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**Before the Joint Economic Committee
U.S. Congress**

April 15, 2015

**Hearing Topic:
“Small Business, Big Taxes:
Are Taxes Holding Back Small Business Growth?”**

Good afternoon Chairman Coats, Ranking Member Maloney and members of the Committee. Thank you for this opportunity to comment on the important topic of small business taxation.

The expiration of President Bush’s tax cuts at the end of 2012 and the limited extension of those tax cuts in the American Taxpayer Relief Act of 2012 resulted in an increase in the top individual income tax rate from 35 to 39.6 percent and the reinstatement of the phase-out of itemized deductions for high-income taxpayers (popularly known as the “Pease limitation.”) Also taking effect at the beginning of 2013 was the 3.8 percent tax on net investment income enacted into law as part of the Affordable Care Act.

These changes had an adverse impact of the profitability and cash flow of many of America’s small businesses. Cash flow is particularly important to small business because it is often difficult for small businesses to obtain bank loans and, unlike large corporations, small businesses cannot borrow directly in bond and commercial paper markets at low interest rates.² In states with high income tax rates, some business owners can face effective marginal tax rates in excess of 50 percent.³

¹ The views expressed here are solely the author’s and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

² Moreover, the financial crisis has compounded the difficulties of small business gaining access to bank credit. One recent study concludes: “Small business lending continues to fall, while large business lending rises.” Karen Gordon Mills and Brayden McCarthy, “The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game,” Harvard Business School Working Paper, July 22, 2014.

³ Kyle Pomerleau and Richard Borean, “The Dual Tax Burden of S Corporations,” Tax Foundation, February 19, 2015.

To add to their tax worries, there is concern that there will be further tax increases on small businesses if Congress pursues a “corporate only” approach to tax reform. Now that United States has highest statutory corporate tax rate of all developed countries, there is near universal agreement the rate should be lowered. The most common suggestion for offsetting the revenue loss from a lower rate is to scale back or completely eliminate business tax benefits, such as accelerated depreciation and the section 199 deduction for domestic manufacturing and production.

These tax benefits, however, are also utilized by businesses not subject to corporate tax. There are three major no-corporate-tax alternatives: S corporations, partnerships, or sole proprietorships. Collectively these three tax classifications are referred to as “passthrough” entities because the profits of these businesses are passed through immediately to owners who must report this income on their individual tax returns. Most small businesses are passthrough businesses, and therefore small business could be subject to a tax increase under corporate-only tax reform. According to one study, the resulting increase in taxes on passthrough businesses could increase by \$27 billion annually.⁴

Understandably in these circumstances there is significant interest in the possibilities for extending tax relief to small business. This testimony provides a menu of options. Below are a description and a discussion of the pros and cons of five general approaches to reducing small business taxes.

Option 1. Reduce the Top Income Tax Rate from 39 Percent to its Pre-2013 Level or Lower.

It is reasonable to ask: If the individual income tax rate increases in 2013 have created an unacceptable burden on small business, why not repeal those rate increases to remove that burden?

To begin to answer this question, it is important to understand that only a small fraction of the income earned by high-bracket taxpayers is generated by small business. This fact is illustrated in Figure 1. The estimates in this figure are derived from a uniquely detailed data set developed by the Treasury Department in 2011.⁵ The figure shows that of all the high-bracket income subject to regular tax rates (that is, excluding capital gains and qualified dividends) about 30 percent is related to passthroughs.⁶ Seventy percent of high-bracket income is from wages and other forms of income unrelated to passthrough business. Only about 21 percent of ordinary high-bracket income is from passthrough employers. And only about 8 percent of ordinary high-bracket income is generated by *small* business employers.⁷

