Tax Issues Facing Small Business

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Chairman Graves, Ranking Member Velázquez, and Members of the Committee, thank you for inviting me to appear today to discuss tax policy and small business.

America's tax system is needlessly complex, economically harmful, and often unfair. Despite recent revenue gains, it likely will not raise enough money to pay the government's future bills. The time is thus ripe for wholesale tax reform. Such reform could have far-reaching effects in the economy, including on small businesses. To provide context for evaluating those effects, my testimony offers six main points about the tax issues facing small business:

- Tax compliance places a large burden on small businesses, both in the aggregate and relative to large businesses. The Internal Revenue Service (IRS) estimates that businesses with less than $1 million in revenue bear almost two-thirds of business compliance costs and that those costs are larger, relative to revenues or assets, for small firms than for big ones.

- At the same time, small businesses are more likely to underpay their taxes. Because they often deal in cash and engage in transactions that are not reported to the IRS, small businesses can understate their revenues and overstate their expenses and thus underpay their taxes. Some underpayment is inadvertent, reflecting the difficulty of complying with our complex tax code, and some is intentional. High compliance costs disadvantage

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responsible small businesses, while the greater opportunity to underpay taxes advantages less responsible ones.

- The tax code offers small businesses several advantages over larger ones. Provisions such as Section 179 expensing, cash accounting, graduated corporate tax rates, and special capital gains taxes benefit businesses that are small in terms of investment, income, or assets.

- Several of those advantages expired at the end of last year and thus are part of the current "tax extenders" debate. These provisions include expanded eligibility for Section 179 expensing and larger capital gains exclusions for investments in qualifying small businesses.

- Many small businesses also benefit from the opportunity to organize as pass-through entities such S corporations, limited liability companies, partnerships, and sole proprietorships. These structures all avoid the double taxation that applies to income earned by C corporations. Some large businesses adopt these forms as well, and account for a substantial fraction of pass-through economic activity. Policymakers should take care not to assume that all pass-throughs are small businesses.

- Tax reform would likely shift the relative tax burden of small and large businesses and recalibrate the tradeoff between pass-through and C corporation structures. A revenue-neutral business reform that lowers the corporate tax rate while reducing tax breaks would likely favor C corporations over pass-throughs and might well reduce some tax preferences targeted at small businesses. The net effect will depend, however, on the details and may vary among businesses of different sizes, industries, and organizational forms. Reform provides an opportunity to reduce compliance burden on small businesses.

I elaborate these points in the remainder of my testimony.

1. Small businesses face high costs complying with the tax code, both in aggregate and relative to large businesses.

Complying with the tax code is expensive. IRS researchers recently estimated that corporations and partnerships spent more than $100 billion complying with the federal income tax for tax year 2009 (Contos et al. 2012).[1] That figure includes both out-of-pocket expenses and the value of worker time devoted to compliance.

Table 1. Federal Income Tax Compliance Costs for Businesses, 2009

	Compliance Costs		Number of
	Total ($ billion)	Average ($ thousand)	Businesses (million)
All businesses	104	12	9.0
By size of receipts			
\$0 - \$100,000	26	5	4.9
\$100,000 - \$1 million	40	13	3.2
\$1 million - \$10 million	25	34	0.7
\$10 million - \$500 million	11	128	0.1
\$500 million +	2	925	*
By size of assets			
\$0 - \$100,000	23	5	5.0
\$100,000 - \$1 million	32	12	2.6
\$1 million - \$10 million	30	27	1.1
\$10 million - \$500 million	16	78	0.2
\$500 million +	4	468	*

Note: Numbers may not add or multiply due to rounding; * = fewer than 10,000.

Source: Contos et al. (2012) and author's calculations.

Small businesses bear the majority of those costs (Table 1). Businesses with less than $1 million in revenue bore almost two-thirds of business compliance costs—$66 billion—a figure that rises to $91 billion for all businesses with less than $10 million in revenue. Those aggregate costs are driven by the sheer number of small businesses. Of the 9 million businesses that the authors identified in 2009, almost 5

[1] These estimates rely on several important assumptions, including the accuracy of underlying survey data, the estimated cost of worker time, and the ability to distinguish tax record-keeping from accounting and reporting activities that companies would have done anyway. Alternative assumptions would change the estimated compliance burden, but would not change the two main findings: compliance costs are large and small businesses bear a larger relative burden than do large businesses. Of particular note is Contos et al.'s (2012) assumption that the average worker in a small firm has a lower hourly wage than one in a large firm. This differs from previous studies that assume equal wage rates, such as the oft-cited estimates in DeLuca et al. (2007). Those earlier estimates found an even-more disproportionate compliance burden on small businesses.

million had revenues less than $100,000, and slightly more than 8 million had revenues less than $1 million.

