NFIB
The Voice of Small Business.

July 17, 2017

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Hatch and Ranking Member Wyden,

Small businesses are a key engine that powers the American economy, creating two-thirds of net new jobs, employing half of the private domestic workforce, and contributing nearly half of the nation's gross domestic product. On behalf of the National Federation of Independent Business (NFIB), thank you both for your leadership on tax reform.

NFIB's monthly Small Business Optimism Index rose to historic levels after the November elections based on the expectation that Congress and the Administration would cut taxes and reform healthcare. As healthcare reform faces gridlock in Washington, small business optimism is beginning to falter. If Congress is unable to deliver tax reform to small business, we expect that small businesses' wavering optimism will lead to a slowing economy.

If the purpose of tax reform is to promote economic growth, it must make helping small businesses a core focus, and not an afterthought. Tax reform that starts with small business will revitalize our economy and spur job creation and investment. To help the committee as it begins the process of reforming our tax code, NFIB offers the following small business tax reform priorities.

- Tax reform must include tax rate parity for all businesses, creating a level playing field between small businesses and their big business competitors. About seventy-five percent of all small employers organize as pass-through entities, and they must not be an afterthought in tax reform.

- Tax reform must ensure that all small businesses pay a lower rate than current law. Congress can address this issue by making sure that the pass-through business rate is graduated.
- Tax reform must simplify the rules and compliance measures that apply to small businesses.

The remainder of our comments flesh out these key principles. It is only by making small business a central focus of tax reform that Congress will be able to unleash economic growth and job creation.

Reducing Tax Burden

The federal tax burden on small businesses is one of the top three concerns that NFIB's 325,000 small business owner members reported in the most recent NFIB *Small Business Problems & Priorities* survey.[1] This is not a minor issue, either: in this same survey, nearly one-third of respondents evaluated it as "critical."[2]

Profits are the major source of capital to finance the growth of small businesses—both directly and indirectly as a support for long-term capital loans. Taxes take this financing away from small businesses before it can ever be put to work creating jobs.

Given this dynamic, Congress must reduce the tax burden on small businesses. NFIB believes the following measures are required to meet this goal:

- Tax rate parity, to ensure that no small business pays a higher rate than their big business competitors (*i.e.*, parity for pass-through small businesses);
- Graduated rates, to ensure that no small business pays more in taxes than they do currently; and
- Ensuring that all small businesses pay the lowest rate possible.

The policy justification for taxing pass-through small business income at a rate higher than that of corporations is based primarily on the Internal Revenue Code's "double-layer" tax design.[3] It is time for Congress to revisit this premise concerning small businesses. As the Finance Committee is well aware following its May 17, 2016, hearing on integrating the corporate and individual tax systems, few corporate dividends are subject to the second layer of taxation in practice.[4] Also, the argument fails to consider the significant impact of federal self-employment taxes on small pass-through business owners that corporate shareholders do not face. With up to 16.2 percent in

[1] HOLLY WADE, SMALL BUSINESS PROBLEMS & PRIORITIES 10 tbl. 1 (NFIB Research Foundation Aug. 2016) (hereinafter "NFIB Research Foundation *Problems and Priorities* survey").
[2] *Id*. at 9 chart 2.
[3] That is to say, small pass-through businesses should pay a higher rate because corporations are subject to tax twice, once at the corporate level and once as a dividend of profits is paid to shareholders.
[4] *See, e.g.*, *Integrating the Corporate and Individual Tax Systems - The Dividends Paid Deduction Considered: Hearing Before the S. Finance Comm.*, 114th Cong. 2-3 (2016) (statement of Steven M. Rosenthal, Senior Fellow, Urban-Brookings Tax Policy Center) (estimating that only 24.2 percent of U.S. corporate shares are held in taxable accounts).

additional self-employment taxes—in addition to a top marginal rate that exceeds the corporate rate—small pass-through business owners can be subject to marginal tax rates well in excess of the combined corporate and dividend tax rate.[5]

The solution to this imbalance is simple: at a minimum, tax reform should bring the small business pass-through rate in parity with the corporate rate.

