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Statement of

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Tax Reform and Taxation of Small Business

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Chairman Baucus, Ranking Member Grassley, and Members of the Committee:

Thank you for inviting me to testify today on tax reform and small business. A tax code that is fair, simple, and conducive to economic growth is in the interest of all Americans and of all businesses, large and small. My testimony will address how the tax system affects companies organized as small businesses, compared with larger enterprises. I will discuss provisions of the current tax law that affect the relative incentive to organize economic activity within small or larger business enterprises and between different forms of enterprises and how selected tax reform proposals would affect these choices.

Small Business and the Current Tax System

Most of our economic activity occurs within large corporations, nonprofits, and public enterprises. But some rough calculations I have made suggest that the small-business sector accounts for about 25 percent of GDP.[1] While the activities of small and large businesses are in many ways complementary—each group is both a customer and supplier to the other—the way in which businesses are organized matters for productivity. Large organizations have advantages of economies of scale, broader reach, and ability to diversify risks, while small businesses have advantages of greater flexibility and less need for bureaucratic controls. No one business form is best for all activities. Ideally, the tax system would be neutral among different forms of business organization so that market forces—rather than tax considerations—will drive firm behavior and allow the optimal forms to emerge.

A few provisions of the current federal income tax code explicitly favor smaller over larger businesses, but provisions that favor flow-through enterprises over taxable corporations have a much greater effect. These provisions do not explicitly discriminate among businesses by size. But they generally favor sectors with relatively large numbers of small businesses, which are more likely to be organized as flow-through enterprises than larger businesses. They influence both small and large businesses to organize themselves as flow-through enterprises and provide incentives for taxable corporations to contract out labor services to and lease capital from flow-through businesses instead of employing labor and capital directly. Finally, the technology of tax administration and compliance confers important advantages and disadvantages on small compared with larger businesses, apart from what the tax law explicitly requires.

Provisions that Favor Smaller over Larger Businesses

Several provisions of the income tax code explicitly favor smaller over larger businesses. The most important are expensing of certain investments under Section 179 of the

[1] Eric Toder, "Does the Federal Income Tax Favor Small Business?" National Tax Association, *Proceedings of the 100th Annual Conference*, 2007. http://www.urban.org/UploadedPDF/411606_income_tax_favor.pdf.

Internal Revenue Code (Section 179 expensing), which will cost $3.7 billion in fiscal year 2008, and graduated corporate income tax rates, which will cost $5.2 billion. Section 179 expensing allows small businesses to deduct immediately instead of capitalizing and recovering through depreciation the first $25,000 of qualifying investments (machinery and equipment). The amount of spending available for the deduction decreases dollar for dollar for investments in excess of $200,000, so if a business spends more than $225,000 the deduction disappears entirely. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) increased the amount that could be expensed to $100,000 and the start of the phase out to $400,000 through tax year 2009. The economic stimulus package enacted in January 2008 temporarily increased these limits only for 2008 to $250,000 and $800,000.

Section 179 reduces the cost of capital for firms that use qualifying machinery and equipment and reduces compliance costs by eliminating the need to apply tax depreciation rules and keep track of the basis of assets. It produces little benefit for those whose capital consists mainly of structures or inventory and no benefit for firms whose investment exceeds the sum of the maximum expensing amount and the beginning of the phase-out limit ($1,050,000 in 2008, $500,000 in 2009, and $125,000 after 2009). The benefit of expensing is larger for longer-lived equipment than for shorter-lived equipment, such as computers, that could otherwise be amortized over three years.

Graduated corporate tax rates benefit high-income owners of small, closely-held corporations with low taxable profits who can avoid the corporate double tax on distributed profits by paying wages and bonuses instead of taking cash out as dividends. The rates are 15 percent on the first $50,000 of taxable income and 25 percent on the next $25,000, compared to rates of up to 35 percent (39.6 percent if the 2001 tax cuts expire as scheduled after 2010) if the profits were taxed to owners as ordinary income. Most of the benefits of graduated rates, however, are recaptured by a 5 percent additional tax on corporate income between $100,000 and $335,000, so that income between $335,000 and $10 million is taxed at flat rate of 34 percent. (There is an additional claw back of the 34 percent rate, so that corporations with income over $18.33 million pay a top rate of 35 percent.) Most economic activity of very small businesses takes place in firms organized as flow-through enterprises, so the overall impact of graduated corporate rates is modest.

