

TAX RELIEF FOR SMALL BUSINESS AND FARMERS

HEARING

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

PRESERVING AND PROTECTING "MAIN STREET U.S.A."

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MARCH 28, 2001
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TAX RELIEF FOR SMALL BUSINESS AND FARMERS

WEDNESDAY, MARCH 28, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:03 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Hatch, Gramm, Baucus, Torricelli, and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Welcome, everybody, particularly those who have come a long way to be with us, and the extra work that our witnesses always go to to be prepared for a specific subject. The committee thanks you very much.

Senator Baucus and I have called this hearing because we want to focus on an issue on which both Republicans and Democrats agree, and that is the importance of tax relief for small business and farmers.

There can be no doubt that taxes are at record levels. Now, according to the CBO, total Federal taxes consume 26 percent of GDP. Since 1993, individual income taxes have doubled in the amount collected, and are at all-time high of about 10.2 percent of GDP.

These record levels of taxes are a problem for everyone, workers, investors, and businesses both large and small. However, all across American the problem of high Federal taxes is evident to everyone. Wall Street measures the economic slowdown by high-tech stock prices.

Main Street uses the number of farmers buying equipment at the local dealer, or the number of loans that are taken out at the community bank. Both measures are very important, but one of them leads to farm auctions and empty storefronts if the economy is not on track.

Now, in order to get the economy on track, it seems to me we have to visit both Wall Street and Main Street. So today we are looking at Main Street. A significant portion of that record tax break is borne by small business and farm people. These are the taxpayers who do business on Main Street.

Farmers and small businesses rarely do business in the conventional corporate form. Most farms and small businesses are owned by sole proprietors, partnerships, subchapter S corporations.

That means farmers and small business folks are paid with their own 1040. Ask any farmer why he or she should pay 39.6 percent versus the 35 percent paid as the top percentage for Fortune 500 type corporations, or other corporations.

Now we have President Bush's plan before us. This cuts marginal individual income tax rates, and that will greatly help these self-employed farmers, small businesses. That is just one of many reasons to support the President's plan.

If the President's plan were in effect, farmers and small businesses would pay a lower marginal rate than the Fortune 500. In addition to marginal rate cuts, there are many tax problems faced by Main Street businesses that we will look at in today's hearing.

We will explore multiple topics such as expensing and accounting methods, and different income tax treatments for various business choices made by small businesses and by agriculture. We will examine several legislative proposals designed to address tax problems faced by small business and farmers.

In a previous hearing, I laid out three principles that I plan to use in designing tax legislation, probably very obviously the same ones that you might choose if you were in this position: efficiency, equity, and simplicity.

In regard to efficiency, we must make sure that changes in the Tax Code come in a way that grows our economy. Small businesses and farms are key to jobs and growth. We should ensure that the tax system does not strangle this important part of our economy with irrational rules.

My second principle, is equity, or you might call it fairness. I want to make sure that tax policy changes come to address inequities in the Tax Code. There are many inequities, some that hit small businesses and farmers hard, and we will hear about those—maybe not all of them but some of them—today.

The principle of simplicity, the third one. Everyone who fills out a Form 1040 knows how the complexity of the Tax Code is bad. All across the country Americans are dealing not only with the burden of paying Federal taxes, but the added burden of tax complexity. Our witnesses today will address those complexities that specifically affect small businesses and farms in the Internal Revenue Code.*

So, I welcome to our witness table and before the committee this morning a constituent of mine by the name of Skip Bright. He is from Keokuk, IA, where is president of the Keokuk Savings Bank and Trust Company. He is also president-elect of the Iowa Bankers Association.

Following Mr. Bright, we have a constituent of Senator Gramm's. I know Mr. Stallman well, but I think Senator Gramm is going to come along to give you a more full introduction. So I am just going to say that Bob Stallman is a family farmer and president of the American Farm Bureau Federation.

*For more information on this subject, *see also*, Joint Committee on Taxation staff report, "Overview of Present Law and Selected Proposals Regarding the Federal Income Taxation of Small Businesses and Agriculture," March 27, 2001, JCX-19-01.

I also will have the introduction of Ms. Turner by Senator Baucus, so I will save that. He is voting right now. He will be here shortly.

Then we hear from Mr. Alexander. I have already seen Mr. Alexander once already this morning. I am glad to see you again. We have with us, as we did last week, Don Alexander, former Commissioner of the Internal Revenue Service. He will be speaking about the need for tax reform for subchapter S corporations.

Then we have Dr. Robert Berney, chief economist and acting director of the Economic Research Office of Advocacy of the U.S. Small Business Administration. He will talk about tax reform on small business.

I am going to have to wait a minute. I have a problem. I hope other members will come right away, because I have a meeting down at the White House that I have to go to, so I will not be here very long.

I think what we are going to do before we start testimony then, is I will recess it until Senator Baucus and other members come. They will be here shortly. I may have a problem in addition to going to the White House.

By the way, just so you know, I do not consider it a problem going to the White House. [Laughter.] You do not know how refreshing it is to be invited to the White House once or twice a week, more times than I have ever been there in the previous 20 years in the U.S. Senate added together.

We are going to be in recess.

[Whereupon, at 10:11 a.m., the meeting was recessed to reconvene 10:17 a.m.]

Senator BAUCUS. The hearing will come back to order.

I apologize for the interim delay here. As you know, Chairman Grassley has a meeting down at the White House, which I imagine is fairly important, and we had votes. So, I will resume.

I understand that several Senators have already spoken briefly. Maybe Senator Grassley, only. In addition, I have a statement, which I will not read. Let us get right to it here.

[The prepared statement of Senator Baucus appears in the appendix.]

I would like to reintroduce witnesses that have already been introduced, and introduce those who have not been introduced so we can get on with your statements.

First, Skip Bright, who is president-elect of the Iowa Bankers Association in Keokuk, Iowa. Thanks for being here, Skip.

John Stallman, president of the American Farm Bureau Federation, the Executive Committee of the Texas Agriculture Summit, in Columbus, Texas.

Joy Turner, who is president of Jeffers Business Services. She's the tax chair of Region II, the White House Conference on Small Business, and is the National Minority Business Advocate of the Year from the Small Business Administration in Piscataway, NJ.

Commissioner Don Alexander, former IRS Commissioner, is a somewhat frequent witness before this committee, and whose experience and advice we appreciate very much.

Bob Berney, Ph.D., chief economist for the U.S. Small Business Administration in Washington, DC.

Why do we not begin with you, Skip? Your statements will be included in the record. I would encourage you to summarize in about 5 minutes, roughly. Just get to the heart of the matter.

But, more than that, I just want to thank you very, very much for taking the time to come and testify before us. As you well know, it is getting to the time where the rubber is meeting the road and we have got to decide what the actual contents are of the various tax proposals generally, and also that specifically affect agriculture and small business.

So, I encourage you to just get to the point, say what you honestly think and feel. Time is short, so let us get on with it. Thank you very much.

Mr. Bright, why do you not proceed?

**STATEMENT OF JOHN "SKIP" BRIGHT, PRESIDENT-ELECT,
IOWA BANKERS ASSOCIATION; PRESIDENT, KSB BANK, KEOKUK, IA**

Mr. BRIGHT. Thank you, Mr. Chairman and members of the committee. I am Skip Bright, president of Keokuk Savings Bank and Trust Company, Keokuk, IA.

I am here on behalf of myself, the Iowa Bankers Association, and the American Bankers Association. We commend you for holding this hearing to focus attention on the importance of small businesses to America's communities.

We have submitted our full written statement for inclusion in the record and we would like to limit our comments today to three points. First, most banks are small businesses that lend to small businesses. Second, the most critical challenge today for businesses is funding. Lastly, legislative changes would protect and preserve small businesses.

The banking industry is the primary source of credit to small businesses throughout this country. These customers are our lifeblood, as we are theirs. Our officers drive by their front doors every day. We take care of them, and they take care of us. They leave their deposits with us and we use them to fund other small businesses.

With additional funding opportunities, we small businesses could do much more. However, without access to deposits, banks cannot possibly meet the needs of our customers.

Banks have seen strong demand for credit, but we are struggling to attract deposits to fund loans. We have seen major changes in the financial services industry, with many new competitors vying for the consumers' dollar. Our biggest funding competition is Wall Street, not the bank across Main Street. Yet, Wall Street is not funding the small business customer. That job is left to us, the banks.

Over the last decade, bank loan growth has surpassed core deposit growth. These funding demands are very personal. For example, last week, just outside of Keokuk, I was at an event announcing the expansion of a small business who had been a customer for 26 years.

It did not take a committee or a week to approve this loan. Instead, it took me a few minutes of conversation with the owner to

understand his needs and agree to help. It is this personalized treatment of our customers that preserves the business next door.

In this regard, the American Bankers Association would like to commend Chairman Grassley and Senator Baucus for introducing S. 313, the Farm, Fishing, and Ranch Risk Management Act.

That bill would create a new tax-deductible risk management account for farmers, fishers, and ranchers. These farm accounts would help keep lendable funds in rural communities, and we urge you to quickly pass this legislation. Similarly, Aggie bonds should be made more widely available.

In order to provide reduced interest rate loans to young and beginning farmers for capital purchases, these bonds should be exempt from the Federal volume caps. Legislation is also needed to help community banks compete on a level playing field with non-bank competitors.

By improving the subchapter S laws, Congress has an opportunity to create greater opportunities to raise capital and preserve small business lending, and to remove many of the competitive barriers now facing community banks.

For the first time in 1997, banks were permitted to become S corporations. While this is beneficial, subchapter S laws need to be modernized to accommodate the unique requirements of banks.

For example, the passive income rules subject subchapter S businesses to a corporate-level tax on excessive passive interest income. Further, their S election will terminate if the corporation receives excess passive income for three consecutive years.

Modernizing the rules would alleviate unnecessary investment costs, especially for regulated subchapter S banks. Another example, is a subchapter S restriction on the ability to issue a second class of stock.

Currently, subchapter S businesses can only issue one class of stock. Allowing small subchapter S businesses to issue a second class would alleviate regulatory capital constraints on small businesses and help raise lendable funds.

Lastly, and most important to my bank, are issues relating to shareholder qualifications and the election process. Currently, subchapter S eligibility requirements exclude many types of institutional shareholders, such as family limited partnerships' IRAs. Because banks could only be C corporations prior to 1997, they are particularly harmed by shareholder decisions made long before the law changed.

Also, in order to elect subchapter S status, there must be 100 percent approval among all shareholders. This permits one individual shareholder to thwart the efforts of the remaining shareholders to opt for subchapter S status. Liberalizing the unanimous consent rule would introduce more fairness to the election process.

In conclusion, I appreciate this opportunity to present these views, and I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Bright appears in the appendix.]

Senator BAUCUS. Thank you very much, Skip.

Our next witness is Mr. Bob Stallman. I think I incorrectly introduced you as John, Bob. I apologize for that.

Please proceed.

STATEMENT OF BOB STALLMAN, PRESIDENT, AMERICAN FARM BUREAU FEDERATION; EXECUTIVE COMMITTEE OF THE TEXAS AGRICULTURE SUMMIT, COLUMBUS, TX

Mr. STALLMAN. Mr. Chairman, distinguished members of the committee, I am Bob Stallman, a rice and cattle producer from Columbus, Texas. I serve as the elected president of the American Farm Bureau Federation. Thank you for this opportunity to talk about Tax Code changes to help preserve and protect America's farms and ranches.

