



Statement of the U.S. Chamber of Commerce

**ON: Assisting Small Businesses Through
Changes In the Tax Code - Recent Gains
and What Remains to be Done**

TO: House Committee on Small Business

DATE: July 23, 2003

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – numbers more than 10,000 members. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 94 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
Assisting Small Businesses Through Changes In the Tax Code
Recent Gains and What Remains to be Done
Before
The House Small Business Committee
by
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On Behalf of
The U.S. Chamber of Commerce
July 23, 2003

Chairman Manzullo, Ranking Member Velazquez and members of the Committee, I am Roy Quick, Principal, Quick Tax and Accounting Service, a 20 year old private home-based business practice located in Saint Louis County, Missouri. The business focus is primarily on small business, startup and individuals tax matters. Previously, I have served as Chairman of the Small Business/Self-Employed Subgroup of the Internal Revenue Service Advisory Council (IRSAC). Currently I am Co-Tax Chair for Region VII of the White House Conference on Small Business and also serve on the Council on Small Business of the U.S. Chamber of Commerce, the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region.

Over ninety-six percent of the Chamber members are small businesses with fewer than 100 employees. Chairman Manzullo, we applaud your dedication and interest in reducing the tax burdens faced by the nation's 24 million small businesses.

The Need For Small Business Tax Reform

In recent years, the importance of small businesses to our economic growth and prosperity has been unparalleled. As economic statistics confirm, maintaining a healthy environment for small businesses to proliferate contributes greatly to our economic expansion and to raising our standard of living. Small enterprises and startups form the foundation for our future economic prosperity.

Furthermore, small businesses have traditionally accounted for most of our nation's job growth. According to statistics from the Small Business Administration's Office of Advocacy, small businesses represent ninety-nine percent of all employers and generate three-quarters of all net new jobs. It would make sense, then, that any efforts to stabilize and grow the economy by job creation through fiscal policy should have a strong small business component.

It is sound economic policy and in the best interest of our country that small businesses be encouraged and nurtured through the promotion of tax policies that allow them the opportunity to devote more of their limited resources to their growth and investment, rather than to the expansion of government. This can be manifested in a number of ways, several of which are presented as follows:

Eliminate the Payroll Tax on Health Care Premiums for the Self-Employed

In 2003 self-employed individuals and partners in a partnership will finally achieve 100% deductibility of health insurance costs for federal tax purposes. Unfortunately, those self-employed and partnerships still cannot deduct health care premiums for the purposes of calculating payroll taxes (Social Security and Medicare). An equivalent exclusion from wages subject to payroll taxes is already enjoyed by owners of subchapter S corporations and C corporations.

As a matter of taxpayer equity and fairness, the treatment of the cost of health insurance premiums for all business forms should be brought to parity by allowing them to be deductible from revenue to derive net income, basing payroll tax (Social Security and Medicare) calculation on this net income figure. At a time when health care costs are soaring, small business owners should not be penalized by an additional tax on their health care premiums for merely choosing one form of business over another.

Furthermore, this tax fairness measure will have the collateral effect of encouraging access for the 3 million self-employed individuals who currently do not have health insurance. Small business self-employed and partnerships, in general, are twice disadvantaged when it comes to purchasing healthcare, not only must they have the added burden of self-employment tax (15.3%) on their health insurance premiums, they must also pay higher premiums to insurance companies due to their small "pool" of workers.

As a matter of tax equity and fairness, *The Self-Employed Healthcare Affordability Act*, H.R. 1873, should be passed without delay. I applaud the Chairman and Ranking Member's leadership for introducing this important bill.

Increase the Allowable Deduction for Business Related Meals

Small businesses are also disadvantaged in the tax code when it comes to marketing and selling their products and services over a meal. In the *Omnibus Budget Reconciliation Act of 1993*, the allowable deduction for business expenses was reduced to 50 percent. Since then, many small businesses, whose business depends on networking contacts, travel or personal presentations at restaurants have been unfairly penalized. Research completed in 1998 by some members of the Travel Business Roundtable showed that one-fifth of business meal users were self-employed, with more than two-thirds of business meal users having incomes of less than \$60,000, and 37 percent having incomes below \$40,000.

Currently, many large companies have on-site facilities suitable for presentations, negotiations and meals which are fully deductible as an “ordinary and necessary” business expense. For a small business owner, however, the “kitchen table” is unsuitable for marketing services or negotiating contracts and the best alternative is usually meeting over a meal at a local restaurant.

Currently, they can deduct 50% of the meal cost. If more than one other person attends the meeting, they get less than 50% personal benefit. Tax fairness would dictate full deductibility. For me, there is no difference in utilizing the atmosphere of a restaurant to provide a presentation to a client and a in-house corporate dining facility for a larger business. At the very minimum, small business owners should have parity with the allowance for those workers covered by DOT regulations.