Effects of More General Provisions—Costs of Capital

The most important provisions affecting the choice among business organizational forms are those that tax corporations organized under schedule C of the Internal Revenue Code (C corporations) more heavily than flow-through enterprises. C corporations pay tax at both the corporate and individual level on returns to equity, while flow-through enterprises bear only the individual income tax.

Table 1. Taxation of $1 Million Per Year of Corporate Profits: 2008–10 and 2011

Income and Tax Items	2008–10 Rates (Current Law)	2011 Rates (Current Law)
Pretax profits	$1,000,000	$1,000,000
Corporate tax	$340,000	$340,000
Dividends	$264,000	$264,000
Realized gains	$198,000	$198,000
Unrealized gains	$198,000	$198,000
Dividend tax	$39,600 (15%)	$104,544 (39.6%)
Capital gains tax	$29,700 (15%)	$39,600 (20%)
Total tax on corporate profits	$409,300	$484,144
Tax on flow-through profits	$350,000 (35%)	$396,000 (39.6%)

Table 1 illustrates the comparative taxation of a company with $1 million in taxable profits that is owned by individuals in the top bracket (35 percent in 2008–10, 39.6 percent in 2011) under C corporation and flow-through rules. Investors in the flow-through enterprise will have annual tax liability of $350,000 in 2008-10 and $396,000 in 2011 (assuming the 2001 and 2003 tax cuts expire as scheduled). The tax liability of owners of a corporate enterprise will depend on how much of its profit the corporation pays as dividends and how much of the undistributed profit the owners realize as capital gains. In the example in Table 1, I assume the firm distributes 40 percent of after-tax profits as dividends and that 50 percent of retained earnings are taxed as realized capital gains. The total individual plus corporate-level tax on corporate profits at current rates is $409,300, 17 percent greater than the tax on a flow-through business. If the 2001 and 2003 tax cuts expire, taxes on both C corporations and flow-through businesses increase, with the differential tax on corporate owners rising to 22 percent.

The corporate form of business organization offers business owners the advantages of limited liability and, for publicly-traded companies, wide access to capital markets, but over the past several decades it has become easier for businesses to gain the advantage of limited liability without paying corporate income tax. Corporations with between 1 and 100 shareholders and meeting other tests can elect to be taxed as flow-through entities under subchapter S of the Internal Revenue Code. Partnerships can be organized as limited liability companies, which has become easier to do since Treasury instituted "check the box" regulations in the 1990s. Over the past decade, the share of businesses organized as partnerships and S corporations and the share of business receipts going to these companies has increased steadily. Flow-through enterprises are the predominant organizational form for smaller companies, although C corporations still account for the majority of business receipts of large companies.[2] Table 2 shows that the percentage of business receipts from C corporations in 2003 increased with business size from 5 percent for very small businesses with annual receipts less than $100,000 to 80 percent for large businesses with annual receipts of $50 million or more. Still, as Table 3 shows,

[2] Eric Toder and Julianna Koch, "Fewer Businesses Are Organized as Taxable Corporations," *Tax Notes* 116-6, August 6, 2007, 491–492.

flow-through enterprises in 2002 accounted for a large share of receipts in some industries even for large businesses—60 percent in arts, entertainment and recreation; 48 percent in construction; 45 percent in agriculture, forestry and fisheries; and 42 percent in professional, technical, and scientific services.