The Farm Bureau commends the committee for holding this hearing to focus attention on farm and ranch needs. While much of America has prospered over the last decade, this was not the case with American agriculture.

As all of you know, many farmers and ranchers have suffered substantial financial losses over the last few years. There are many reasons for this, and just as many possible solutions. Some of those solutions involve changes in the Tax Code.

We are pleased that Chairman Grassley, and you, Senator Baucus, have recognized many of these tax provisions and introduced them as S. 312. The Farm Bureau supports S. 312, the Tax Empowerment and Relief for Farmers and Fishermen's Act, or TERFF.

I plan to spend most of my time with you today talking about Farm, Fishing, and Ranch Risk Management accounts, or FFARRM accounts, because of their potential benefits for farm and ranch families.

Unpredictable weather and uncontrollable markets determine whether or not farmers and ranchers will be able to harvest a crop and the price that they will receive for the commodities that they are able to market. As a result, farmers and ranchers are never certain of their incomes.

Serious financial problems arise in low-income years when not enough revenue is generated to cover farm expenses. Farmers and ranchers need new risk management tools that encourage savings as a means of stabilizing their incomes.

The Farm Bureau supports the creation of FFARRM accounts to help farmers and ranchers manage risk through savings. Using FFARRM accounts, agricultural producers would be encouraged to save money in good economic times for the ultimate lean economic years.

Like other small businessmen, farmers and ranchers have predictable expenses. Each month they must pay for fuel, animal feed, equipment repairs, building maintenance, insurance, utilities, and payroll. They must plan for seasonal expenses, such as taxes, seed, heat, and fertilizer. They must also budget for major purchases, such as equipment, land, and buildings.

Let me reiterate a point I just made. While many expenses can be predicted, and to some degree controlled, farm income is neither predictable nor controllable. Farmers and ranchers do not know from 1 year to the next if their gross income will exceed expenses or if their income will fall short of what they need to pay their bills.

FFARRM accounts would encourage farmers and ranchers to save for a rainy day by deferring income tax, but not self-employment taxes, on up to 20 percent of their net farm income. Money

could remain in the account for no more than 5 years and would be subject to income taxes at withdrawal, while interest would be taxed as it is earned.

Safeguards in the bill limit the use of farm accounts to bona fide farmers and ranchers and require that FFARM funds be held in interest-bearing accounts.

Other TERFF provisions that would save farmers significant tax dollars are those that clarify that self-employment taxes are not owed on cash rental income or conservation reserve program payments, and language to make sure that the use of income averaging does not trigger the Alternative Minimum Tax.

Although not included in TERFF, I would like to mention the need for capital gains tax relief. Farming and ranching is a capital-intensive industry that requires huge investments in buildings, equipment, and land.

Congress increased the capital gains homeowner exclusion in 1997 and made the benefit usable once every 2 years. While these improvements were very helpful for homeowners, the benefits for farmers and ranchers are limited. The Farm Bureau supports S. 362 to expand homeowner capital gains exclusion to include farmland.

Lastly, no Farm Bureau statement on taxes would be complete without a word on death taxes. Repeal of death taxes is our number-one tax priority. Families own 99 percent of our Nation's farms and ranches. Unless death taxes are repealed, many of these family farms are at risk.

The Farm Bureau endorses S. 275 because it eliminates death taxes immediately, while preserving the stepped-up basis for assets worth \$5.6 million per couple.

We commend you for recognizing the urgency of death tax repeal and for building the case for repeal through the hearing process. Thank you again for holding this hearing on tax relief, important to America's farmers and ranchers. The Farm Bureau wholeheartedly supports S. 312, and we pledge the resources of our organization to help pass it into law.

I will be glad to answer any questions.

[The prepared statement of Mr. Stallman appears in the appendix.]

Senator BAUCUS. Thank you. Thank you very much, Bob.

Ms. Turner?

STATEMENT OF JOY J. TURNER, PRESIDENT, JEFFERS BUSINESS SERVICES; TAX CHAIR OF REGION II, WHITE HOUSE CONFERENCE ON SMALL BUSINESS; NATIONAL MINORITY BUSINESS ADVOCATE OF THE YEAR FROM THE SMALL BUSINESS ADMINISTRATION, PISCATAWAY, NJ

Ms. TURNER. Chairmen Baucus and Hatch, in the absence of Chairman Grassley, and members of the committee, it is an honor to have the opportunity to discuss issues that relate to the small business community.

Small business is often referred to as the engine of our economy. Thank you for this opportunity to speak as a small business owner. I am also speaking on behalf of the Regional Tax Chairs of the White House Conference.

I appreciate your interest. In light of our current depressed economy, it is encouraging that small business is receiving timely attention. I hope that your committee and the 107th Congress will put into place measures to protect and preserve small business.

As an active advocate for small business from a diverse background, I am the owner of a small business, an accounting, tax, and small business consulting company. I hold two degrees in accounting and business management. My post-graduate work includes specialization in taxation and financial planning.

My work with small business has been varied, as small businesses are unique. I provide tax and business consulting and accounting services to start-ups and established small businesses.

I work with entrepreneurs from the inception of an idea to completing the business plan. I discovered that small business owners need a lot of hand-holding to walk through the maze of tax compliance red tape.

At first, their attention and interest is on how to pay the rent and how to make the payroll. They wear many hats. I believe that Congress needs to make things easier for them.

While a staff accountant with a large corporation, I was frequently approached by co-workers and other working people, such as the building janitor, bus drivers, and even my dentist, who were experiencing difficulties with their tax situations.

I felt compelled to help these people through the red tape as I began to see the many complexities and unfairness of the current Tax Code. They were literally drowning in a sea of complex tax laws.

After completing 26 years with a Fortune Top 10 corporation, I started a full-time small business. This is my 24th year.

For 10 years, I was a volunteer for the Internal Revenue Service and provided workshops and community outreach that was designed to help small business owners comply with tax law. I realized that our tax laws were too complex for the average citizen to understand.

I also felt that the penalties were very unfair for those who did not understand the law and could not afford to hire professional assistance. My corporation background has provided me the insight to observe and measure the differences in small and large business.

In a large corporate structure, so much is taken for granted. Hiring, training, and retaining employees, incurring risks and unlimited liability, plus the burdens of taxation are major differences.

I merely want to point out that there are dramatic differences in requirements for starting and keeping a small business alive than what is required in a large corporation.

According to SBA research data, small businesses represent 99 percent of all employers. Women-owned firms generated \$3.1 trillion in revenues and employed 23.8 million employees in the last 10 years. Minority-owned firms generate \$495 billion in revenues and employ nearly 4 million people every year. More than 60 percent of women-owned businesses started in the home. These are the innovators of U.S. inventions and jobs.

During the start-up phase in the life cycle of a small business, the goal is to survive. Cash flow and lower tax burdens are needed.

Complicated and confusing Tax Codes discourage the new business owner.

If our economy is to flourish and expand, it must be built by small business. Business owners must make hard decisions to expand or to hire people. Access to growth capital and the ease of securing it is critical.

My next point of view comes from working with the White House Conference on Small Business. In 1995, 4,000 small business people closed down shop and attended the conference, it was that important.

During the past 6 years, the tax chairs have had a strong relationship with Congress and have diligently worked with the committees to address small business concerns. We believe that you listened, and our input is reflected in the tax and small business legislation that came out of previous Congressional sessions.

Our tax issues are covered in detail in my written testimony. We recognize that many of them are addressed in the current tax proposals. We would like Congress to consider acting quickly on these small business issues.

Clarification of the independent contractor definition is key. The current law addresses the question, who is an employee, rather than who is an independent contractor. Let us, first, clearly determine who is an independent contractor. Anyone else must be an employee.

A real opportunity exists for this Congress to take positive actions on issues that are vital to the survival of small business. There are many important things that a bipartisan Congress can do to help small business survive.

The White House Conference on Small Business Tax Chairs welcomes the opportunity to continue our work with Congress to suggest ideas that would help the Nation's small business community.

We hope Congress continues to listen to the recommendations and analyze all legislative proposals for their impact on small businesses and their employees. Small businesses, after all, provide the majority of new jobs for our economy. We thank you for listening to us.

[The prepared statement of Ms. Turner appears in the appendix.]

Senator BAUCUS. Thank you very much, Ms. Turner.

I see that we are joined by the Senator from Texas. Senator Gramm, I know, wanted to introduce his fellow Texan, Mr. Stallman. Although Mr. Stallman has already spoken, maybe, Senator, you might want to have an opportunity to say a word or two, if you would.

Senator GRAMM. Mr. Chairman, thank you very much. It is not every day that I get an opportunity to introduce a Texan who is president of the American Farm Bureau. Bob is the first person to hold that job during my political life, perhaps my adult life.

I would just like to say that I am very proud to have him here representing the American Farm Bureau Federation. Bob is not only president of the American Farm Bureau, he was president of the Texas Farm Bureau. He is in the rice business and cattle business in Columbus.

He is a third generation farmer. If you can stay in business in agriculture with three generations, you are doing something right.

So, we are very proud to have him here representing American agriculture.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator.

We are also joined by the senior Senator from Utah, Senator Hatch, who we turn to very often for advice on this committee. He would like to introduce the next witness.

Senator HATCH. Thank you. I am happy to have all of you here, but in particular my friend Don Alexander. It is wonderful to be able to introduce an old friend of mine who has done so much in this area to advise this committee as former Commissioner of the Internal Revenue Service and currently a partner in the firm of Akin, Gump, Strauss, Hauer, and Feld. I think I got that right, did I not?

Mr. ALEXANDER. You certainly did.

Senator HATCH. Don has been giving valuable tax counsel to this committee, and others, for decades. I just wanted to make sure that we welcome you appropriately. I look forward to hearing your comments here today.

We appreciate all of you. Mr. Stallman, as you know, we really are appreciative of the work that you are doing with the Farm Bureau. It is very, very important.

Ms. Turner, you are one of the winners of the small business awards, so we are very proud of you, and the rest of you as well, Dr. Berney.

Don?

Senator BAUCUS. Thank you, Senator.

With that great introduction, Mr. Alexander, why do you not proceed?

**STATEMENT OF DONALD C. ALEXANDER, FORMER IRS
COMMISSIONER, WASHINGTON, DC**

Mr. ALEXANDER. As a former tax collector, I certainly appreciate a kind word. [Laughter.]

Senator BAUCUS. Take it while you can. That is right.

Mr. ALEXANDER. That is right. Anything I can.

I am here to talk about subchapter S. Mr. Bright has already mentioned the need for basic reform of subchapter S to aid banks.

We also need similar reforms, overlapping reforms, to aid the more than 2,500,000 subchapter S corporations that we have in this country and that are almost entirely small family businesses, the engine that moves America.

Now, strangely enough, we are not asking for a level playing field. I know that comes as a great surprise to the Committee, because nearly everybody asks for one. We are not. We are not asking for partnership treatment of subchapter S corporations.

Partnership treatment would give us the "flexibility" that allows one partner to have a disproportionate allocation of partnership income or loss and that allows a partner to include partnership debt in the partner's basis.

Now, those are good rules. I am not complaining about the rules. They are good rules for partnerships. But subchapter S proponents of reform are not asking for that.

What we are asking for, is the removal of some shackles and restrictions thought necessary, perhaps, in 1958, which were not removed when subchapter S was basically reformed in 1996.

A lot of good things were done in 1996. Banks were permitted to be subchapter S corporations. But the rules are still too tight. The rules still do not make much sense. Rigidity creates complexity.

I want to join with my friends at this table in saying that complexity is probably our greatest problem with the Internal Revenue Code now.