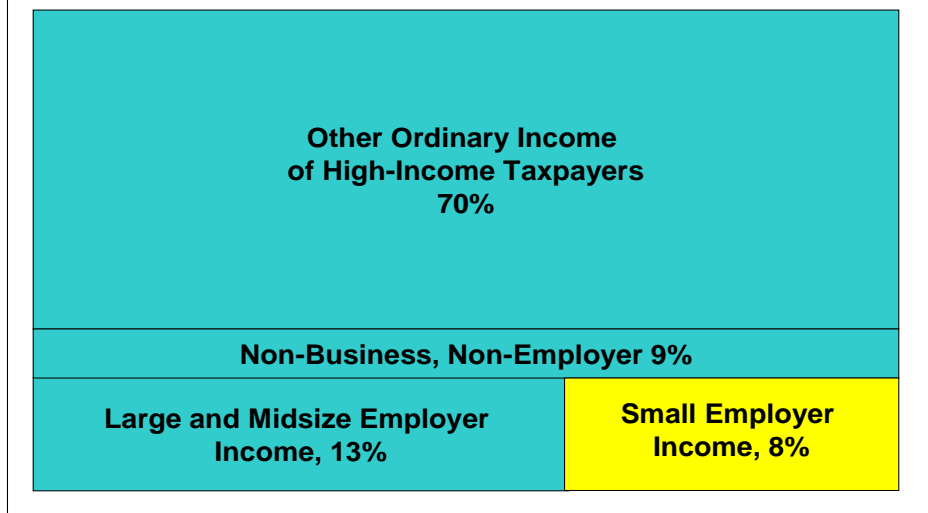
⁴ Robert Carroll and Gerald Prante, “The Flow-Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform,” April 2011.

⁵ Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, “Methodology to Identify Small Businesses and Their Owners,” Office of Tax Analysis, Technical Paper 4, August 2011.

⁶ In these calculations, high-income taxpayers are those who would be adversely affected by not extending the Bush tax cuts for taxpayers in the 33 and 35 percent brackets (in place in 2012)

⁷ For details of these calculations, see Martin A. Sullivan, “The Myth of Mom-and-Pop Business,” *Tax Notes*, September 12, 2011, p. 1085.

Figure 1. Composition of Income Affected by High-Bracket Rate Changes



The bottom line: most of the benefit of a cut in the top tax income tax rate would not be directed to small passthrough business. So, providing tax relief to *all* income in high brackets is an extremely inefficient way of achieving that objective. The merits of reducing the top income tax rate are better considered in relation to issues other than the impact on small business, such as the need for deficit reduction, the impact on fairness, and the impact on the *overall* economy.

Option 2. Reduce Income Tax Rates for Passthrough Businesses Only.

To preserve revenue and avoid some of the criticisms of the prior section, reduction of individual income tax rates could be targeted so that only passthrough business income is provided tax relief (for example, by excluding from the rate cut for the 70 percent of other income shown in Figure 1).

At the federal level, the most prominent example of across-the-board passthrough relief was the Small Business Tax Cut Act (H.R. 9) sponsored by former House Majority Leader Eric Cantor, R-Va., and passed by the House of Representatives on April 19, 2012. That bill would have provided passthrough businesses a deduction equal to 20 percent of income, subject to the limitation that the deduction does not exceed 50 percent of wages. In 2009 then-Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, included a similar provision in his Small Business Tax Relief Act (S. 1381), which would have provided a 20 percent deduction for business income of passthrough entities with less than \$50 million in annual gross receipts.

Several states have actually adopted variations on this approach. Beginning in 2013, Kansas has exempted all passthrough income from its state income tax. North Carolina had a similar measure in place since 2012, but it limited the deduction to \$50,000 per taxpayer (\$100,000 for couples). That provision has since been repealed for the years after 2013, a casualty of the state's latest tax reform legislation. In 2012 South Carolina approved an income tax rate cut on passthrough business income from 5 percent to 3 percent phased-in over three years. In 2013 Ohio enacted a tax deduction equal to 50 percent of the first \$250,000 of business income earned by owners of passthrough businesses.

There are two major problems with a broad-based rate cuts for passthrough businesses. First, it encourages wasteful tax avoidance that reduces revenue but does little to create jobs (except for tax advisors).⁸ Taxes can be reduced, for example, by business owners paying themselves smaller salaries and taking larger profit. Taxes can also be reduced by employees arranging for themselves to be classified as independent contractors who earn exempt business profits instead of taxable salaries.⁹

The second problem with this approach is that without limitations on the size of businesses that can qualify it is not well-targeted to providing tax benefits to small business. Many large businesses are limited liability companies (taxed as partnerships) and Subchapter S corporations. As shown in Table 1, there were nearly 15,000 S corporations with more than \$50 million in receipts in 2011 (the latest year data are available). They accounted for 27 percent of all S corporation profit. Their average level of profit was \$6.4 million. Other IRS data from 2012 (not shown in the table) indicate 17 percent (\$89 billion) of Subchapter S profits were earned by 3,700 corporations that each had over \$100 million in assets.