Table 2. Percentage Distribution of Business Receipts by Type of Business and Size of Business Receipts, 2003

	Size of Business Receipts					
Type of business	All receipt groups	<$100,000	$100,000–$500,000	$500,000–$1 million	$1–50 million	$50 million and over
All businesses	100.0	100.0	100.0	100.0	100.0	100.0
Sub C corporations	64.6	5.3	17.7	27.1	38.2	79.9
Sub S corporations	19.0	9.8	30.7	41.8	44.2	8.5
Partnerships	11.6	3.3	7.7	9.9	13.5	11.5
Non-farm small proprietorships	4.8	81.7	44.0	21.2	4.1	0.1
All flow-through businesses	35.4	94.7	82.3	72.9	61.8	20.1

Note: Detail may not add to total because of rounding
Source: IRS Statistics of Income, SOI Integrated Business Dataset, at http://www.irs.gov/pub/irs-soi/02ot2busbr.xls

Table 3. Share of Business Receipts Accounted for by Flow-Through Enterprises by Industry and Firm Size—Selected Industries (percent)

	Business Receipts		
Industry	< $1 million	$1–50 million	$50 million +
All industries	80.6	61.2	19.1
Arts, entertainment, and recreation	84.2	77.9	60.1
Construction	84.7	64.6	47.6
Agriculture, forestry, and fisheries	70.1	63.5	45.2
Professional, scientific, and technical services	83.9	61.7	42.0

Source: IRS Statistics of Income, SOI Integrated Business Dataset, at http://www.irs.gov/pub/irs-soi/02ot2busbr.xls

Effects of More General Provisions—Labor Costs

While general rules for taxing earnings do not differ by size of business, small businesses do benefit from more favorable taxation of labor services when owner-managers or active business partners provide much of the labor the firm uses. Owner-managers or partners can effectively deduct all their employee business expenses from the business or partnership income they report, while employees may deduct only amounts in excess of 2 percent of adjusted gross income (or none if they pay alternative minimum tax). Owner-managers may also more easily represent some personal expenses (home office expenses or automobile use) as business expenses because it is difficult to monitor or even determine the proper boundary between the two.

The relative effects on different size businesses of tax provisions affecting health insurance are more complicated to assess. Self-employed persons can now deduct 100 percent of health insurance premiums, which places them at an advantage relative to employees of firms that do not offer health insurance or who must pay their share of premiums with after-tax dollars. But arguably tax benefits for health insurance provide a differential advantage for larger over smaller businesses because the advantages of pooling risks allows large employers to purchase tax-free health insurance for their employees at lower costs. Because large firms are more likely to offer health insurance than smaller firms, the exclusion of employer-paid premiums from tax may magnify this differential advantage they have in attracting workers. And large firms incur significantly lower administrative costs per worker.

Technology of Tax Compliance and Administration

So far I have focused on how tax law affects relative tax liabilities of large and small businesses and how this might affect business structure. But businesses also incur burdens in complying with the tax law and in some cases benefit by failing to comply. Recent research shows that compliance burdens consume a larger share of receipts for small firms than for big businesses, but that smaller firms have higher rates of noncompliance.

A recent study sponsored by the IRS finds that small businesses spend between 1.7 and 1.8 million hours and between $15.0 billion and $16.4 billion in out-of-pocket expenses in preparing and filing tax returns.[3] If one values the time of small-business employees engaged in tax preparation activities at $45.40 per hour (about $90,800 per year), the small-business compliance burden is between $92 billion and $100 billion per year, about as large as the total compliance burden for all individual income taxpayers.[4] IRS data

[3] Donald DeLuca, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance for Small Businesses," presented at 2007 National Tax Association meetings, Columbus, Ohio, November 2007.

[4] The hourly estimate is reported in DeLuca et al. The estimate assumes all tax recordkeeping costs are incremental costs imposed by the tax system. If some of these expenses would be otherwise incurred for purposes of internal business management, the incremental costs imposed by the tax system would be lower. For a recent estimate of costs borne by individual income taxpayers in complying with the tax law,

also show that compliance costs as a percentage of gross receipts rise sharply as firm size shrinks, because of the large fixed costs of keeping tax records and preparing returns. Compliance costs are estimated at 15 to 17 percent of receipts for firms with receipts between $50,000 and $100,000, but only 0.5 percent of receipts for firms with receipts over $1 million.