Let us take a couple of examples. Subchapter S corporations are limited to 75 stockholders, but you can go over that limit if you are willing to create a partnership with the subchapter S corporation and its owners.

Subchapter S corporations cannot have a non-resident alien as an owner, but a non-resident alien can go into partnership with a subchapter S corporation. It does not make sense to have to go through the back door. These rigid rules create unnecessary, archaic, and obsolete complexity and we hope they can be done away with.

Senator Hatch, in the last Congress, introduced S. 1415, an excellent bill with many provisions which would remove unnecessary restrictions on subchapter S corporations and which, combined with Senator Allard's bill, would not only solve many of the problems of the banks in operating in subchapter S form, but also the problems that general family-owned businesses have.

In my statement, I mention a number of initiatives that I hope will be taken. They do not cost much, but they would do a lot of good for subchapter S corporations.

One is removing or lifting the restriction on the number of shareholders. Another, as Mr. Bright mentioned earlier, is to provide for mezzanine capital that is necessary to attract capital to small business, and also necessary when the senior generation wants to move from common stock to preferred stock in the family company in order to assist that company's survival.

There are a number of other provisions that are worthy of this committee's examination, and will not create problems with revenues. This Congress should take a look at what is needed to make subchapter S corporations really workable, and to take the actions necessary to permit these companies to operate as pass-through entities, receiving the benefit that Senator Grassley mentioned of the reduction in individual rates, which may well come about, and continue to serve a very useful purpose for the more than 2,500,000 small businesses now operating as subchapter S corporations.

[The prepared statement of Mr. Alexander appears in the appendix.]

Senator BAUCUS. Thank you very much, Mr. Alexander.

I see we are joined by the senior Senator from New Jersey, Senator Torricelli, who I know, had he been here, would like to have introduced Ms. Turner, from New Jersey.

Senator, this might be an opportunity for you to make that introduction.

Senator TORRICELLI. Thank you. Thank you very much. I want to apologize to Ms. Turner. Only the fight on campaign finance re-

form, which is at the heart of every member of the Senate, would have kept me from being with you. But I appreciate you testifying before the committee.

Mr. Chairman, Ms. Turner has 26 years' experience in accounting. She can bring a unique perspective to this committee on the problems of small business. She has worked in the field for years. She had a very successful tenure with AT&T in financial management. She participated in the White House Conference on Small Business.

She has been a champion of the needs of small business through the years. She will add tremendous to the committee. I have already understood that her testimony was very helpful. I apologize to her again for not having been here.

But I am very grateful for her service in coming before the Senate today to offer her insights. Thank you for allowing me to share the comments.

Senator BAUCUS. Thank you, Senator.

Our final witness is Dr. Berney. Why do you not proceed, Doctor?

STATEMENT OF ROBERT E. BERNEY, PH.D., CHIEF ECONOMIST, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC

Dr. BERNEY. Thank you. My name is Robert Berney. I am currently the chief economist and acting director of Economic Research for the Office of Advocacy. But I have basically been a professor of economics at Washington State University for some 36 years.

So, I have a hard time talking about the economy without giving it kind of a macro perspective, but when I hear Joy Turner talking about the problems of small business, I agree with everything she says.

When I hear Skip Bright talking about the problems of banking, I agree. But from a perspective of a professor of economics and somebody watching small business for some six and a half years, since I go back and forth from the university to the Office of Advocacy.

Office of Advocacy, as you know, is the independent voice of small business. My testimony has not been cleared by SBA, the Office of Management and Budget, or the White House. It is my own testimony.

I have been asked to talk about two things. First, given the push for tax reduction, what tax reform provisions would be most helpful to small business, and, therefore, the economy?

Second, given the current economic conditions, what will be the impacts on small business if the economy slips into a recession? So I want to talk about those two things.

First, given the dramatic expansion of our economy during the 1990's and the late 1980's, a lot of foreign visitors that come to SBA ask, what are we doing that these other countries have not been doing?

My answer is, what we have done is unleashed entrepreneurship in this country. Our current data shows that if you look at job creation, 50 percent of all new jobs that have occurred in the 1990's came from small businesses with 20 employees and less.

Then another 25 percent of these new jobs were created by firms of between 20 and 500 employees. So, 75 percent of the net new jobs created in the United States, are created by small business. So that is one point.

These new small firms are innovative, they are leading to our increases in productivity. These small business, these under 20 employee firms, are creating this economic miracle that we have had in the United States.

It was not too many years ago that Wal-Mart came on the scene, as a small firm, got some bank loans, a lot of innovations on how to handle inventories, and now they are the number-one retailer in the world. This creative destruction that small firms bring about is important to nurture.

My emphasis is going to be: how do we help these potential gazelles of our economy? How do we help them to take off? How do we help them become the next Wal-Mart, the next Microsoft, giving our economy the employment growth, the innovation growth, that we have in the United States? This is truly supply-side economics developing programs for a small business.

What is a public policy perspective? Well, first of all, it is to ensure that we have a level playing field for different sizes of businesses, and in particular we need to make sure we have a level playing field for the start-ups, the firms that are just getting started, the potential gazelles.

What we want to do is allow for the maximum amount of competition in our economy, because that is what has caused this economic miracle that we have.

What we are talking about is helping the potential gazelles. We know that some 90 percent of small businesses are not filing corporation returns. So what we are concerned about, are tax policies that affect the individual income tax.

Whenever I am in front of a classroom talking about tax reform, just like Senator Grassley, I talk about equity, efficiency, but I use the term "adequacy" as the primary goals for tax reform.

What we are looking for is simplification. That is number-one in importance. The other, would be to broaden the base so that we can lower marginal tax rates.

Now, let me quickly get into talking about what we might see happen to the small business sector if we slip into a recession. Small businesses suffer more than proportionately in a recession, benefit more than proportionately in an expansion, small business tends to dominate the most cyclical industries. I have listed these in my testimony.

But what we need to make sure of, is if the economy does slip into a recession, we need to ensure that these small firms that are just getting started have the bank loans that they need, have the encouragement they need, can minimize their taxes so that they can get a fair start in the changing economy.

I will be happy to answer any questions that you might have.

[The prepared statement of Dr. Berney appears in the appendix.]
Senator BAUCUS. Thank you, Dr. Berney.

I would like to focus a little bit on rate reduction as it affects small business. This is meant to be just a good-faith examination as to really what does affect small business and what does not.

As you know, the President has proposed roughly \$1.6 trillion in tax cuts over the next 10 years. The basic question I have, is how that directly affects small business and agriculture in America.

It is my understanding that about 24 million small businesses are taxed under individual rates, and that according to Treasury, 75 percent of these, or 18 million, do receive some benefit from the administration's tax proposal. But about 600,000, or 2.5 percent, would benefit from reductions in the top two rates. That is, in the 36 percent bracket as well as the 39.6 bracket, which means that the remaining 17 million are roughly in the 15, 28, or the 31 percent brackets.

What I am trying to get at is, if Congress lowered the top marginal rate for individuals, say, in the 33, but left the top corporate rate as it currently is at 35, what effect would that have on small businesses, practically, where they convert to some pass-through entity like S corporations, partnerships, or sole proprietorships, or are there other non-tax considerations which drive small business decisions in terms of organization?

That is the basic question. Who has a strong feeling about this? Dr. Berney?

Dr. BERNEY. Well, I have a strong feeling. I think marginal reductions are good, but I think they should be equal across the spectrum. It seems to me what we want to do, is be sure that we are distributionally neutral over all the income levels.

So marginal reduction is fine, but again, my feeling is, from the supply side aspects of this, the tax cuts should be more focused on the smallest businesses, the ones that reinvest every dollar of savings into their business.

Senator BAUCUS. So you are saying what, that rate reductions should focus a little more on the other brackets, or equally on the 39.6?

Dr. BERNEY. I would say equally across the whole spectrum.

Senator BAUCUS. Even though not very many small businessmen are in the top two. It's 2.5 percent that are in the top two.

Dr. BERNEY. Right. I would say, let us lower each one, say, by 1 percent. That would be neutral across the rate structure.

Senator BAUCUS. All right.

Dr. BERNEY. Then focus the other money into encouraging small business the farms using the provisions that have been mentioned at this table.

Senator BAUCUS. Right. Other thoughts?

Ms. TURNER. My thoughts on that question are based on my own personal experience with small businesses. I do not really know of any businesses, personally, who pay the 39 percent. That is from my own point of view. My businesses do not make that kind of money.

I think that, in general, a tax rate cut could help across the board. But I believe that, in talking about what helps small business, we have to talk about targeted tax cuts.

We have to talk about some of the suggestions that we have included in the White House Conference Tax Chairs action plan, the reduction of meals and entertainment expense, the increase of the Section 179 expensing, and the other tax-type credits and deductions, allowance of the health care deduction for small business

people. I think that those are the types of tax benefits that would benefit small business somewhat more than just a general tax rate cut.

Senator BAUCUS. Mr. Stallman, do you have a view?

Mr. STALLMAN. With respect to the overall rate cuts, it would be certainly an incremental improvement for agriculture. Obviously, the majority of agriculture pays taxes at the lower rate levels.

But more helpful would be the more targeted ideas, particularly with respect to FFARRM accounts, which allows risk management to address the volatility issues we have in agriculture. Plus, a long-term structural benefit for agriculture is estate tax repeal, because repeal would continue the viability of farms and ranches from one generation or the next. Farmers would not have the ability to pass farms diminished by having to sell pieces and parts of farms and ranches for estate taxes.

Senator BAUCUS. Again, we all understand the importance of rate returns. Obviously, it does not hurt. It certainly helps. But also, obviously, there are a certain number of dollars. We have to make some choices. So you are suggesting, again, a little more targeted look.

You mentioned farm accounts, you mentioned estate tax. What about on rate reductions? Would you have them proportionate across the board? I am not trying to put words in your mouth. I am just wondering, because more are in the other brackets, would you focus a little more on those or not?

Mr. STALLMAN. Well, our policy really is not specific as to how those rate cuts should be distributed across the different brackets. Once again, in general, agricultural producers pay a lower rate level rather than a higher rate level, and there will be incremental improvement regardless of what methodology is adopted.

Senator BAUCUS. I want to thank you. I appreciate your testimony on CRP, and the payroll tax income with respect to CRP. That is just wrong, and I hope we can correct that with this tax bill.

Mr. STALLMAN. It would be beneficial.

Senator BAUCUS. Thank you very much. My time has expired.

Next on the list, is Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman. Thanks very much to our panel. I am pleased that we could get so many different perspectives.

Senator Torricelli was complimenting Ms. Turner from being from New Jersey. I still have to claim Mr. Alexander. He is a native of Pine Bluff, Arkansas. [Laughter.]

Mr. ALEXANDER. Yes, ma'am.

Senator LINCOLN. I still claim him.

Today, two million or so of our American businesses called S corporations operate under a long list of limits. Mr. Alexander, you mentioned a lot of those restrictions on the number and type of shareholders, and the type of debt and equity that they can hold, the type of income they can receive.

I guess, in our home State of Arkansas, Mr. Alexander, we have relatively new statutes which create limited liability companies, the LLCs. Like the S corporations, these LLCs enjoy limited liabil-

ity and are subject to only one level of tax. But they do not have the multiple restrictions that are talked about there.

I understand they work well and are very popular among small businesses and farming operations, family farms. I actually know that personally.

I guess my question is just very basic. Why is it that we continue to have any of these old regulations and limitations on the two million American small businesses, while new businesses that are organizing under an LLC really have none.