In addition to the problem of parity, Congress must also account for the impact of the current graduated rate structure on small businesses. It is axiomatic that tax reform will not help small businesses if they would pay the same (or more) in federal income tax post-enactment. This simple lens brings into sharp relief a key concept for supporting small businesses in tax reform: tax reform must account for the graduated rate structure that is currently applicable to "small business" income.

As a result, it must either adopt such a graduated structure or account for the graduated rate applicable to current law in some other way. Failure to account for a graduated rate structure will mean that Main Street small businesses could either face a tax hike or not benefit at all from tax reform.

Under current law, small business income benefits from a graduated, progressive rate. For incorporated businesses, the first $50,000 of taxable income bears a 15 percent rate, taxable income above $50,000 but below $75,000 bears a 25 percent rate, and a 34 percent rate applies to taxable income above $75,000 but below $10 million. Income above $10 million is subject to federal corporate income tax at a 35 percent rate.

Pass-through businesses also benefit under current law from a graduated rate structure because the income flows-through to the owners and is taxed under the progressive, graduated rates applicable thereto. In 2017, for example, the first $18,650 of taxable pass-through income is taxed at 10 percent, taxable income between $18,650 and $75,900 is taxed at 15 percent, taxable income above $75,900 and below $153,100 bears a 25 percent rate, taxable income between $153,100 and $233,350 has an income tax rate of 28 percent, taxable income above $233,350 and below $416,700 has an income tax rate of 35 percent. Taxable income above $470,700 has an income tax rate of 39.6 percent.

Nearly all of small business net income is already subject to progressive, graduated income tax rates under current law that are equal to or lower than the rates proposed in some recent tax reform proposals. In other words, the committee needs to ensure that

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[5] At the margin, a small business owner is subject to a top income tax rate of 39.6 percent—combined with up to an additional 16.2 percent of federal self-employment taxes. Corporations face a top rate of 35 percent, and dividends received by shareholders a top rate of 23.8 percent. Assuming $100 of income, the combined tax paid by a corporation and shareholder can be as much as $50.47: $35 of tax on the $100 of income, and $15.47 of tax on the remaining $65 that can be distributed to the shareholder. Assuming this same $100 of income, the combined tax paid by a small pass-through business owner can be as much as $55.80: $39.60 in income taxes levied on the $100 and $16.20 of self-employment taxes levied on the same income. Thus, small pass-through business owners can face a marginal rate that is more than 5 percentage points higher than the combined corporation/shareholder rate.

tax reform, in addition to rate parity, creates a tax system that provides lower rates for all small businesses.

Both of the issues raised above lead to a third conclusion: small businesses should not simply be brought into parity and left “unharmed” by tax reform. Rather, small businesses should be incentivized and revitalized by tax reform by receiving the lowest possible rate. The tax code is frequently utilized for policy aims (*e.g.*, supporting health insurance and home ownership). Given the data described above, another laudable aim would be to support the truly small businesses that drive America’s innovation and growth.

Such a goal is best achieved by improving the circumstances for small businesses, such as by reducing their tax burden to the lowest absolutely possible. Circling back to the second paragraph of this section, business profits are the key to small business survival and growth. Small businesses already face enormous odds against success. Lack of profits to fund growth due to burdensome federal taxation should not be one of these.

Simplification and Compliance

In addition to burdensome taxes, small business owners are very concerned about the complexity of determining and paying the taxes they owe. Tax complexity is the fifth greatest small business owner concern in the most recent NFIB *Problems and Priorities* survey, and more than a quarter of small business owners believe the problem is “critical.”[6]

There is a definite monetary cost to the complexity problem. The overwhelming majority (96 percent) of small businesses must rely on professional advisors (accountants, software, or both) to calculate the amount of taxes they owe and prepare the necessary paperwork, resulting in 1.7 to 1.8 billion hours of tax compliance per year.[7,8] On average, small business owners spend at least $74 per hour on preparing tax returns and other accompanying paperwork.[9] The IRS itself has calculated that small businesses spend at least between $15 and $16 billion per year on tax compliance costs.[10] The direct costs are not great, but small businesses that make mistakes can face sizable penalties for imperfect compliance.