As you would expect, compliance costs increase with business size. A typical firm with revenues less than $100,000 incurs about $5,000 in compliance costs, one with revenues of $1 million to $10 million incurs about $34,000, and one with revenues above $500 million incurs an average of more than $900,000. A similar pattern holds comparing businesses based on the value of their assets.

These figures confirm previous research that found substantial economies of scale in tax compliance (Slemrod and Venkatesh 2002; DeLuca et al. 2007). Compliance costs are larger for bigger firms, but they grow much less rapidly than do revenues or assets. For partnerships with assets of $100,000 to $1 million in 2009, for example, annual compliance costs averaged 3 percent of assets.[2] For partnerships with assets between $1 million and $10 million, that ratio fell to less than 1 percent. And for partnerships with assets more than $10 million, it was less than 0.1 percent. Tax compliance thus places a bigger relative burden on small firms than on large ones.

2. Small businesses are more likely to underpay their taxes.

The IRS (2012a) estimates that taxpayers underpaid their federal taxes by $450 billion for tax year 2006.[3] Small businesses accounted for a substantial portion of that gap (Table 2). Underreporting by sole proprietorships, partnerships, and other types of businesses whose income is reported on individual tax returns accounted for $122 billion. Underreporting by small C corporations (those with assets less than $10 million) added another $19 billion. Underreporting of self-employment taxes added $57 billion. Together, those three categories of underreporting by small businesses and the self-employed total almost $200 billion.

One reason for this gap is that transactions with and by smaller firms, particularly sole proprietorships, are often not subject to IRS reporting and withholding requirements. In addition, they often deal in cash. As a result, it is much easier for them to underreport revenues and overstate expenses and thus underpay their

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[2] These figures are based on average compliance costs for partnerships (Contos et al. 2012) and average assets (IRS 2011). Compliance costs relative to assets are higher still for partnerships with less than $100,000 in assets, but data limitations prevent me from giving a specific figure.

[3] The IRS (2012a) estimates that through enforcement actions and late payments, IRS will recover $65 billion of those underpayments, leaving a net tax gap of $385 billion.

taxes. Given the complexity of the tax code, some of this underpayment is undoubtedly inadvertent. Indeed, GAO has estimated that 9 percent of sole proprietors overstated their income in 2001 and, in a somewhat similar context, a third of individual investors who misreported security sales overstated their gains or understated their losses. Those errors are presumably unintentional. Of course, some small businesses underpay intentionally. Small businesses that are willing to engage in tax evasion can thus have an advantage over larger firms that have more transparent systems for monitoring and reporting income and over small businesses that play by the rules.

Table 2. Sources of the Tax Gap, 2006

	Tax Gap ($ billion)
Underreporting	
Individual Income Tax	
Business Income	122
Non-Business Income	68
Credits, Deductions, Exemptions, Adjustments	45
Corporate Income Tax	
Large Corporations (assets ≥ $10 million)	48
Small Corporations (assets < $10 million)	19
Employment Tax	
Self-Employment	57
FICA and Unemployment	15
Estate Tax	2
Underreporting	***376***
Nonfiling and Underpayment	
Individual Income Tax	61
Employment, Corporate, Estate, Excise	13
Nonfiling & Underpayment	***74***
Total	**450**

Source: Internal Revenue Service (2012a) and author's calculations.

Research confirms that document matching and withholding significantly affect compliance. The IRS (2012a) estimates that taxpayers report less than half of their income when it is subject to little or no document matching; that category includes sole proprietors and farms (Table 3). Taxpayers report almost 90 percent of income

Table 3. Information Reporting and Individual Income Tax Compliance, 2006

	Fraction of Income Reported	Tax Gap ($ billion)
Little or No Information Reporting Sole proprietors, farms, rents & royalties, adjustments, Form 4797, other	44%	120
Some Information Reporting Partnership income, capital gains, deductions, exemptions, alimony	89%	64
Substantial Information Reporting Pensions, annuities, dividends, interest, Social Security, unemployment insurance	92%	12
Substantial Information Reporting and Withholding Wages and salaries	99%	11

Source: Internal Revenue Service (2012a) and author's calculations.

that is subject to some information reporting, a category that includes partnerships. Reporting rises to 99 percent for wages and salaries, which are subject to both information reporting and withholding.