While small businesses face relatively higher compliance costs than do larger businesses, they appear to pay a much smaller share of the tax they owe than larger businesses and their employees and owners, especially if they have large cash receipts.[5] Based on a random audit study of 2001 individual tax returns, the IRS reports that large percentages of income not subject to withholding or document matching go unreported – 57 percent for non-farm proprietor income, 72 percent for farm income, and 51 percent for rents and royalties. In contrast, income sources that make up the majority of income originating in large corporate businesses have very low underreporting rates – 1 percent for wages and 4 percent for dividends and interest. IRS estimates of underreporting of corporate profits tax by large and small corporations are based on extrapolations from earlier studies and are less reliable, but the order of magnitude estimates reinforce the conclusion that large businesses are more compliant. The IRS does not directly report a *percentage* gap for the corporate tax, but its estimates of underreported tax in 2001 ($25 billion for large corporations and $5 billion for small corporations) suggest misreporting percentages of about 14 percent for large corporations and 28 percent for small corporations.

These estimates do not imply that all or even a majority of small business owners are tax evaders or that they necessarily reap all the benefits of underreported income. Some of the benefits of tax evasion may be passed forward to consumers of selected goods and services through lower prices and, in businesses where noncompliance is more prevalent, honest business owners receive lower profits if competition from the less compliant firms drives prices down. What is evident is that differences in compliance among income sources cannot be ignored in assessing how the income tax affects business organizational structures.

Effects of Tax Reforms

Tax reforms now under consideration could significantly affect incentives for structuring business organizations. I comment very briefly on a few potential reforms.

Corporate Tax Rates and Base Broadening

A number of tax reform proposals, including proposals by Ways and Means Chairman Rangel and the President's 2005 Tax Reform Panel, would lower the corporate tax rate and reduce or eliminate some business tax preferences. While the main motivation for

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see John L. Guyton, Adam K. Korobow, Peter S. Lee, and Eric J. Toder, "The Effects of Tax Software and Paid Preparers on Compliance Costs," *National Tax Journal* , September 2005, 439–448.

[5] See Joseph Bankman, "Can We Legislate Our Way Out of the Tax Gap? Eight Truths about Collecting Taxes from the Cash Economy," *Tax Notes* 117-5, October 29, 1997, 506–516.

lowering the corporate tax rate is to bring the United States tax system more in line with those of our main trading partners and thereby reduce incentives to shift investment and reported profits overseas, a reform of this type would also reduce the relative tax advantage of flow-through enterprises over C corporations. A revenue neutral tax reform that balanced corporate rate cuts with base broadening would lower the relative cost of corporate capital because the rate cut would only benefit corporations, while reduced business preferences would increase effective tax rates on both corporations and flow-through businesses. A lower corporate tax rate, with the individual rate unchanged, could induce some businesses to become C corporations to take advantage of the lower rate. Any business that pays a significant amount of dividends or whose owners realize capital gains attributable to retained profits, however, would still face lower combined corporate and individual taxes if organized as a flow-through enterprise.

Elimination of Double Taxation of Corporate Dividends

Since the early 1970s, there have been numerous proposals by academic economists and tax reform panels and in Treasury reports to eliminate the double taxation of corporate dividends. There are many ways to do this, including allowing corporations to deduct dividends, allowing shareholders to claim a credit for corporate taxes associated with dividends paid (effectively treating the corporate tax as a withholding tax on dividends), exempting corporate dividends from tax, and exempting all corporate dividends and interest from individual income tax, while eliminating the deductibility of corporate interest payments (The Comprehensive Business Income Tax, or CBIT proposal, advanced by the U.S. Treasury Department in 1992). In addition to these general design options, there are many other choices involved in designing double tax relief. These include options for whether and how to flow through corporate tax preferences to shareholders when dividends are paid and whether or not to extend the benefits of double tax relief to foreign investors and tax-exempt institutions.