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[6] NFIB Research Foundation *Problems and Priorities* survey, *supra* note 1 at 9.
[7] NFIB Research Foundation, Taxes and Spending: Small Business Owner Opinions 14-15 (Mar. 2013).
[8] Donald Deluca and Scott Stilmar, Aggregate Estimates of Small Business Taxpayer Compliance Burden, IRS Research Bulletin 2007

[9] *Id*. This dollar cost figure is from 2003, and has doubtless increased significantly since then.
[10] Donald DeLuca et. al., IRS Research Bulletin: Proceedings of the 2007 IRS Research Conference - Aggregate Estimates of Small Business Taxpayer Compliance Burden 148, 164-165 tbl. 4 (2007). This estimate is based upon data from 2004, and the cost has doubtless increased since then.

The Internal Revenue Code is incredibly complex, with myriad interrelated (and sometimes inconsistent) provisions providing pitfalls to the unwary or ill-advised business owner. The great difficulty in navigating the Code drives the massive compliance burden facing small businesses. Uncertainty is also at the root of the complexity problem: uncertainty about what the rules are to calculate the taxes a small business owes, uncertainty about whether rules will subsequently change, uncertainty about the forms and processes of paying the taxes are, and uncertainty regarding disputes as to the proper amount of tax.

NFIB believes that in the least, several measures are necessary to reduce the massive tax compliance burden on small businesses:

- Enact simple, fair, blackletter rules and forms that apply to small businesses, and reduce the amount of unnecessary reporting and record-keeping requirements applicable to small businesses; and
- Reform the structure and mission of the IRS to make it more accessible to small business taxpayers.

The first goal hardly needs further explanation. The Internal Revenue Code is simply too complex for small businesses (as most taxpayers) to safely work with without expensive professional advice. Carving off any needed complexity for larger businesses (or businesses that elect to use the complex rules) is a useful approach that Congress could take. For example, when Congress enacted complex insurance reserve discounting rules as part of the Tax Reform Act of 1986, it also enacted a provision in Codes section 831(b) to allow small property and casualty insurance companies to bypass these (and other) insurance rules and pay tax using a simplified method electively (i.e., on investment income). The election is limited to truly small companies based on a dollar cutoff. Provisions like Code section 831(b) could allow small businesses to ease the time burden and complexity of complying with the Internal Revenue Code. In addition to these complex rules, there are a number of reporting and record-keeping requirements that the Internal Revenue Code (or Treasury Regulations) imposes on small businesses that generate massive compliance costs. These also need to be streamlined.

Administration of the tax code is also a great source of complexity. Sixteen percent of small business owners evaluated “Dealing with the IRS” as a “critical” tax issue.[11] Dealing with IRS adds complexity for small businesses in a number of ways. The IRS is not structured as a taxpayer-friendly organization. It is difficult to access information, to obtain advice (the IRS is prevented from providing taxpayers specific advice about their tax liability), and to work through the endless intricacy of the organization’s bureaucracy. The IRS not infrequently takes adversarial positions vis-à-vis taxpayers (such as

[11] NFIB Research Foundation *Problems and Priorities* Survey, *supra* note 1 at 9.

national audits of a specific transaction), and is also capable of needlessly targeting certain transactions or taxpayer groups. Also, the IRS sometimes uses the laws to pressure taxpayers, such as was seen through the myriad “structuring” cases where the IRS inappropriately seized lawfully-obtained monies.

NFIB believes it is important for tax reform to address these sources of complexity, and make the tax code more predictable, stable, and accessible to those who are subject to it. Making the changes discussed above will go far towards addressing the complexity the plagues taxpayers, including small businesses.

Conclusion

Congress has a historic opportunity to enact tax reform that will spur job creation and unleash the small business economic engine. NFIB looks forward to working with your committee to enact tax reform that starts with small business.

Sincerely,

Juanita D. Duggan

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