	Number	Total Profit (billions)	Avg. Profit (millions)	% of Total (all size) S Corp. Profit
All Industries	14,856	\$102.2	\$6.9	27%
Agriculture, Forestry	323	\$0.8	\$2.5	14%
Mining	133	\$4.0	\$30.3	35%
Utilities	12	\$0.2	\$16.4	45%
Construction	1,578	\$7.4	\$4.7	29%
Manufacturing	2,301	\$25.1	\$10.9	49%
Wholesale, Retail Trade	7,967	\$31.5	\$4.0	42%
Transportation, Warehousing	503	\$1.5	\$3.0	20%
Information	186	\$2.7	\$14.7	28%
Finance and Insurance	188	\$9.9	\$52.9	33%
Real Estate, Rental, Leasing	90	\$0.6	\$6.7	4%
Professional, Technical Services	630	\$5.5	\$8.7	9%
Holding Companies	80	\$5.4	\$68.0	39%
Administrative, Support Services	361	\$2.8	\$7.7	20%
Educational Services	43	\$0.5	\$10.9	23%
Health Care, Social Assistance	216	\$1.4	\$6.4	4%
Arts, Entertainment, Recreation	71	\$1.2	\$17.3	17%
Accommodation, Food Services	118	\$1.4	\$11.6	19%
Other Services	57	\$0.4	\$6.3	5%

Table 2 looks at large partnerships. It presents 2012 data from income tax returns of 22,000 partnerships that had assets of \$100 million or more. Even though these partnerships were less than

⁸ Nicholas Johnson and Michael Mazerov, “Proposed Kansas Tax Break for ‘Pass-Through’ Profits Is Poorly Targeted and Will Not Create Jobs,” March 26, 2012.

⁹ A prominent expert from the Tax Foundation has called the Kansas exemption of passthrough income a “loophole.” See, Joseph Henchman, “Kansas Income Tax Cuts: Boom, Bust, or Wash?” Tax Foundation, March 28, 2011.

one percent of the total number of partnerships, they accounted for 62 percent of the partnership profits. These partnerships on average had 461 partners and profits of \$16.2 million.

Table 2. Partnerships with \$100 Million or More in Assets, 2012					
	Number	Avg. # of Partners	Total Profit (billions)	Avg. Profit (millions)	% of Total (all size) Partnership Profit
All Types	22,174	461	\$481.9	\$21.7	62%
By Legal Form:					
LLC	8,406	127	\$113.2	\$13.5	47%
Other	13,768	665	\$368.7	\$26.8	69%
By Broad Industry Class:					
Finance	13,161	269	\$248.5	\$18.9	74%
Real Estate	4,545	44	\$23.6	\$5.2	35%
Other	4,468	1,449	\$209.8	\$47.0	56%

These data shows that it is a serious mistake to conflate the terms “passthrough” and “small business.” Providing tax relief to all passthrough business is not an efficient method of providing tax relief to small business because many large businesses that compete with corporations subject to two levels of tax would benefit.

Option 3. Reduce the Income Tax Rate for Passthrough Business Income of Certain Industries.

As part of his sweeping proposal to overhaul the U.S. tax system, former Ways and Means Committee Chairman Dave Camp, R-Mich., proposed that qualified domestic manufacturing income (QDMI) of passthrough business be taxed at no more than a 25 percent rate.¹⁰ (Under the Camp proposal, the top individual rate would be 35 percent and the corporate rate would be 25 percent.) QDMI generally would include net income from manufacturing, producing, or growing tangible goods in the United States or from construction in the United States. The proposal would include oil and gas income in QDMI, but it would exclude self-employment (i.e., sole proprietorship) income and income from the development of software.

In 2013 Rep. Ron Kind, D-Wis., introduced a bill (H.R.2940) that also would provide tax relief for passthrough businesses in manufacturing and other goods-producing industries. The effective rate of tax on income that qualified would be 20 percent and the amount of income qualified could not exceed 25 percent of the sum of Form W-2 wages paid, depreciation, and research expenditure.