The effects of double tax relief on the cost of corporate capital and after-tax returns to domestic investors depend importantly on the details of its design. Double tax relief by itself would lose revenue and disproportionately benefit high-income taxpayers, so it is best included as part of a larger overall reform package that addresses these concerns. But virtually all proposals for double tax relief would produce a net efficiency gain by taxing capital income from C corporations and flow-through enterprises in a much more neutral fashion. Eliminating the double taxation of dividends would remove the incentive for businesses to organize as flow-through enterprises, reduce the tax bias favoring sectors in which flow-through businesses predominate, and eliminate the bias for corporations to finance themselves with debt instead of equity and to retain earnings instead of paying dividends.

Health Care Reform

Approaches to health care reform range from proposals that would mandate employers or individuals to purchase health insurance (with subsidies for low-income employees) to proposals that would replace all or a portion of the exemption for employer-provided

health care with a refundable credit available to both employees and employers. The approaches differ greatly between relying on mandates and regulations or relying on improved incentives to increase insurance coverage and control health care costs. But both broad approaches to health reform would reduce the relative tax advantage for large employers that the current unlimited exemption provides. Mandated universal coverage, accompanied by community-rated premiums, would eliminate the advantage large employers currently have in pooling risks and improve the competitive position of smaller employers by reducing their relative labor costs. Replacing the tax exemption with a refundable credit available to all individual taxpayers would also reduce the current advantage of large employers, but could lead some employers to drop coverage and could reduce coverage overall if not accompanied by insurance market reforms.

Introduction of a Consumption Tax

The United States is the only major advanced economy that does not use a national-level consumption tax as a major revenue source. There have been numerous proposals over the years to introduce a value-added tax (VAT), mostly notably a recent proposal by Michael Graetz to use revenues from such a tax to exempt all but very high-income individuals from paying individual income tax and lower the corporate income tax rate.[6] My colleague Len Burman recently proposed introducing a VAT to finance health care.[7] If Congress eventually decides more revenues are needed as part of a general budget agreement that addresses the retirement of the baby boomers and rising health care costs with a combination of revenue increases and entitlement spending cuts, a VAT deserves consideration in a world of increased capital mobility because it would generate additional revenues without raising U.S. taxes on internationally mobile capital.

Many countries with a VAT exempt businesses with receipts below a threshold amount from the tax to avoid imposing large compliance costs on them. One should reasonably expect such an exemption if the United States imposes the standard type of credit-invoice VAT that other countries use.

Conclusion

The current income tax generally favors smaller over larger businesses and flow-through enterprises over C corporations, most notably because of the double taxation of corporate dividends. In response to these incentives and to changes in tax laws and regulations that facilitate the use of S corporations and limited liability partnerships, the share of businesses organized as flow-through enterprises has been growing. Small businesses and the self-employed also benefit from being able to use more work-related deductions than employees of larger businesses, but the tax exemption for health insurance favors larger

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[6] Michael J. Graetz, *100 Million Unnecessary Returns—A Simple, Fair, and Competitive Tax Plan for the United States*, Yale University Press, New Haven CT, 2008.

[7] Leonard E. Burman, "A Blueprint for Tax Reform and Health Reform," Statement to the Senate Finance Committee, May 13, 2008, at http://www.taxpolicycenter.org/library/listpubs.cfm?ListUTypes=true&Listpubs=true&UTypeID=10

businesses that have advantages over small businesses in pooling employee health risks. Finally, the technology of tax administration and compliance affects different types of businesses differently, with small businesses subject to larger compliance burdens per dollar of revenue than larger businesses, but also having more opportunities for noncompliance.

Tax reforms under consideration might make the tax law more even-handed in its treatment of smaller and larger businesses and of corporate and noncorporate organizational structures. These include proposals to reduce the corporate tax rate and broaden the business tax base, proposals to eliminate the double taxation of corporate dividends, and proposals to restructure tax benefits for health insurance. Beyond that, if a new federal consumption tax is ever introduced, the issue of exempting small businesses to avoid imposing large compliance burdens on them will certainly merit careful consideration.