Furthermore, the restoration of full deductibility of restaurant meals as a business expense would encourage travel and tourism within the United States. The hospitality and travel industry, which is made up of mostly small businesses, has been particularly hard hit over the last two years. As such, to restore fairness to the tax code for small businesses by allowing full deductibility of meals, as well as providing relief to the beleaguered travel and tourism industry is just good public policy.

Accelerate the Cost Recovery of Business Assets and Make Permanent the Increase in the Small Business Equipment Expensing Allowance

Under the recently enacted *Jobs and Growth Tax Relief Reconciliation Act of 2003*, businesses can annually expense up to \$100,000 of asset purchases. This is a marked

improvement from the allowance of \$25,000 provided by former law. The quadrupling of that figure was complemented by a doubling of the phase-out threshold, and both are, for the first time, to be indexed for inflation. Furthermore, the Act provides that off-the-shelf computer software is now eligible for expensing.

The Act also increased first year “bonus depreciation” introduced by the *Job Creation and Worker Assistance Act of 2002*, from 30 percent to 50 percent of the investment in qualifying business assets. Unfortunately, the legislation did not go far enough. The Section 179 increases expire after 2005, reverting to the \$25,000 cap provided in earlier law. Bonus depreciation is set to fully expire after 2004.

In general, businesses investing more than the annual expensing allowance must recover the cost of their expenditures through an elective first year bonus depreciation and through mandatory cost recovery of the remainder over several years through the depreciation system. Inflation, however, erodes the present value of future depreciation deductions taken in all but the initial year of business use.

This injustice can be remedied through the full expensing of business personal property, or, at the very least, reduced through extension or permanency of the bonus depreciation and Section 179 expensing provisions, coupled with further increases to the Section 179 cap. Such measures would spur additional investment in business assets and lead to increased productivity and more jobs. They would also simplify the tax code and reduce compliance burdens for small businesses by allowing cost recovery in the year of asset purchase.

One such measure that would provide for the permanency of the newly enhanced Section 179 provisions is H.R. 2638, the *Small Business Expensing Permanency Act of 2003*, recently introduced by Representative Wally Herger (R-CA). The U.S. Chamber strongly supports this legislation and asks that the Congress make its enacting a priority.

Another reform crucial to small businesses would be the expensing or expedited cost recovery of investments in leasehold improvements. Small business owners often invest large sums in improving their storefronts, building interiors, or shop floors to remain competitive. The tax code currently provides for recovery over 39 years. We feel it is an excessive and unreasonable span of time, and that it should be changed.

We also feel that cost recovery provisions should keep up with technological advances. While the *Jobs and Growth Tax Relief Reconciliation Act of 2003* allows for expensing of off-the-shelf software, legislation should be enacted to treat computers

and peripheral equipment in the same manner, thus ensuring cost recovery before this equipment becomes obsolete.

Currently, the “listed property” or “luxury car” rules apply to limit cost recovery on vehicles. The term “luxury car” is a misnomer, as the limitations are so modest that they restrict recovery of even modestly priced vehicles. These constraints are sorely in need of updating.

Repeal the Individual and Corporate Alternative Minimum Tax

Originally designed to ensure that all taxpayers pay a minimum amount of taxes, the Alternative Minimum Tax (AMT) unfairly penalizes businesses that invest heavily in plant, machinery, equipment and other assets.

The AMT significantly increases the cost of capital and discourages investment in productivity-enhancing assets by negating many of the capital formation incentives provided under the "regular" tax system, most notably accelerated depreciation. To make matters worse, many capital-intensive businesses have been perpetually trapped in the AMT system, unable to utilize their suspended AMT credits.

Furthermore, the AMT is extremely complex, burdensome, and expensive to comply with. Even businesses not subject to the AMT must go through the computations to determine whether or not they are liable for the tax. While the *Taxpayer Relief Act of 1997* (P.L. 105-34) exempted "small business corporations" from the AMT, larger corporations and individuals may not be exempt. Furthermore, the tax code does not provide for indexing this onerous tax for inflation, leaving more and more middle-income individuals – including business owners taxed as individuals – vulnerable to the AMT. In fact, a 2001 study by the Joint Economic Committee projected that the number of individuals subject to the AMT would balloon to 17 million in 2010. While the AMT was originally geared to target high-income taxpayers, the lack of indexing is causing many middle-income taxpayers to get caught in its ever-expanding web – an unfortunate result that was inadvertently not protected against in the tax code.

Repealing the AMT would spur capital investment within the business community, thereby creating more jobs. The AMT system needs to be repealed – and, until that time, made less complex and easier to comply with. Good steps in that direction would include the raising of exemption amounts coupled with indexing for inflation.