IRS's tax gap estimates have sparked some criticism. Small Business Administration research suggests, for example, that earlier IRS estimates may have understated the tax gap created by large businesses and thus overstated the relative importance of small business (Quantria Strategies 2011). More recently, the Treasury Inspector General for Tax Administration (2013) reviewed the current IRS methodology and noted that it had made some improvements in both data and methodology. However, TIGTA also raised concerns about estimating the tax gap for large, international corporations and about distinguishing the tax gap for businesses engaged in otherwise legal activities from those engaged in illegal ones. Addressing those concerns could change the relative amounts of the tax gap attributed to large and small businesses, but would not eliminate the basic facts that underpayment by small businesses is a significant contributor to the tax gap and that non-compliance as a share of taxes owed is larger for smaller than for larger businesses.

3. The tax code favors small businesses in several important ways.

The tax code favors businesses that are small in terms of investment, income, or assets. The most important such preferences include Section 179 expensing, cash accounting, graduated corporate tax rates, and special capital gains treatment.[4]

- *Section 179 expensing.* Under Section 179, businesses can deduct from their taxable income the full cost of qualifying investments up to a specified dollar limit; those investments would otherwise need to be capitalized and written off over time. Such expensing benefits firms by reducing their tax liabilities immediately and eliminating the record-keeping burden of tracking basis and depreciation. In 2013, the maximum amount that firms could immediately expense was $500,000; this benefit was then taken back dollar for dollar for investments in excess of $2 million. Those temporarily higher limits, and some expansions in eligible investments, expired on December 31, 2013. If Congress does not extend them, the relevant limits for 2014 and beyond are much less generous: a maximum of $25,000 in investment, phasing out beginning at $200,000. Under today's law, firms thus benefit from Section 179 if they make less than $225,000 in qualifying investments; in 2013, that figure was $2.5 million.

- *Cash accounting.* If a business involves inventory, it must use accrual accounting for federal tax purposes. The tax code provides exceptions, however, for small firms. Businesses whose revenues averaged no more than $1 million over the previous three tax years can use cash accounting, as can some firms with average revenues as high as $5 million or $10 million (IRS 2012b). Many firms find cash accounting easier to implement than accrual accounting, so this provision helps reduce compliance burdens. Cash accounting also allows many firms to claim deductions for inventory costs sooner than they would under accrual accounting.

- *Graduated corporate tax rates.* Corporate income tax rates are 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000, and 34

[4] Other small business benefits include exemption from the corporate Alternative Minimum Tax, amortization of business start-up costs, a tax credit to help small businesses enroll employees in retirement plans, a tax credit for employers to make business more accessible to disabled workers, and some additional capital gains relief. See Gale and Brown (2013) for details.

percent up to $10 million.[5] These rates are lower than the 35 percent that applies to larger corporations. The tax code thus favors corporations with small profits over those with larger profits. In some cases, these businesses are owned by high-income individuals who would pay higher current rates on their income if it were subject to individual income tax.

- *Lower capital gains taxes.* The tax code offers favorable treatment to some capital gains from individual investments in small businesses. For investments made in 2013, capital gains (up to the larger of $10 million or ten times the taxpayer's basis in the stock) resulting from new equity investments in qualifying small businesses (C corporations with less than $50 million in assets) were exempt from income taxes if the stock is held for more than five years. For new investments, that treatment expired on December 31, 2013. Unless reinstated, this provision will return to permanent law which excludes 50 percent of such gains from taxation.

As noted, both Section 179 expensing and lower capital gains taxes for investments in small business are part of the current discussion of the "tax extenders," several dozen temporary tax preferences that expired at the end of last year.[6]

4. The tax system favors pass-through entities over C corporations.

The tax system distinguishes among businesses based on how they are organized. S corporations, partnerships, limited liability companies (LLC), and sole proprietorships do not pay the corporate income tax. Instead, their profits are reported and taxed on the returns of their owners. The earnings from pass-through entities thus escape the double taxation that otherwise can apply to the income of C corporations.