Mr. ALEXANDER. That is an excellent question. The answer is, it does not make much sense to have all the restrictions that we continue to have on subchapter S corporations, a form of pass-through entity, while we have no restrictions on LLCs.

Now, LLCs, of course, were sort of a creature of the Treasury Department, as well as one of the Wyoming legislature where they started, because one of the attributes of a partnership was that you couldn't have absolute limited liability.

Somebody had to be responsible for the partnership debts. Under an LLC, nobody is. You have got limited liability, you have got the partnership rules, the immense flexibility that partnership rules give, and you do not have any of these restrictions that we have got on subchapter S. Do these restrictions make sense any more? The answer is, they do not.

Senator LINCOLN. So there is no real reason why.

Mr. ALEXANDER. Well, there are a number of reasons expressed. I do not think that many of them make much sense. One of them is: simple rules for simple people. Well, LLCs are supposed to be for simple people as well as these sophisticated people just on the other side of the river from Senator Torricelli's State.

If you have these restrictions for subchapter S, why not have them for LLCs? If we are all going to be in shackles, let us all march around in 12-inch steps. That does not make much sense.

So, let us see what rules are necessary and what are not. In Senator Hatch's bill in the last Congress, he would have removed many of the current restrictions that do not make much sense and left in place those that do. Some do, many do not.

We have attempted to spell out in my little statement certain of them that ought to be removed, as well as the items that Mr. Bright mentioned that ought to be removed. Then we can have, not that level playing field, but we can have more equity between two types of flow-through business entities, one subchapter S and the other LLCs. Of course, there are also the "check-the-box" rules.

Senator LINCOLN. I have a very basic question that I know has a very technical answer, I am sure. By why can you not move from one to the other? Why is it not practical to move from a subchapter S to an LLC?

Mr. ALEXANDER. If you could move from a subchapter S into LLC, a limited liability company form, without a prohibitive tax toll charge, many people might do that. Now, banks cannot because they have to conduct their business in corporate form, and some other people cannot. But many could.

The problem is, right now, there is a huge toll charge on the gain at the shareholder level, and also the gain at the corporate level, if you have been lucky and been successful in your business.

Now, it has been suggested in the past that toll charge might be greatly reduced. But in the past, Treasury Departments have not found that to their liking.

Senator LINCOLN. Thank you. I am learning more and more and I appreciate your input.

I just want to compliment Mr. Stallman. Coming from a seventh generation Arkansas farm family, we appreciate certainly what the estate tax can do to us as farmers. I agree with you that passing it from generation to generation is really one of the key things in keeping continuity in the family farm.

I also want to applaud Senator Baucus and Senator Grassley for their FFARRM Act, which I have worked with them on the last several years and feel like that can be a real tool for our small businesses and family farms.

I will say, Mr. Bright, that when we had our last press conference on the need for family farmers, we included the local bankers, who came and were a very important part of our press conference.

Thanks, Mr. Chairman.

Senator BAUCUS. Thank you very much, Senator.

Next, Senator Torricelli?

Senator TORRICELLI. Thank you, Mr. Chairman.

Coming from a second generation suburbanite, let me focus my questions more directly. [Laughter.]

If this tax proceeds as I might imagine, and there are some of us who are committed to voting for comprehensive reduction in tax rates, in order to get members of my party to be part of this we are going to ask that certain deductions be added to the reductions in the marginal rates. This cannot be a very long list. It may be a list consisting of one or two things.

I think about the things in my State. What would impact middle income families the most? The range of possible deductions we could be adding to the Federal Tax Code would include \$5,000 or \$10,000 in college tuition, day care expenses, proceeding to the immediate and complete deduction of health care expenses, long-term care expenses.

But in the real world, only one or two of these things are going to be possible, and probably not the full deduction, either. No one can afford to do a full deduction of college tuition, given the rates of tuition in the country today.

But in your own experiences—let me start with you, Ms. Turner, and then anyone else who would like to join in—the things that you think for people operating small businesses on modest incomes, if you could add one of these things that you think would impact life the most, people that you would tend to care about the most, what would you change in the Tax Code, consistent with our theme in this hearing about protecting Main Street USA? What would you add that protects Main Street USA the most?

Ms. TURNER. Believe it or not, that is a pretty difficult question, because then I have to sort through all those really important things and just come up with one or two.

Senator TORRICELLI. That is the position we are in. So now I am shifting it to you. [Laughter.]

Ms. TURNER. Yes. I think the health care deduction is an extremely important one if we are talking about deductions for the small business owner on Main Street. That is a really important one.

I think Section 179 is really an important one as well, because today many of the small business people I know who are attempting to expand or just keep up with technology in today's world are expending much more than the minimum allowance that is currently available under Section 179.

I think it would help them to be able to expense those types of business expenditures immediately rather than having to go into long, lengthy depreciation schedules. As far as families are concerned, my own selfish interest would say that tax credits for children going to college would be a wonderful thing.

I have a granddaughter who is heading to college right now, and I think that tax credits would be very beneficial to parents with those children. But then we are talking about a smaller part of the population, because when we look at Main Street we are not talking about everyone with children, or college-aged children, we are talking about just the general business owner on Main Street. Then we have to say, strictly business expenses, like the meals and entertainment expense, the Section 179, and the increased 100 percent deduction for health care.

Senator TORRICELLI. We in a similar position. The question has been asked to me, but I am seeking confirmation on it, that for business purposes, it appears to me doing something about the cost of the health care expenses would be the principal thing you could do for small business.

Ms. TURNER. Absolutely.

Senator TORRICELLI. But for middle income families, nothing, including rate reductions, would do more for financial security of families than deductibility of, partial, at least, college costs.

It appears to me, for the best of reasons, that people are so devoted to their own children they will do anything, including depleting their retirement savings, using the equity in their homes, encountering enormous debts.

Ms. TURNER. Right.

Senator TORRICELLI. Whatever is required to educate those children. It is impacting both the quality of life, and more importantly the financial security, of individual families or their small businesses in order to meet that need.

Ms. TURNER. It is also, I think, insuring the future of America, because with the more students we have educated, the better able our country will be to compete in the years ahead.

Right now, we have problems with skilled labor or people with highly technical backgrounds in education.

Senator TORRICELLI. Yes. There is no question about that.

Ms. Turner, under the unbelievable rules of this committee, if I can get a question in before that light goes red I get a second question, and then I get additional time for you to answer. So, let me talk very fast and get a question in. [Laughter.]

Senator BAUCUS. You take as long as you want.

Senator TORRICELLI. On the inheritance tax, one of the things that surprised me in looking at the inheritance tax issues—let me

put this out to everybody—is the remarkable negative impact it has on people creating small businesses.

I have read statistics that two-thirds of small businesses are unable to be passed on to a third generation, because in paying the tax after death it is necessary to destroy the business in order to meet their Federal obligations.

Interestingly, I have read recently from a group of minority business owners that this is becoming an acute problem now in the minority community, where people have created small businesses, have the struggle of their lives to create these businesses, only to have it destroyed upon death by paying the Federal income tax.

Is this an acute a problem as I have read? Do you share this assessment of it? If you do, if you could fix for the committee, recognizing we are trying to lose as little Federal revenue as possible—in a perfect world you would repeal it entirely. That is, probably financially untenable.

What is a level at which we are really reaching the small business person who cannot afford to pay this? What is a threshold, \$5 million? A \$10 million threshold where we are getting people out of harm's way without unnecessarily losing Federal revenue?

Mr. ALEXANDER. You want me, the tax collector to say something on that one? First, I would like to comment, if I could, on the last question. I would hope that the committee would give careful thought to the additional burden on the American taxpayer and the addition burden on the Internal Revenue Service that has to try to administer our tax laws, adding anything to the Internal Revenue Code that really is disguised spending, spending through the Internal Revenue Code.

Now, we do have serious educational problems. We do have needs that must be met. One of the things that we have outside of the Internal Revenue Code are PELL grants. PELL grants work very well. PELL grants, I hope, will be greatly expanded.

Putting a deduction in the Internal Revenue Code for something that has nothing to do with the computation of income, but has a lot to do with national needs, is simply spending—disguised spending, if you will—that I think, as a former tax administrator, could be better handled directly rather than indirectly.

Moving on to estate taxes. You have some provisions in the Code now, that do not work, that are intended to try to solve the problem of the family business and the family farm. They do not work. Why? Because they have too many restrictions. Besides, the exclusions are not big enough.

Suppose you manage to take advantage of, say, Section 2057, or 2032(a)—one of which was only recently put in the Code, the other has been in the Code a little while—try to ease some of the heavy burden that falls when the owner of a successful small, independent business dies.

You find, among other things, that you have got to keep the business operating as such for about 10 years, because there is a look-back rule, for goodness sakes, in 2057. That does not make much sense.

So if you take those provisions, put them together, clean them up, simplify them, and give a high enough number, \$5 million, \$10

million, you can exempt substantially all of the closely held family businesses in this country.

You can exempt the same number of farms. You can keep an estate tax that falls where it should fall, with lower rates and a higher exemption. That might be a good way out to solve the problem of the revenue number that seemed to create concern in the House this week.

Senator LINCOLN. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator.

I would like to follow up a little bit on this discussion. I think this is very helpful, particularly on Federal estate taxes, because—and I do not know if it is accurate or not—there was a report in the papers the last couple of days that the computation of the President's proposal is a lot more expensive than he had earlier suggested.

We are caught with the problem that Senator Torricelli is mentioning. Namely, how do we help people out, particularly small business and agriculture because that is the category of people that really need the most help, yet fulfill our responsibilities here in meeting other needs?

When Mr. Alexander was speaking, I noticed you, Mr. Bright, somewhat nodding your head. I was wondering the degree to which you agree with the approach Mr. Alexander is taking, and I want to ask the same question then of Mr. Stallman.

Mr. BRIGHT. I think that where it hits me and where it hits our business, is that banks are small businesses. Sharing earlier that, out of 430 banks in the State of Iowa, 385 are banks under \$100 million in assets. We deal with family farms and small businesses on a firsthand basis. I know all of my customers.

I also know that the majority stockholder in my bank who owns 63 percent, the day he passes away, will trigger a series of events that will result in the sale of my bank because of the estate tax burden.

I have a friend who, unfortunately, passed away in the prime of life, and had taken a business that was an absolute failure in the middle 1980's, turned it into a raging success in the late 1990's. His family had to sell a small manufacturing business to settle estate taxes.

I think it is patently unfair to the future of this country to require that an asset be sold to settle these kinds of situations. My particular bank has been in the same family for 132 years.

Senator BAUCUS. This committee would agree with that. I am quite certain I speak for every member of this committee. The question, really, is the degree to which the solution outlined by Mr. Alexander will solve the bulk of the problem in the country.

That is, cleaning up the family-held business provisions and raising the exemptions up, as Mr. Alexander suggested, to \$5, \$10 million, something like that. How much of that will solve the bulk of the problem for your customers and people who live in your community?

Mr. BRIGHT. It would solve the problem for 99 percent of my customers and the people in my community. We are not the Walton family. Everyone in Southeast Iowa, basically, is in some kind of

an agricultural-related industry, whether it is a bank that loans money to farmers or actual producers.

Senator BAUCUS. Mr. Stallman?

Mr. STALLMAN. We have talked about this internally for quite a few years, about, raising exemptions. Does that solve the problem? Or repeal? We have come down on the side of repeal for the simple reason that, no matter where you set that bar, the uncertainty still exists.