Simplify/Clarify the Worker Classification Rules (Employee vs. Independent Contractor)

The reclassification by the Internal Revenue Service of workers from independent contractors to employees can be devastating to small business owners. Such reclassification often subjects a business to back federal and state taxes, penalties and interest, as well as administrative laws. To satisfy their assessments, business owners must dip into their cash reserves, lay off workers, sell assets, or in the worst-case scenario, liquidate or declare bankruptcy. In addition, businesses that choose to dispute IRS reclassification may have to deplete their resources to defend their positions. The last White House Conference on Small Business ranked this problem as the number one issue facing small business

Existing worker-classification rules are too complicated, confusing and subjective. Clearer classification guidelines – either statutory or regulatory – should be carefully written and include improved resolution of classification disputes and better training for IRS examiners. Mr. Chairman, your bill the *Independent Contractor Determination Act of 2001*, H.R. 1783, introduced in the 107th Congress and the Senate companion bill S. 837 introduced by Senator Bond in the 107th Congress, contained objective criteria to determine who is not an employee. This legislation would be significantly clearer and easier to apply than the existing subjective 20-factor test and “Section 530” safe harbor rules. Also included in this bill, was anti-abuse language to avoid problems of wholesale reclassifications of legitimate employees as independent contractors.

It is our hope that similar legislation would be introduced and passed in the current Congress. The worker classification rules must be clarified and thoughtfully reformed to increase flexibility and reduce burden for America’s small businesses.

Expand Individual Retirement Accounts and Other Forms of Retirement Saving, and Simplify Overly Complex Pension Rules

As the nation’s “baby boom” generation moves towards retirement, there is a growing realization that many individuals have not sufficiently saved for their retirement years. When considered along with an increased life expectancy and concerns regarding the future viability of Social Security, the necessity for a strong and effective private retirement system is paramount. Throughout the 1980s and into the mid-1990s, Congress amended the tax code and the *Employee Retirement Income Security Act* (ERISA) almost annually. This has resulted in a system of rules and regulations so complex that establishment of a retirement plan is often not an affordable business option for employers. This is especially true for small employers; lower coverage rates in this sector bear this out.

Congressional initiative is needed to simplify the pension law and increase the incentives for businesses, especially small employers, to offer retirement plans to their workers. While it is imperative that our nation's employee benefit system remains voluntary – giving employers the flexibility they need to tailor benefits to their own workforce – it is, likewise, important to enact legislation that encourages employers to choose to participate in the private retirement system.

For example, one change that would help small employers is to allow an extension for IRA contributions similar to that for other retirement vehicles. Under current law, all IRA contributions that are to be deducted from any year's income are due by April 15th of the following year. As a matter of equity with other retirement vehicles, the due date for the contribution should be the same as the tax-filing date including extensions. Many times the sole proprietor does not have the cash to pay the balance due, the first quarter estimated tax payment and fund an IRA all at the same time. Since retirement saving is a priority recognized by the federal government, the IRA contribution deadline should include extensions to help small business owners balance their short-term capital needs.

Additionally, legislation is also needed to allow workers to save more in Individual Retirement Accounts and 401(k)-type pension plans, thus allowing workers to save more for their retirement.

Make the Marginal Tax Rates Reductions Permanent

Most small business owners choose to organize as flow-through tax entities in order to do business, such as subchapter S corporations, LLC's, partnerships and sole proprietorships. According to the IRS, about 31 million Americans include small business income when they file their individual federal tax returns. Thus, small business owners are closely tied to the individual marginal tax rates. These rates will determine the level of personal savings as well as the ability to accumulate personal equity, retire debt, or expand operations.

Indeed, other than infusions of outside venture capital by third parties and cash generated by debt, the personal investment of savings, loans from family members, and the plowing back into the business of its profits throttles the expansion of most small businesses. Lowering individual marginal rates will have a positive affect on the ability of many entrepreneurs to expand. Taxes matter. As individual tax rates go down, entrepreneurial enterprises grow at a faster rate, they buy more capital, and they are more likely to hire workers.

Currently, small business taxpayers face uncertainty because they do not know whether the current tax rate reductions that were implemented in the *Economic Growth and Tax Relief Reconciliation Act of 2001*, and accelerated recently in the *Jobs and Growth Tax Relief Reconciliation Act of 2003*, are going to be permanent. This uncertainty hinders business planning and makes it difficult to make long-term business decisions.

Making permanent the reduction in the individual marginal income tax rates, provides the broadest possible long-term tax implications for both potential and incumbent entrepreneurs. It fosters entry, stimulates growth and provides a generally more robust small business community.

Also, reducing the marginal tax rates, not only for income taxes, but for those on dividends and gains from the sale of capital assets will put more money in the hands of taxpayers, will increase purchases of goods and services, and the resulting increase in demand will help businesses to grow.

