends. For example, international tax rules may need to be simplified to address the international sales activity (of goods, intangibles and services) of small businesses.

III. Use Principles of Good Tax Policy

Principles of good tax policy, such as simplicity, equity and economic efficiency, should be used to:

- Identify where current rules violate such principles and what reforms will enable rules to better meet the principles.
- Evaluate proposals to determine if they meet the principles of good tax policy and where such principles are not met, the principles can help identify improvements.

Various formulations of principles of good tax policy exist. The Joint Committee on Taxation and Government Accountability Office have suggested appropriate principles in reports. The American Institute of CPAs (AICPA) has suggested a set of ten principles. These formulations are all quite similar with key principles being:[4]

- Equity

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[3] See links in article at footnote 1.
[4] For a list of various formulations including the ones noted in this testimony, visit http://www.cob.sjsu.edu/nellen_a/TaxReform/PolicyApproachToAnalyzingTaxSystems.pdf.

- Simplicity
- Neutrality
- Economic growth and efficiency
- Minimum tax gap
- Transparency

Recommendation:

F. Before reforming the tax system, identify the key provisions relevant to small businesses and evaluate them against the principles of good tax policy to identify where improvements are needed.

G. Evaluate all proposals for change against the principles of good tax policy. If any principles are not met and the proposal cannot be modified to meet most of the principles, do not enact the provision.

IV. Simplify

While simplicity is a principle of good tax policy, it is important to stress this as a separate consideration in tax reform and small businesses. The costs of tax complexity are quite high in terms of compliance costs, risks of error, costs of not utilizing incentive provisions and lost time from business development activities.

Recommendation:

H. Focus on simplification. If you cannot describe in a few simple sentences how a rule works, if it requires alternative calculations or multiple definitions, or if new forms are needed, the rule likely is not simple and either needs to be revised or repealed.

I. Recognize that for small businesses, simplification may trump accuracy. Thus, for example, a standard deduction for home office expenses, may be warranted to simplify compliance. Or, tax forms may need to be consolidated, such as is allowed for employers of household employees.

J. Avoid temporary provisions and numerous changes that complicate the tax law and increase compliance costs.

V. Consider Integration of the Corporate Tax System Before Making Rate Changes

Small businesses are not inclined to operate as a C corporation due to double taxation of business income. Double taxation increases the effective tax rate on corporate income relative to other types of income, thereby distorting investment decisions (in violation of the neutrality and economic efficiency principles).

Discussions about lowering the corporate tax rate involve more than international competitiveness considerations. The overall rate on corporate income should be considered which today includes a temporary 15% rate on qualified dividends earned by individuals. Concerns about the corporate preference for debt also ties to the need for discussion of integration. Finally, international competitiveness also warrants discussion of integration of the corporate tax system as double taxation is not a prevalent design feature.

Recommendation:

J. Evaluate the pros and cons of integrating the corporate tax system *before* lowering the corporate tax rate, changing the rate on dividend income or making other major business tax reforms. Integration has been studied for decades and various proposals already exist on how integration can be achieved and the pros and cons of various approaches.

VI. Consider Administrative Improvements Including Use of Technology

Technological approaches to collecting and reporting data have changed tremendously since our modern income tax was created.

Recommendation:

K. Consider how current data management systems used by small businesses might tie to tax compliance that would streamline the compliance process.

VII. Clarify Worker Classification Rules

The worker classification issue has been left unaddressed since at least 1978. As more individuals today become self-employed entrepreneurs, they need greater assurance of their status than is possible today.

Recommendation:

L. Provide guidance to clarify the worker classification area. Such clarification would allow Section 530 to be repealed as no longer needed and would allow the IRS to issue guidance in this area.

VIII. Resolve State Tax Issues That Need to be Addressed by Congress

In addition to federal complexities, many businesses of all sizes face state tax issues that require involvement of Congress to resolve. For example, a small business might have customers in all states and may have representatives or property in many states. The law is not always clear as to whether a business has income or sales tax nexus in any state. The guidance on income tax nexus was enacted by Congress in 1959 (P.L. 86-272) and only applies to sales of tangible personal property. This law is clearly outdated.

With respect to sales tax, in 1992 in the *Quill* decision, the U.S. Supreme Court noted that Congress governs the commerce clause and thus has the authority to provide guidance on when a vendor has sales tax nexus and collection responsibilities in a state.

The Internet and e-commerce model make it easier for businesses of all sizes to have multistate operations. Small businesses need guidance and assistance from Congress to make multistate compliance manageable.

Recommendation:

M. Be sure a tax reform agenda that aims to help businesses compete in the global Internet era, also includes addressing state nexus issues that require congressional involvement.