Tell me what land prices are going to do in any given area in the next 10 years with respect to agricultural land. That is one of the problems we are facing. So an increased exemption does not remove the need for expensive planning, which farmers and ranchers very often cannot afford.

It also still leaves a tax policy in place that discourages savings and investment and encourages consumption. In essence, that is the basic flaw with estate tax. Plus, when you get up to a certain level, the “mega-rich” have the money to hire lawyers so they do not pay the tax.

Senator BAUCUS. I hear you. To be absolutely candid about this, I do not know that we have the money for total repeal. If we do not have the money for total repeal, we have to find what we can do to help solve the problem.

I think cleaning up the family-held provisions, as well as the market value of provisions, as well as raising exemptions very substantially, I think will go a long way. We may be forced into an approach like that because we just do not have the money for total repeal.

Dr. Berney, you mentioned that, in a downturn—and God knows, we hope we do not have a downturn, but sometimes that happens—that small business is disproportionately adversely affected. Could you outline some of the reasons why?

Then, second, what can we do to address that and help level the playing field? At the very best, we do not want small business to be hurt, but we particularly do not want it to be disproportionately hurt compared with other businesses, presumably C corporations.

Dr. BERNEY. I think part of it is the nature of small business. The construction industry is heavily dominated by small business. A lot of the areas where small business exists tends to be more cyclically sensitive. So, that is part of the problem.

But I think the other part of the problem, is through the credit crunch of the 1990's we saw that, once the economy appears to be in recession or going to a recession, bank regulators tighten up the regulations. This forces the small banker to tighten up their lending to small firms.

So if we can get the bank regulators to be consistent over time, and if we can encourage the banks to keep lending. It seems to be happening at this point. If you look at the senior loan officer surveys, the last two surveys, the tightening up in the credit market is not on small business where it normally occurs first, but it is tightening on middle and larger firms because that is where the defaults are.

So it seems to me the senior loan officers are beginning to understand that it is not small business en masse that are the problem. It is the ones that have expanded too fast, and these are normally

the medium and larger firms. So, if we can maintain a good monetary policy, a good bank regulatory policy, that will certainly help.

Senator BAUCUS. Even if, say, the Federal Reserve lowers the fed funds rate, you are saying that the regulators tighten up on the other hand.

Dr. BERNEY. Right. That certainly happened during the credit crunch period. The regulators tightened up. Again, that means that small businesses are hurt, because the regulators work on the small banks. The small banks are the primary lenders to small business in the farm communities.

Senator BAUCUS. But you are saying that the real money is not so much in small business, it is maybe the mid-size. That is where they should tighten up more.

Dr. BERNEY. Yes. That is what appears to be happening this time around, which is unique.

Senator BAUCUS. Mr. Bright, do you have a thought on that?

Mr. BRIGHT. Having worked through the last downturn in the economy in banking, I can speak from some experience that the regulators do land had on banks during times of downturn. However, I feel like the onus is probably on the bank to do a good job of lending up front, and then provide appropriate guidelines for their borrowers.

The borrowers who get you in trouble are the people who are out there pushing the envelope. They are not the ones who are running a business with some conservatism, and the like.

At the same time, when a regulator is standing in front of you and criticizing some of what you consider your best credits, it does make you pull back. The availability of credit maybe does not dry up. It is the stringency with which you adhere to dotting the i's and crossing the t's. I think that, in small banks, that creates a problem.

Senator BAUCUS. I appreciate that. I do not know what I am going to do about that, but it is important to know that.

Dr. BERNEY. Could I add one more thing?

Senator BAUCUS. Yes. Sure.

Dr. BERNEY. One of the things that you want to be careful about, is that we do not have government cutting back. Take, for example, the Small Business Administration. Their lending patterns in the past have been somewhat counter-cyclical.

If we move into a recession, allowing the Small Business Administration to make more loans would be an important way toward helping the small banks and help the bank regulators because they would feel more comfortable about an SBA guarantee than they would be about just a regular small business loan.

Senator BAUCUS. Thank you.

Senator Lincoln?

Senator LINCOLN. Thank you.

Just briefly, in my home State of Arkansas our small businesses are our largest employers. So, being able to provide them the kind of assistance that they need to grow and be solvent is important.

When I listen to them, the one consistent thing I hear from small businesses is something Ms. Turner mentioned briefly in the list when Senator Torricelli asked her about the one thing that would

be most important, and that is depreciation, improving on our depreciation schedule.

So I guess it is a two-part question. One, is how important is that, and how productive could that be for small businesses? To Mr. Alexander, from your tax standpoint, what is the revenue cost if we were to go into those depreciation schedules, if that were to be the one thing that we could do that would really help grow small businesses? Any comments from you all about how productive that would be for us?

Ms. TURNER. I think that would be very productive, if we are only talking about the Section 179 expensing, because that would improve the cash flow for small business.

It would allow them to be able to expense the items for technological improvement and business expansion in the year that they incur the expense rather than carrying it over a period of time.

I do not know about the revenue impact, as Mr. Alexander would know.

Mr. ALEXANDER. Regrettably, I do not know about it either, because I am constantly amazed by the enormous revenue impact of things that I thought had little impact, and the lack of impact of things I thought were going to be big. I would have to call on Joint Staff there.

But I agree with Ms. Turner on the 179 expensing. I think it is a great simplification. I think it is a good idea. I think it takes away a lot of problems in tax administration and a lot of expense for taxpayers, particularly small business taxpayers. Raising that number would be, I think, a good idea. How much money would be put on it? I do not know.

As to depreciation generally, I have a problem, and the problem is of two dimensions, benefit and revenue. The real issue is whether you can recover your cost that the small business, the independent business, incurs in making a needed improvement, in adding needed equipment whether you can recover it from the tax standpoint in sufficient time to prevent a tax penalty being placed on you for doing something that is clearly in the interest of your business.

In other words, I am in favor of quicker, rather than slower recovery. I am in favor of understandable rules rather than complex rules, seeking perfection is illusory, and if you find it you are not going to keep it in this imperfect world.

I would hope that we would follow up on Treasury's recent depreciation study with an examination of what these rules ought to be. They ought to be simple without being arbitrary. They ought to give the taxpayer quicker, rather than slower, recovery when the recovery period is in doubt. I am thinking of computer software, among other things.

Senator LINCOLN. Right.

Mr. ALEXANDER. And they ought to be reasonably fair and surely understandable. Do we have that now? No.

Senator LINCOLN. Does anybody else have comments on depreciation?

Mr. STALLMAN. Well, the Section 179 expense deduction is something that is very beneficial to farmers and ranchers. We are prob-

ably operating with some of the oldest equipment as an industry, and it is necessary, obviously, to replace over time.

But, given the income problems that the farmers and ranchers have had, it is very difficult. Increasing that expense deduction would certainly make it easier—for producers to make those decisions and improve their cash flow in the process. That is a very important component of farm and ranch investment planning.

Senator LINCOLN. Thanks.

Mr. BRIGHT. Senator, I would just like to add, once again, that banks are small businesses, too. Technology is outrageously expensive. Small banks suffer disproportionately to large banks because of the cost of technology. This would be extremely beneficial for those small businesses which are banks, and I would encourage you to seriously consider it.

Senator LINCOLN. Thank you.

Dr. BERNEY. I think simplification, the expensing, makes a lot of sense. Let us not forget that cash accounting would certainly simplify tax returns for small business and make it that much easier for them. There are a lot of limits that have been placed. You mentioned the \$5 million, or \$1 million, or whatever. A lot of these limits should be adjusted for price changes. What was a good thing 10 years ago is not good now, so a lot of these ought to be increased. We allow write-off now for a car at \$14,400. You cannot buy a van to make your deliveries at that price. That should easily be raised, and software packages, and other things of this sort—need to be adjusted for price changes.

Senator LINCOLN. Certainly high tech needs to come much more. Thank you.

Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Senator, very much. This has been very helpful. One of the things that has become more clear, is, clearly, the problem of complexity, that is, the provisions and so forth.

I am very hopeful, and I know I can speak for the Chairman, in saying we are going to do what we can to get rid of the complex provisions that are needlessly there. If anything else, that is to provide a service to the small business people. But, in addition to that, there are specific tax provisions. I appreciate the testimony on the FFARRM accounts, that is certainly going to help agriculture, and other suggestions that you all have made.

I just thank you very much for taking the time. We are going to do our best to enact as much of the recommendations you mentioned as possible, because I think there is virtual agreement in this committee that you are basically on target, and we just have to figure out a way to do it.

Thank you very much.

Senator LINCOLN. Thank you.

Senator BAUCUS. The hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF DONALD C. ALEXANDER

My topic is the need for reform and simplification of the restrictive rules, largely enacted over 40 years ago, that still shackle the more than 2,500,000 Subchapter S corporations in the United States. While a number of constructive changes were made in 1996, much remains to be done to permit family-owned corporations and banks to conduct their businesses through an entity that provides both limited liability and a means of passing through the entity's income to its owners.

As you know, some years ago Subchapter S corporations were the entity of choice if the owner of a small business wished to obtain the benefits of operating through the corporate form (limited liability) without suffering the detriment of double taxation on the business's earnings. However, after the Treasury's blessing of the limited liability company, plus the Treasury's adoption of check-the-box rules, partnership tax treatment (correctly called "tax nirvana") has been conferred upon entities that were not formerly treated as partnerships. Limited liability companies are clearly preferable to Subchapter S corporations from the Federal tax standpoint; examples of favored treatment are the partnership basis rules (partner's basis includes partnership debt) and liberal disproportionate allocation rules. But some entities, like banks, must conduct their businesses in corporate form and others need to do so. These must use Subchapter S. Moreover, many Subchapter S corporations are locked in to elections made years ago; while they might now prefer to adopt the tax-favored partnership form, they cannot without a heavy tax toll charge. Subchapter S corporations are found on Main Street, not Wall Street. They are not asking for the famous "level playing field," i.e., the favored tax treatment granted to partnerships. Instead, they are simply asking that some of the fetters imposed in another era be removed.

Some past Treasury tax policy officials, particularly those whose practice was concentrated on deal making through partnership "flexibility," have not been responsive to the proponents of Subchapter S reform. Among the reasons for opposition is the notion that while it is fine for partnerships to seek and obtain tax advantages through a sea of complexity, Subchapter S must be kept simple for simple people. By confusing rigidity with simplicity, this notion creates complexity. Examples are the rules prohibiting a nonresident alien from being a stockholder in a Subchapter S corporation and limiting the number of Subchapter S stockholders. Example 2 of Reg. § 1.701-2(d) shows that a nonresident alien (or the 76th stockholder) can participate in a Subchapter S corporation's business by becoming a partner with the Subchapter S corporation. Why require this maneuver? Why not permit the nonresident alien, or the 76th stockholder, to come through the front door?

When she testified for the American Bar Association Tax Section before the House Committee on Small Business on the impact of the Code's complexity on small businesses, Ms. Pamela Olson, now Deputy Assistant Secretary of the Treasury (Tax Policy) stated:

The definition of an "S corporation" contained in section 1361 establishes a number of qualification criteria. To qualify, the corporation may have only one class of stock and no more than seventy-five shareholders. Complex rules provide that the shareholders must be entirely composed of qualified individuals or entities. On account of state statutory changes and the check-the-box regulations, S corporations are disadvantaged relative to other limited liability entities, which qualify for a single level of Federal income taxation without the restrictions. The repeal of many of the restrictions would simplify the law and prevent inadvertent disqualifications of S corporation elections.