Additionally, a lower capital gains tax rate will spur capital formation, mobility, and investment activity, thus creating jobs and expanding the overall economy, benefiting individuals of all income levels.

Make Permanent the Repeal the Estate and Gift Tax

The current federal estate and gift tax system can deplete the estates of those who have saved their entire lives, force family businesses to liquidate and lay off workers, and motivate people to make financial decisions for estate tax purposes rather than for sound business or investment reasons.

Family-owned businesses should not be punished for being successful or for having their owners pass away. Fundamentally, the United States is the land of opportunity, encouraging free enterprise and rewarding entrepreneurs. Estate and gift taxes run contrary to this basic philosophy. They are burdensome taxes that heavily penalize saving and investment, especially in family-owned businesses.

The *Economic Growth and Tax Relief Reconciliation Act of 2001* offered some progress in alleviating these problems, providing for reductions in the gift tax and the phase-out and temporary repeal of the estate tax. However, the prospect for the estate tax arising again looms in the distance, as it is set to do in 2011, wreaking havoc with attempts to plan for an orderly transition of businesses to subsequent generations. These taxes should be permanently repealed.

Permanently Extend the Research and Experimentation Tax Credit

The Research and Experimentation (R&E) Tax Credit encourages technology-based companies to invest additional resources into the research, development and experimentation of various products and services, which promotes both job creation and economic expansion.

The R&E Tax Credit should be permanently extended and expanded. It provides an extra incentive for firms to invest more in the research and development of their goods and services.

A permanent extension of the R&E Tax Credit, rather than temporarily renewing it during the political bargaining process, would provide businesses with continuity and certainty. A permanent credit would allow business to make long-range planning decisions, which are important in many fields where it takes years of research before a product can be brought to the market.

Reform the S Corporation Rules

S Corporations operate in every business sector in every state and account for almost one-half of all corporations. There are over 2.5 million S corporations nationwide and the vast majority of them, as small businesses, are responsible for most new jobs created each year. S corporations serve as useful vehicles for the organization and operation of family-owned businesses, offering the benefits of operating in corporate form, with the attendant limited liability of shareholders, while sparing the businesses' earnings from being subjected to double taxation.

The tax laws that currently govern these entities remain too restrictive, complex and burdensome. The current rules – adopted in 1958 when S corporations were created, and subsequently amended – are out of sync with modern economic realities and impede the growth of small businesses and burden them with unnecessary administrative complexity.

Despite the various S corporation tax relief provisions enacted in 1996 and in previous years, other reforms are still needed. The current rules should be liberalized, simplified, and clarified to encourage the growth of small businesses.

Reform the Federal Unemployment Tax Act (FUTA)

The Federal Unemployment Tax Act (FUTA) came into existence in 1939 to guarantee financing for a national employment security system. The idea was for

employers to pay the costs of administering the unemployment compensation and national job placement system. In return, employers would receive assistance in recruiting new workers and the unemployed would be able to find jobs more quickly.

The current maximum tax imposed is at a rate of 6.2 percent – including the “temporary” surtax of 0.2 percent that was added to the tax rate in 1976, and extended through 2007 – on the first \$7,000 paid annually by employers to each employee.

It is time to end the "temporary" FUTA surtax and stop all attempts to collect the FUTA tax on an accelerated payment schedule.

It is also time to take a closer look at the system to determine if it is working properly, whether the federal government is collecting an appropriate amount of money from employers, whether claimants are receiving adequate benefits, and whether the states are receiving a sufficient return of dollars to fund services promised to workers and employers.

Permanently Extend the Work Opportunity and Welfare-to-Work Tax Credits

The Work Opportunity Tax Credit and Welfare-to-Work Tax Credit encourage employers to hire individuals from several targeted groups. Eligible workers under the Work Opportunity Tax Credit include, among others, economically disadvantaged youths, Vietnam veterans and welfare recipients. Eligible workers under the Welfare-to-Work Tax Credit include long-term family assistance recipients. Without the Work Opportunity Tax Credit and Welfare-to-Work Tax Credit, employers may have less incentive to hire individuals from the targeted groups.

Both credits should be permanently extended. They provide employers with an added incentive to hire disadvantaged individuals, which in turn, benefit the local and national economies. Permanent extensions would provide continuity and certainty to the income tax system and maximize the beneficial aspects of the credit.

Conclusion

In order to encourage long-term stable growth within the American economy, providing continued small business tax reform must be a top congressional priority. While many small businesses has been investing in research, building plants, buying equipment, expanding their markets, creating jobs and developing the workforce, this has happened against the backdrop of a federal tax code that is becoming ever more complex and uncertain and still often penalizes savings and investment.

If business – small business in particular – is to continue to lead the economy, additional tax reforms are warranted and those already enacted must be made permanent to encourage jobs, savings, and investment. Implementation of the recommendations previously set forth will go a long way toward these ends.