A major difference between the Camp-Kind approach and the general passthrough relief provided in the House-approved Cantor bill is that manufacturing and other goods-producing industries account

¹⁰ Chairman Camp originally released his tax reform plan as a discussion draft on February 26, 2014. He formally introduced it as the Tax Reform Act of 2014 (H.R.1) on December 11, 2014.

for only about one-quarter of all income of passthrough businesses. So the revenue loss from this more targeted passthrough relief is much less than across-the-board relief.¹¹

This approach, however, gives rise to two major problems. First, for no economically justifiable reason, it violates the principle of tax neutrality. There is great sentiment in America to support manufacturing, but as stated in a recent Congressional Research Service report on manufacturing tax incentives: "Providing a tax break for certain industries can distort the allocation of capital in the economy, reducing economic efficiency and total economic output."¹²

Second, discerning which income is qualified for these special benefits creates massive administrative problems for the IRS. For taxpaying business it imposes significant compliance costs, and it creates opportunities for unproductive tax planning (for example, by shifting profits within a firm from unqualified to qualified lines of business). These are the same well-documented problems that stem from the enactment of income tax benefits for manufacturing and production income under section 199 of the Code.¹³ Rate cuts targeted to specific industries would greatly increase compliance costs for small business.

Option 4. Provide Tax Benefits for the Cost of Inputs Used by Small Businesses.

Instead of providing "back-end" tax relief for income generated by small business, Congress could provide "front-end" relief in the form of tax benefits for business inputs, such as capital expenditure, employee compensation, and research spending. This approach has several advantages over the rate reductions described in the three previous sections. First, it is generally far easier to identify and measure the costs of qualified inputs than it is to identify and isolate income qualified for tax benefits.¹⁴ Second, there is generally far less opportunity for costly and unproductive tax planning because there are not major tax benefits from income shifting. Third, this approach allows Congress to target tax benefits to small businesses that promote particular policy goals. So, for example, if the goal of Congress is to promote job creation, it can better achieve this objective with a wage credit for small business than a small business rate cut of equal revenue cost.

By far the most popular and often cited tax benefit targeted to small business is the ability to write-off the entire cost of capital spending in the year of purchase. This is known as "expensing." As tax

¹¹ For details of this estimate, see Martin A. Sullivan, "Kind's Manufacturing Bill Is a Perfect Fit for Tax Reform," *Tax Notes*, April 7, 2014, p. 22.

¹² Molly F. Sherlock, "The Section 199 Production Activities Deduction: Background and Analysis," Congressional Research Service, February 27, 2012.

¹³ With enactment of the American Jobs Creation Act of 2004 Congress added the Section 199 domestic production activities deduction to the Internal Revenue Code. The Joint Committee explanation of the provision stated that Congress wanted to promote domestic manufacturing and "enable small businesses to maintain their position as the primary source of new jobs in this country." (Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted In the 108th Congress*, May 2005, JCS-5-05, p. 170.) The complexities of section 199 are numerous: "Congress introduced an alphabet soup of new acronyms (MPGE, DPGR, QPAI, etc.) as well as principles not found elsewhere in the tax code. This led to a great deal of computational complexity." (Andersen Tax, "Section 199 Domestic Production Deduction: Time for a Closer Look," September 2010.)

¹⁴ Identifying property qualified for investment incentives or wages qualified for hiring incentives is relatively straight forward. Identifying research qualified for tax credits, however, can be complicated and controversial.

breaks go, expensing is one of the most meritorious. It provides an incentive for capital spending. It increases cash flow. And it simplifies recordkeeping.

In 2007 Congress increased the limit on amount of capital expenditure that can be expensed from \$25,000 to \$125,000. Subsequently the limit was increased to \$250,000 for 2008 and 2009, and to \$500,000 for expenditures incurred after 2010 and thereafter. All of these increases, however, were temporary. Under current law the \$500,000 limit expired at the end of 2014.