The Impact of Complexity in the Tax Code on Small Businesses: Hearing Before the House Subcomm. on Tax, Fin. and Exp. of the Comm. on Small Bus., 106th Cong. (statement of Pamela F. Olson).

Ms. Olson is right. S corporations are indeed disadvantaged, these restrictions are extremely complex, and their removal would greatly simplify the law for Main Street businesses.

These simplifications should include, at least, the following:

1. S corporations should have access to senior equity by the issuance of preferred stock, as well as bank directors' qualifying shares. Payments to owners of such stock or shares should be treated as an expense to the S corporation and ordinary income to the shareholders.

2. The number of S corporation eligible shareholders should be increased from 75 to 150 over a four-year period, thus helping community banks to broaden their ownership and Subchapter S corporations to provide equity to key employees. Members of a family should be treated as one stockholder, as they are for other purposes of the Code.

3. The current draconian rule that terminates S corporation status for corporations that have both subchapter C earnings and profits and that derive more than 25 percent of their gross receipts from passive sources for three consecutive years should be repealed.

4. Capital gains should be excluded from classification as passive income. Capital gains would be subject to a maximum 20 percent rate at the shareholder level, thus conforming to the general treatment of such gains as well as their treatment under the personal holding company rules. Also, interest and dividends on investments maintained by a bank for liquidity and safety and soundness purposes should not be treated as passive income.

5. Nonresident aliens should be permitted to own Subchapter S stock, subject to the limitations applicable to partnerships.

6. Subchapter S corporations should be permitted to issue convertible debt.

7. The provisions relating to qualified subsidiaries of a Subchapter S corporation and relating to trusts permitted to own Subchapter S stock should be modified to make them workable and useful.

Most of the improvements listed above were contained in Senator Hatch's bill, S. 1415, and Representative Shaw's bill, H.R. 689, in the last Congress. As Representative Shaw stated on introduction of his bill:

Today over two million businesses pay taxes as S corporations and the vast majority of these are small businesses. The Subchapter S Revision Act of 1999 is targeted to these small businesses by improving their access to capital preserving family-owned businesses, and lifting obsolete and burdensome restrictions that unnecessarily impede their growth. It will permit them to grow and compete in the next century.

Cong. Rec. E196 (Feb. 10, 1999) (statement of Rep. Shaw).

S corporations operate in every business sector of every state. Typically, they are family-owned and operated businesses or otherwise closely-held organizations that have been reliable engines of job growth and productivity for the domestic economy. The rules adopted in 1958 when S corporations were created, and as subsequently amended, are out of sync with modern economic realities. The S corporation reforms we propose would address the troubling gap between the antiquated laws established forty years ago and the operating and capital needs of S corporations today. These reforms were developed after careful and thorough study. In short, these reforms would provide the boost, at a critical time, that thousands of small businesses in America need to continue the growth of American entrepreneurship and competitiveness, and they have the strong support of Main Street business organizations, such as the National Federation of Independent Business and the Chamber of Commerce.

PREPARED STATEMENT OF ROBERT E. BERNEY, PH.D.

Good morning. My name is Robert E. Berney. I am currently Chief Economist and acting Director of Economic Research for the Office of Advocacy, U.S. Small Business Administration (SBA).

The Office of Advocacy, created by Congress in 1976 to serve as an independent office for data gathering, analysis and advocacy regarding the role of small business in the economy, is a unique government agency. Although housed in the Small Business Administration, the office is headed by a separate presidentially appointed, Senate-confirmed Chief Counsel for Advocacy. The Chief Counsel in turn appoints professional staff to renewable annual appointments based on needed expertise, not

political or civil service status. In addition, Congress expects the Office of Advocacy to present testimony, reports, conferences, etc. that are independent of review by SBA, the Office of Management and Budget and the White House.

As of today President Bush has yet to nominate a Chief Counsel for Advocacy. Therefore, my testimony today presents my own views, based on research conducted or sponsored by the Office of Advocacy as well as my 38 years as a Ph.D. trained economist. I have been either the chief economist or chief economic advisor for Advocacy three times while on leave from Washington State University, where I spent most of my academic career. My primary areas of teaching at the graduate and undergraduate levels and research interests were macroeconomics, public finance as well as money and banking. Since my first stint with Advocacy, my research interest has centered on small business economic issues.

This testimony will stress two important aspects about small business. First, given current economic conditions, what will be the impacts on the most dynamic sector of the economy if it slips into a recession? Second, given the push for tax reduction, which provisions would be most helpful for small business and, therefore, the economy?

INTRODUCTION

I sincerely believe that economics is the all-important academic discipline for making the world a better place. That is why I am a teacher of economics and why I have brought my economics training into government.

At a simplified level, microeconomics teaches us that to have perfect competition there must be many buyers and sellers in each market; as well as ease of entry and exit in these markets. Therefore working for the Office of Advocacy has been a significant part of my career of teaching and researching economics. While teaching college students has appeal, improving the environment for small firms by increasing our understanding of the importance of small firms in the U.S. economy and what is needed to nurture them to improve the competitive environment is a higher calling.

My understanding of the causes of the dramatic expansion in our economy in 1980s and 1990s was that entrepreneurship was unleashed, increasing the amount of competition in not only the high tech but also the low tech areas of our economy. Because of this, a wave of what economists call "creative destruction" took place with large firms reorganizing and downsizing, and small firms with some great new ideas becoming the rapidly growing firms or the 'gazelles' in the economy as well as becoming the dominant firms in their industries (e.g. Wal-Mart and Microsoft). Advocacy's research has shown that some 75 percent of the net new jobs created in our economy have come from small firms (firms with fewer than 500 employees); and some two-thirds of these net new jobs were created by firms with fewer than 20 employees.¹

It is a fact that in the past two decades the U.S. has had the most vibrant economy in the world and I believe that is due to the entrepreneurial nature of our economy. The Global Entrepreneurship Monitor (GEM) is a research effort that puts entrepreneurial activity into a global perspective. Two recent GEM reports show how the U.S. has a more supportive entrepreneurial environment than any of the countries with whom we compete. (Japan typically comes in last in GEM's rankings.²)

From a public policy perspective it is important for the economic success of this country to:

- (1) ensure there is a level playing field for firms of different sizes and ages, that is to ensure that tax and regulatory policy do not create undue burdens on start ups and on existing small firms,
- (2) ensure that market failures do not discourage start ups and the expansion of existing small firms (e.g. the availability of debt and equity financing for small firms).

With the changing economic conditions in the U.S. today, one area where the playing field may not be level is the impact of a recession on small firms.

¹*The State of Small Business, A Report of the President, 1998*, Chapter 2, "New Data for Analysis of Small Business Job Creation", United States Government Printing Office 1999.

²Andrew Zacharakis et al, and Paul Reynolds et al, *Global Entrepreneurship Monitor, National Entrepreneurship Assessment, United States of America and Global Entrepreneurship Monitor, 2000 Executive Report*, Kauffman Center for Entrepreneurial Leadership, 2000.

THE EFFECTS OF A RECESSION ON SMALL BUSINESS

The Office of Advocacy turned out a number of studies in the 1980s exploring the impacts of recessions on small business.³ More recent information (early 1990s) has been generated on the impacts of a credit crunch on small business.⁴ Given the current changing economic conditions, the Office of Advocacy has this topic in our draft Request for Proposal to see if researchers have developed new information on the impacts.

What have we learned:

1980s

1. Small businesses suffered more than proportionately in recessions and benefited more than proportionately in expansions. Small businesses tended to dominate the most cyclically sensitive industries—wholesale trade and construction—and were more cyclically sensitive than large firms in the service, manufacturing, finance, insurance and real estate industries.

2. Business starts appeared to vary cyclically and therefore tended to decline in a recession while business dissolutions appeared to be random.

3. During business cycles, small business tended to have longer recession phases and shorter recovery phases than large business or the economy as a whole.

4. Self-employment appeared to be counter-cyclical. When people lost their jobs, they often become self-employed. When jobs become plentiful and wage and benefits packages were increasing, self-employment declined.

5. Survival rates for the self-employed were lower in a recession, partially due to the lower availability of capital for starting or acquiring a business. This was particularly true for women.

1990s

1. Loan losses at commercial banks, forced banks to reduce the supply of bank credit. Since small businesses are more dependent on commercial banks for their credit needs, real economic activity of small business shrank by more than large business, confirming the results in 1.

2. Small banks shrank their loan portfolios considerably more than large banks during the credit crunch, so small businesses that rely on small banks for credit were most vulnerable.

3. Bank regulators toughened their standards during the recession/credit crunch period, reducing the amount of bank lending.

The evidence is suggestive that small firms are affected more severely in a downturn. And once a recession has started it can be made worse by inappropriate bank regulatory policies or perverse fiscal policies. A strong counter-cyclical public policy of reducing interest rates, lowering taxes and increasing federal expenditures is appropriate. Countercyclical measures that are specifically focused on small firms would level the playing field of negative impacts and would likely reduce some of the negative employment effects.⁵ But the lags in the impacts reaching the economy need to be considered in selecting appropriate policies.

SUPPORTING ENTREPRENEURSHIP

The entrepreneurial small firms that are so important for the economic health of the nation tend to be starved for growth capital. Every dollar of profit or tax relief tends to be re-invested in the firm. Consequently, if one expects the federal budget to be in surplus of over the longer run so that tax adequacy is not a concern, tax relief for entrepreneurs will provide desirable supply-side benefits.

Besides adequate capital, what tends to limit the growth of entrepreneurial firms is the inability to find and keep qualified employees. Policies to help fund and sim-

³For example, see: Joel Popkin and Company, *An Analysis of the Effect of Recessions on Small Business Output*, Small Business Research Summary, October 1982 and Richard Boden and Alfred Nucci, "On the Survival Prospects of Men's and Women's New Business Ventures", mimeograph.

⁴Diana Hancock and James Wilcox, "The 'credit crunch' and the availability of credit to small business", *Journal of Banking and Finance*, vol. 22, August 1998. Allen Berger et al, "Did U.S. Bank Supervisors Get Tougher During the Credit Crunch? Did They Get Easier During the Banking Boom? Did it Matter to Bank Lending?", forthcoming in *Prudential Supervision: What Works and What Doesn't*, Frederic S. Mishkin, ed. University of Chicago Press.

⁵For example, a strong counter-cyclical SBA lending policy to potentially profitable firms being squeezed out of the credit market could be useful. Banks respond to their declining net worth and the growing feeling by regulators and bankers that all small loans are risky. Such a lending policy could shorten the recession, reduce some of the negative employment effects, and make the distribution of the negative impacts of the recession more equitable among businesses of different size.

plify needed health care and pension plans is crucially important to help the small entrepreneurial firms that I am concerned with grow and prosper.

Small businesses provide many workers with their first jobs. Small firms also are better able to accommodate workers needing flexible, part-time or other special schedules. However, small businesses have difficulty competing with large employers on benefits, in part because of the complexity and frequent changes in law regarding many types of employee benefits. Small firms cannot afford to devote the resources needed to administer, and keep abreast of changes in benefits tax laws and regulations. As a result, small businesses are at a competitive disadvantage in attracting and retaining the large numbers of workers for whom pensions, health coverage and other benefits are important.

Provisions that would give small businesses a tax credit or other incentive to start providing pension or health coverage for workers can help offset the steep "learning curve" and startup expenses of putting a plan in place and making the owner familiar with the necessary law and procedures. To be effective, such provisions must offer small businesses a degree of certainty that they can continue to rely on the law. In addition, they must be relatively simple and have broad enough eligibility that they do not create further distinctions among otherwise similarly situated small businesses.