To illustrate, consider a small business owner in the top 39.6 percent personal income tax bracket. If she structures her business as an LLC, she will pay about 40 cents in personal taxes and retain about 60 cents of net income on each additional dollar that her business earns. If she structures her business as a C corporation, however, the income will face two layers of tax. The business will pay a 35 percent corporate income tax on each additional dollar of earnings. The 65 cents in after-tax

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[5] A 5 percent additional tax between $100,000 and $335,000 recaptures the benefits of the 15 and 25 percent brackets. A 3 percent additional tax between $15 million and $18.3 million recaptures the benefits of the 34 percent bracket.

[6] For a general framework for thinking about the tax extenders, see Marron (2011).

income is then subject to personal income taxes when it gets distributed to the owner. Any earnings distributed as dividends, for example, would be taxed at a top personal rate of 23.8 percent, including both the regular dividend rate of 20 percent and the 3.8 percent net investment income tax enacted to fund healthcare reform.[7] If the company paid out all 65 cents in after-corporate-tax income as dividends, the resulting personal taxes would be about 15 cents. The owner's after-tax income would thus be only 50 cents from a C corporation versus 60 cents from an LLC. The difference between a 50 percent effective tax rate and a 40 percent rate is a powerful incentive to structure as a pass-through.[8]

That's one reason that most small businesses organize themselves as pass-throughs. But that doesn't mean that all pass-throughs are small businesses. Some large, closely-held businesses also organize themselves as partnerships, S corporations, LLCs, or even sole proprietorships. As noted in Marron (2011), these large pass-throughs are few in number but account for a large fraction of the economic activity pass-throughs undertake. Policymakers should therefore take care not to equate pass-throughs with small business.

5. **Tax reform will likely shift the relative tax burdens of small and large businesses and recalibrate the choice between pass-through and C corporation structures.**

The past few years have witnessed a growing consensus on the need for wholesale tax reform. People differ greatly in the details of their proposals, but one common theme is the idea of rolling back tax breaks and using the resulting revenue for some combination of tax rate reductions and deficit reduction. In various ways, that approach was endorsed by the Bowles-Simpson Commission, the Rivlin-Domenici Task Force (on which I served), President Obama in his business tax proposal, and, most notably, in Ways and Means Chairman Dave Camp's comprehensive reform proposal.

It is difficult to make any sweeping claims about the effects of tax reform on small business. The net effects will depend on the details and may well vary by size,

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[7] The phase-out of itemized deductions for high-income taxpayers, known as Pease, can lift the top effective marginal rate another 1.2 percentage points to a total of 25 percent.

[8] This comparison highlights the potential double taxation but excludes other factors that might reduce the tax difference. Most importantly, the owner could retain some of her earnings in the company rather than paying them out as dividends. That delay would reduce the difference in effective tax rates.

industry, and organizational form. Still, a few themes seem evident from the discussion thus far.

- A revenue-neutral business reform that lowers the corporate rate while eliminating business tax preference will reduce taxes, on average, for C corporations and increase them on other businesses. The reason is simple: lowering the corporate tax rate reduces taxes only on C corporations, while reducing preferences increases taxes on all businesses. This effect may cause some closely-held businesses to organize as C corporations rather than pass-throughs. Some tax reform proposals include other changes to try to mitigate this effect. Chairman Camp, for example, proposes a 25 percent rate for pass-throughs engaged in domestic manufacturing. That matches the 25 percent corporate rate in his plan and is lower than the 35 percent top rate that would otherwise apply to pass-through earnings in his proposal.

- Some reforms could reduce the compliance burden on small businesses. Chairman Camp, for example, proposes to expand the use of cash accounting for businesses whose revenues have averaged less than $10 million in the past three years. This simplification would be partly offset, however, by the requirement that some larger firms—personal service corporations with revenues above $10 million—use accrual accounting.

- To raise revenue or pay for rate reductions, policymakers may reduce or eliminate some existing tax breaks that specifically benefit small business. Chairman Camp, for example, would replace graduated corporate rates—which now start as low as 15 percent—with a flat 25 percent rate, and would eliminate the favorable capital gains treatment for investments in small businesses.

- Other reductions in tax breaks would hit larger businesses and thus increase the relative advantage given to smaller ones. For example, Chairman Camp proposes to require the capitalization and amortization of 50 percent of advertising expenses, but would exempt up to $1 million in advertising costs for firms with no more than $1.5 million in total advertising. That safe harbor gives a relative advantage to small firms with limited advertising budgets. Camp would also make depreciation allowances less favorable for capital investments. Lengthening of depreciation schedules would increase the value of the relief offered by Section 179 expensing.

Thank you again for inviting me to appear today. I look forward to your questions.

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