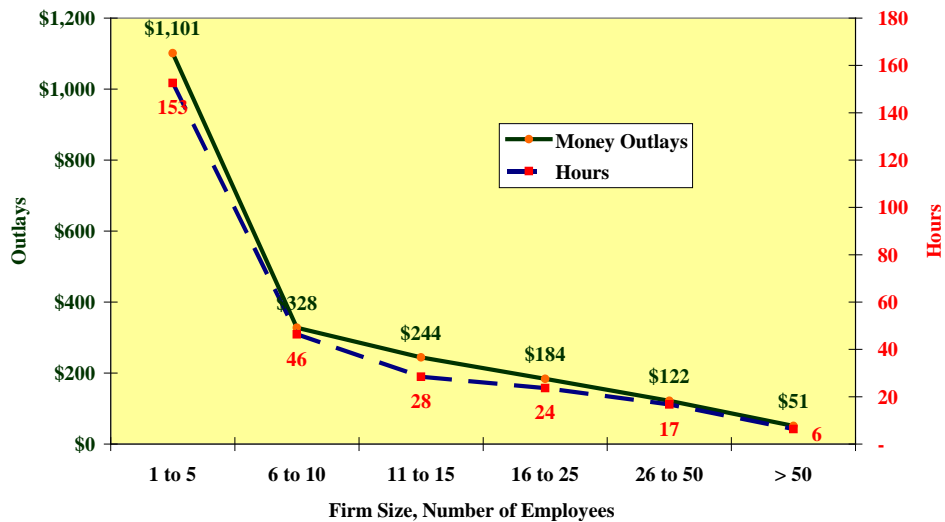
As in the past, it is likely Congress will provide retroactive relief. Small business expensing enjoys broad bipartisan support. On February 13 the House of Representatives passed by a 272-142 margin the America's Small Business Tax Relief Act of 2015 (H.R. 636) which included permanent extension of the \$500,000 limit on small business expensing. And in its latest budget the Obama Administration has proposed raising the cap to \$1 million on a permanent basis.

If Congress wants to provide small business with additional tax benefits for inputs beyond those provided by proposed extensions of expensing, it could consider provide a wage credit for small business hires. Alternatively, it could make the research credit more attractive to small, start up businesses by following the lead of several states that have made the credit refundable.¹⁵

Option 5. Reduce Small Business Compliance Costs Through Tax Simplification.

According to the latest estimates, small businesses spent about 1.75 billion hours and \$15.5 billion on income tax compliance. Most of the time burden is for record keeping. And most of the financial burden is in paying for professional help. What about differences in cost by firm size? Estimates shown in the Figure 2 confirm what common sense would have us assume: small businesses face

Figure 2. Business Federal Tax Compliance Burden, Per Employee



¹⁵ For example, Arizona, Iowa, and Minnesota have refundable research credits.

significant fixed compliance costs, and cost per employee decreases with firm size.¹⁶

The figure demonstrates the need for small business tax simplification. The inordinately large compliance costs faced by small businesses place a tax penalty on them that is the economic equivalent of a tax surcharge for being small. That distorts the allocation of capital away from small businesses and reduces economic growth.

Of course, everybody wants a simpler tax system. But tax simplification is especially important to small businesses. In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small business.

One particularly promising approach for small business tax simplification would be expansion of cash accounting methods used to compute income tax. In an article for *Tax Notes*, David Kautter and Donald Williamson propose that small business recognize income and deductions only when cash is received or expenses are paid.¹⁷ This proposal includes the elimination of calculations for depreciation and cost of goods sold, which the authors believe will not reduce government revenue and will increase compliance among small businesses and entrepreneurs. This is just one in a long line of proposals for simplified accounting for small business.¹⁸ In its latest budget, the Obama Administration has proposed expanding the cash method of accounting by creating a uniform threshold of \$25 million in average annual gross receipts for allowing exceptions from certain accounting rules.

In-depth examination of tax rules required to achieve small business tax simplification is neither easy nor glamorous. But it is one surefire way to reduce business costs and promote economic growth with minimal damage to the deficit.

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Thank you for this opportunity to comment on this important topic. All questions are welcome.

¹⁶ The data in this paragraph and in Figure 2 are from Donald DeLuca, Scott Stilmar, John Guyton, Wu-Lang Lee, and John O'Hare, "Aggregate Estimates of Small Business Taxpayer Compliance Burden," *IRS Research Bulletin--Proceedings of the 2007 IRS Research Conference*, p. 147.

¹⁷ David Kautter and Donald Williamson, "A Simplified Cash Method of Accounting for Small Business," *Tax Notes*, February 13, 2012.

¹⁸ President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Nov. 2005; Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax Systems for the 21st Century," Dec. 2007; President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010; Nina E. Olson, "How Tax Complexity Hinders Small Business: The Impact on Job Creation and Economic Growth," (testimony of the national taxpayer advocate before the House Committee on Small Business), Apr. 13, 2011; and Testimony of Rick Endres, President, The Washington Network, Inc., before the U.S. House of Representatives House Committee on Small Business, April 9, 2014.