TAXATION

Before discussing specific categories of tax policies that are important for small business, I'd like to make a couple of observations. First, I would note that approximately 90 percent of small businesses are taxed at the individual, not the corporate, level. A recent fact sheet from the Treasury Department's Office of Tax Policy states:⁶

There were in 1998, (the most recent year for which data are available) about 24 million businesses organized as flow through entities:⁷

- 17.1 million sole proprietorships,
- 2.1 million farm proprietorships,
- 1.9 million partnerships, and
- 2.6 million S corporations.

Therefore, tax changes to keep small businesses healthy and competitive should focus on the individual income tax.

Second, in every public finance class that I have ever taught, whenever I would talk about tax reform or tax change, I would discuss the concepts of *equity*, *efficiency*, and *adequacy*. Briefly, *equity* deals with treating equals equally⁸ and treating those with more ability to pay differently from those with less ability to pay. *Efficiency* deals with minimizing the burdens and costs of collecting taxes both to the government and to the taxpayer. Thus, a basic rule of improving both *equity* and *efficiency* in tax reform, is to

- (1) broaden the base on which taxes are calculated so that the marginal rates can be lowered and
- (2) simplify the calculations.

Adequacy has to do with raising the necessary revenue to cover the services that government provides. Currently this does not seem to be an important issue in the public finance of the federal government.

For small business, *equity* generally means that the tax rates paid by owners are not distorted by hidden phase-outs, limitations and alternative minimum tax (AMT) calculations. In addition, tax rates should be low enough and graduated gently enough from one bracket to the next so that the tax system does not introduce unreasonable distinctions between competitors at different income levels.

Efficiency implies that business owners are not forced to spend undue amounts of money or time (which would otherwise be devoted to the business) on learning the law, record keeping, filing returns and planning tax strategies. Moreover, the tax system should not drive owners to choose one legal form of organization over another, for instance by having lower rates and relief from AMT only for C corporations.

⁶"Flow-Through Entities That Benefit from the Administration's Tax Cut Plan," U.S. Department of the Treasury, Office of Tax Policy, February 12, 2001 (received via e-mail).

⁷In fact, the Internal Revenue Service estimates that there were even more nonfarm sole proprietorships in 1998: 19.4 million when multiple Schedule C's of individuals and couples filing joint returns are counted separately. Thus, there were 24 to 26 million businesses taxed at the individual level, compared to roughly 2.6 million C corporations.

⁸All people with equal incomes under the same circumstances should pay the same amount of tax.

In the current surplus environment, reducing revenue adequacy would insure small business receive an appropriate share of the tax relief that goes to businesses taxed at the individual level.

In addition, the Tax Foundation continually points out that for most small business the cost of record keeping is greater than the taxes paid by them, a clear inefficiency.⁹ So any tax reform proposal that simplifies the record keeping requirements for small businesses will improve efficiency in two ways. First, it will make the tax system more efficient and secondly, and more importantly, it will make the economy more competitive, and therefore more efficient. A number of tax proposals that simplify the tax preparation and provide direct benefits to the entrepreneurial small firms have been discussed over the past few years by various small business tax experts:

Alternative Minimum Tax Relief

For individual taxpayers, the individual AMT has become an increasingly burdensome stealth or backdoor tax, raising the marginal tax rates on those taxpayers that must pay it. For the sole proprietors, partners, and S corporation shareholders, the individual AMT increases their tax liability by limiting depreciation and depletion deductions, net operating loss write-offs, the deductibility of state and local taxes, and expensing of research and experimentation costs. In addition, because of its complexity, this tax forces small business owners to waste precious funds on tax professionals to determine whether the AMT even applies.

Clarification of Cash Accounting Rules for Small Businesses

It has been suggested that section 446 of the Internal Revenue Code should be amended to provide a clear threshold for small businesses to use the cash receipts and disbursements method of accounting, instead of requiring accrual accounting. To qualify, the business must have, say, \$5 million or less in average annual gross receipts based on the preceding three years. In addition, a taxpayer meeting the average annual gross receipts test should not be required to account for inventories under section 471. The taxpayer should be required to treat such inventory in the same manner as materials or supplies that are not incidental. Accordingly, the taxpayer could deduct the expenses for such inventory that are actually consumed and used in the operation of the business during that particular taxable year.

Increase in Expense Treatment for Small Businesses

Section 179 of the Internal Revenue Code could be amended to increase the amount of equipment purchases that small businesses may expense each year beyond the current \$24,000. This change would eliminate the burdensome record keeping involved in depreciating such equipment and free up capital for small businesses to grow and create jobs.

Another proposed change would raise the phase-out limitation for equipment expensing from the current \$200,000 to some higher figure, thereby expanding the type of equipment that can qualify for expensing treatment. This limitation along with the annual expensing amount should be indexed for inflation.

Following the recommendation of the National Taxpayer Advocate, a related change would amend section 179 to permit expensing in the year that the property is purchased or the year that the property is placed in service, whichever is earlier. This would eliminate the difficulty that many small firms have encountered when investing in new equipment in one tax year (e.g., 2000) that cannot be placed in service until the following year (e.g., 2001). In addition, expensing of computer software up to, say, \$50,000 might be desirable.

Modification of Depreciation Rules

The outdated depreciation rules that permit taxpayers to depreciate computer equipment and software over a five-year and a three-year period need to be amended. With the rapid advancements in technology, these depreciation periods are sorely out of date and can result in small businesses having to exhaust their depreciation deductions well after the equipment or software is obsolete. A change to two years would make the tax code in this area more consistent with the technological reality of the business world.

⁹J. Scott Moody, *The Cost of Complying with the U.S. Federal Income Tax*, Tax Foundation, November 2000. Their studies as well as ours (which includes the cost of regulation and paperwork in all of government, not just IRS) show that the relative burden are greater on the smaller firms. See: *The Changing Burden of Regulation, Paperwork and Tax Compliance on Small Business: A Report to Congress*, Office of Advocacy, U.S. Small Business Administration, October 1995. This report is currently being updated.

A related change would amend section 280F of the Internal Revenue Code, which limits the amount of depreciation that a business may claim with respect to a vehicle used for business purposes. Under the current thresholds, a business loses a portion of its depreciation deduction if the vehicle placed in service in 2000 costs more than \$14,400. Although these limitations have been subject to inflation adjustments, they have not kept pace with the actual cost of new cars and vans in most cases. For many small businesses, the use of a car or van is an essential asset for transporting personnel to sales and service appointments and for delivering their products.

Simplification of Estimated Tax Rules

The current rules for calculating the level of estimated taxes necessary to avoid the interest penalty for underpayment of estimated taxes needs to be changed. Currently, small business owners can avoid the interest penalty if they pay estimated taxes equal to at least 90% of their tax liability for the current year. Alternatively, for taxable year 2001, small business owners who earned more than \$150,000 in income for taxable year 2000 can avoid the interest penalty if they pay estimated taxes equal to 112% of their 2000 tax liability. For taxable years 2002 and beyond, the threshold will be 110%. In contrast, taxpayers earning \$150,000 or less, can avoid the penalty by paying estimated taxes equal to 100% of their prior year's tax liability.

The proposed change being discussed simplifies the estimated-tax rules by providing a consistent test for avoiding the interest penalty: taxpayers must deposit estimated taxes equal to 90% of the current year's or 100% of the prior year's tax liability. This change will eliminate many complex calculations currently required of small business owners and will ease strains on the business' cash flow.

Exemption from Partnership Rules for Sole Proprietorships Jointly Owned by Spouses

The Internal Revenue Service (IRS) National Taxpayer Advocate's Annual Report to Congress for 2001 identified a problem facing married couples operating a small unincorporated business. Although these couples file a joint tax return, they are currently required to comply with the onerous partnership rules instead of being permitted to treat the business as a sole proprietorship. According to IRS estimates, the additional burden of the partnership rules can add more than 200 hours to the time required to prepare the business' tax return than would be necessary if it were treated as a sole proprietorship. This proposal is not unique in the tax code since spouses owning S-corporation stock can be counted as a single shareholder.

The Code should be amended to permit married couples who file joint tax returns to opt out of the partnership rules and treat their jointly owned business as a sole proprietorship. The self-employment tax rules should also be amended to allow such married couples to receive Social Security credits on an individual basis, which they currently receive when filing a partnership return.

Electronic Filing for Paperwork Reduction but as a Goal, not a Mandate

I believe it makes sense for this Committee and Congress to continue to support efforts to reduce and unify small business tax and wage related reporting requirements. For most small businesses, multiple employment reports made to state and federal agencies are the most burdensome requirement placed on them by the government.

The STAWRS (Simplified Tax and Wage Reporting System) effort seeks to make modern technology (such as computerized forms and internet reporting) available to even the most modest businesses. The goal is to complete one straightforward quarterly employment questionnaire online and then route the appropriate information to the IRS, Social Security Administration, Labor Department and state agencies that need it. Two of the leading experiments in this field have been in Iowa and Montana and they have proved that this kind of advance can show significant results in the paperwork reduction for small businesses. Hopefully, the Committee will continue to support the necessary legislation to allow the STAWRS effort to go forward. (The bill introduced last year by Senator Kerry on this subject helps to move the project along.)

It would also be desirable to amend the IRS Restructuring and Reform Act of 1998 (Public Law 105-206) to clarify that the IRS should set as a goal, but not a mandate, that paperless filing should be the preferred and most convenient means of filing tax and information returns in 80% of cases by the year 2007. Concerns have been raised that in order to reach this goal, the IRS may have to require certain taxpayers to file electronically that are not computer literate which will unnecessarily raise the cost to these firms. Electronic filing should be a voluntary option for taxpayers, not a new government mandate.

CONCLUSIONS

Tax reform that

- (1) Simplifies the tax structure add to economic efficiency.
- (2) Broadens the tax base allowing for a reduction in marginal rates adds both to economic efficiency and tax equity.
- (3) Focuses on entrepreneurial small businesses makes the capitalistic system more competitive and therefore more efficient. Such change will increase employment growth and the rate of innovation, leading to increases in productivity.

More broadly, changes in public policy should

- (1) Level the competitive playing field between large and small business,
- (2) Limit market failures that occur because of a lack of perfect knowledge.

Thank you for the opportunity to present my views on the importance of entrepreneurial small business in the economy. It is always desirable that changes in public policy help or at least not hurt the small business sector as that sector insures that competitive capitalism continues to exist. In addition, small firms will be able to generate the employment growth that is needed as well as a significant share of the exciting innovations.

I will be happy to provide any additional information that is desired by the Committee.

PREPARED STATEMENT OF JOHN "SKIP" BRIGHT

Mr. Chairman and members of the Committee, my name is John (Skip) Bright, President of the Keokuk Savings Bank & Trust Co., Keokuk, Iowa. I am pleased to appear before you today to present my testimony the views of the American Bankers Association (ABA) on "Preserving and Protecting Main Street USA."

Keokuk Savings Bank & Trust is a \$92 million community bank that serves primarily individual, small business, and agricultural customers. Our bank has been serving the citizens of Keokuk for 132 years.

Community banks are small businesses that serve individuals and small business customers. Because of our unique role in America's communities, and the unique needs of our bank customers, the legitimate competitive concerns and special needs of community banks warrant special attention. On Main Street U.S.A., community banks are as much a part of the economy and growth of a local community as any other small business. Therefore, the special needs of all small businesses, including community banks, should be better appreciated and preserved.

In my statement today, I would like to emphasize three key points:

- Most banks are small businesses trying to meet the needs of our communities—particularly the other small businesses that are the heart and soul of our economic livelihood.
- The most critical challenge today for businesses is funding. Without access to deposits, banks cannot possibly meet the needs of our customers.
- Legislative changes would protect and preserve small businesses.

Although I am testifying today on behalf of myself, through my involvement with the Iowa Bankers Association and the American Bankers Association, I know that my views are widely shared among other community banks. The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

MOST BANKS ARE SMALL BUSINESSES THAT LEND TO SMALL BUSINESSES

Small businesses, farmers, rural customers, and rural leaders look to their hometown bankers for leadership to help them survive and thrive. The banking industry is the primary source of credit to small businesses throughout this country. Today, banks have more than \$230 billion in loans outstanding to small businesses almost a 10 percent increase from the prior year's level and we continue to meet the needs of small businesses. Moreover, according to the U.S. Department of Agriculture, banks are the primary source of credit for farmers.

Most banks are small businesses that lend to small businesses. Nationally, over half of the banks in the U.S. can be classified as small, rural businesses, and over 40 percent have less than 25 full-time employees. In Iowa, over 60 percent of all banks have less than 25 employees.

Keokuk Savings Bank & Trust is a small business with 42 employees. The small business customers that we generally lend to are not typical according to any standard Washington definition, but are certainly typical in rural America. While the Small Business Administration definition of small business generally includes those firms with up to \$5 million in sales, my typical business borrower has between \$350,000 and \$400,000 in annual sales. The typical loans our bank would have to such a customer would include a \$50,000 to \$60,000 operating line of credit and a \$100,000 to \$200,000 loan for equipment.

While direct agricultural lending represents only 20 percent of our bank's loan portfolio, every employer in our community is a value-added industry to agriculture or a service provider dependent on these businesses and agriculture for their survival. These customers are our lifeblood, as we are theirs. Our officers drive by their front doors every day. We take care of them, and they take care of us. They leave their deposits with us and we use them to fund other small businesses. With additional funding opportunities, we could do much more.

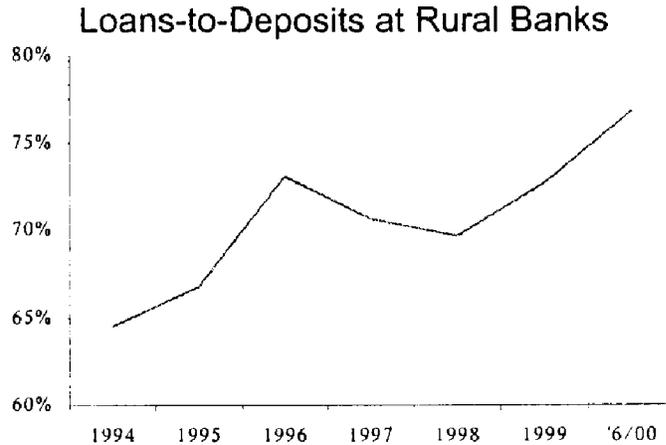
THE MOST CRITICAL CHALLENGE TODAY FOR BUSINESSES IS FUNDING

Finding funds to support loans is the number one challenge facing banks today. During periods of diminished liquidity, small business loans are at a disadvantage relative to other more liquid investments. The funding side is where banks presently need the most assistance in lending to small businesses, making this the ideal time to explore new options to ensure that lenders have a reliable, dependable source of funds to meet small business borrowers' credit needs. Such efforts are crucial to assisting banks in their continued role as engines of local economic development.

Banks have seen strong demand for credit from the businesses and consumers in their districts, but we are struggling to attract deposits to fund loans. The past two decades have seen major changes in the financial services industry, with many new competitors vying for the consumer's dollar. Our biggest funding competition is Wall Street, not the bank across Main Street. Growth in money market funds, stock prices and mutual funds has lured core deposits away from us. Chart 1, which is included at the end of this testimony, demonstrates that depositors are shifting funds out of bank checking accounts ("demand deposits") and into money market funds. Similarly, Chart 2 shows that the money that used to be in savings accounts ("time deposits") at banks is increasingly going into mutual funds.

The November 2000 *American Bankers Association 2000 Farm Credit Survey Report* found that this problem is especially acute for rural banks. In urban areas, our banks are struggling to attract deposit funds, and are successful only at rates that squeeze earnings. Our rural banks, on the other hand, are finding that money has left the community and is simply not available. Of the rural banks that responded to the survey, 57 percent said that their deposits did not grow fast enough to meet loan demand, up from 33 percent a year earlier. Moreover, six percent of the rural banks surveyed recently reported that they have had to turn down good loans because they could not get deposits.

Although Wall Street competes with us for funding, it is not funding the small business customer. That job is left to the bank. Over the last decade, bank loan growth has surpassed core deposit growth. As the following chart shows, loan-to-deposit ratios continue to rise at rural banks. The run-off of deposits has left us struggling to maintain the flow of credit. So far, we have been able to continue making loans, but we are running out of funding mechanisms and searching for deposits so that we can continue to make good loans to small businesses, farmers, and others in our communities. This has placed pressure on bank liquidity and the ability of banks to meet the credit demands of small businesses.



Sources: FDIC and ABA

These funding demands are very personal. Last week, just outside of Keokuk, I was at an event announcing the expansion of a small business who had been a customer for 26 years. It didn't take a committee or a week to approve this loan, instead it took me a few minutes of conversation with the owner to understand his needs and agree to help. It is this personalized treatment of our customers that preserves the business next door.

LEGISLATIVE CHANGES WOULD PROTECT AND PRESERVE SMALL BUSINESSES

The following tax-related incentives would help preserve small business and protect local communities:

- Create FFARRM accounts
- Strengthen "Aggie" bonds
- Improve and expand Subchapter S for community banks

Create FFARRM Accounts. I would like to commend Chairman Charles Grassley (R-IA) and Ranking Member Max Baucus (D-MT) for introducing S. 313, the Farm, Fishing and Ranch Risk Management ("FFARRM") Act. FFARRM bank accounts will be an important tool to help farmers, ranchers and fishermen manage the inherent financial risks of their businesses.

FFARRM accounts would help keep lendable funds in rural communities. Farmers, ranchers and fishermen would deposit funds in FFARRM accounts, and the deposits would be stored in banks for longer periods to be ready for harder times. These deposits would then be available for the banks to lend locally.

Mr. Chairman, I wholeheartedly support S. 313. FFARRM accounts would benefit local communities, both by helping farmers, ranchers and fishermen manage financial risk and by bringing credit back into rural areas. FFARRM accounts would provide a badly needed source of funding for all types of lending.

Strengthen Aggie Bonds. Aggie bonds should be made more widely available. These bonds represent a cost-effective method of providing reduced interest rate loans to young and beginning farmers for capital purchases of farmland and equipment.

Unfortunately, aggie bonds are subject to a federal volume cap on industrial revenue bonds (IRBs) and must compete with industrial projects for bond allocation. This results in insufficient volume for aggie bond programs. In many states, aggie bond availability is severely limited, and deserving young farmers and ranchers are not able to benefit from these bond programs unless they are at the right place at the right time. Opportunities that may exist for a beginning farmer at one point in time may not exist six months later or during the next fiscal year. Arbitrary allocations have real impacts in terms of providing equal opportunity for beginning farmers and impose unequal hardship conditions on otherwise eligible beginning farm-

ers. Timing of finance is often a critical factor in the acquisition of agricultural property.

The IRB volume cap is often allocated to larger manufacturing and multi-family housing projects. Therefore, small beginning young farmers and startup businesses in rural and under-served areas are often left without adequate access to aggie bonds. Aggie bonds should be exempt from the state bond volume caps. This would encourage states to start aggie bond programs and provide more beginning farmers with low-cost capital.

Improve and Expand Subchapter S for Community banks. Various innovative forms of business organization, such as Subchapter S corporations and limited liability companies, are available to a wide range of businesses. In order to create greater opportunities to raise capital and preserve small business lending, banks should be provided greater flexibility and choice concerning organizational structure. Legislation is needed to help community banks compete on a level playing field with non-bank competitors. By improving the Subchapter S laws, Congress has an opportunity to help protect America's communities, preserve create additional tax savings for small businesses and remove many of the competitive barriers now facing community banks.

In order to survive in this intensely competitive market, community bankers, like any other small business, must continually look for ways to improve efficiencies, operations and tax savings. Non-bank competitors, such as farm credit system lending institutions and credit unions continue to enjoy significant tax advantages, which make it even more difficult for banks to compete in their local communities. Therefore, tax changes, such as the improvement and expansion of the Subchapter S tax laws for banking institutions, are a particular interest to community banks.

For the first time in January of 1997, the Small Business Job Protection Act of 1996 permitted eligible banks to become S corporations. Subchapter S of the Internal Revenue Code allows eligible small businesses to be taxed similar to partnerships for federal tax purposes. All earnings, deductions and credits are generally passed through and taxed at the shareholder level rather than being taxed at both the business and shareholder level.

A 1999 American Bankers Association Subchapter S Survey of community banking institutions confirms the need for changes in the Subchapter S laws and identifies obstacles banking institutions face, whether or not they have elected Subchapter S status. In addition, the June 2000 U.S. General Accounting Office (GAO) report entitled "Implications of Proposed Revisions Governing S Corporations on Community Banks" acknowledges that proposed Subchapter S changes would cause an increase in Subchapter S elections, thus impacting the overall competitiveness of the banking community. My bank is currently prevented from taking advantage of this unique tax status due to overly strict eligibility standards.

To help small businesses, the following changes to Subchapter S are recommended:

- An expansion in the shareholder threshold from 75 shareholders to 150. Currently, for a small business to be eligible for Subchapter S status, it can have no more than 75 shareholders. Expanding Subchapter S eligibility to more small businesses would eliminate an artificial constraint on small businesses to raise capital. My bank currently has 35 shareholders. As with many other small businesses, the shareholders are Keokuk citizens interested in investing in their community. The soundness of community banks, as with other small businesses, requires reaching out to many investors. Thus, many smaller banks find it difficult to operate as S corporations within the current 75 shareholder limitation.
- An expansion in the type of shareholders. Currently, Subchapter S eligibility requirements exclude many types of institutional shareholders, such as family limited partnerships and individual retirement accounts. Because banks could only be a C-corporation prior to 1997, they are particularly harmed by shareholder decisions made long before the law change. My own bank is affected in this way; a significant shareholder has a non-qualifying corporate status.
- The ability to issue a second class of stock. Currently, Subchapter S businesses can only issue one class of stock. This restriction on stock offerings constrains the ability of small businesses to raise capital. Allowing small Subchapter S businesses to issue a second class of stock would alleviate this regulatory capital constraint on small businesses and help raise lendable funds.
- A modernization of the passive income rules. Currently, Subchapter S businesses are subject to a corporate-level tax on excess passive investment income. Further, their S election will terminate if the corporation receives excess passive income for three consecutive years. Modernizing the passive investment rules would encourage the growth of small businesses and alleviate unnecessary investment costs, especially for regulated Subchapter S banks.

- A liberalization of the unanimous shareholder consent rule. Currently, for a small business to elect Subchapter S status, there must be 100 percent approval among all shareholders, which permits one individual shareholder to thwart the efforts of the remaining shareholders to opt for Subchapter S status. Liberalizing the unanimous consent rule will introduce more fairness into the election process.

CONCLUSION

I appreciate having this opportunity to present my views during the hearing today on "Preserving and Protecting Main Street USA." We look forward to working with you in the future on these most important matters.

Chart 1

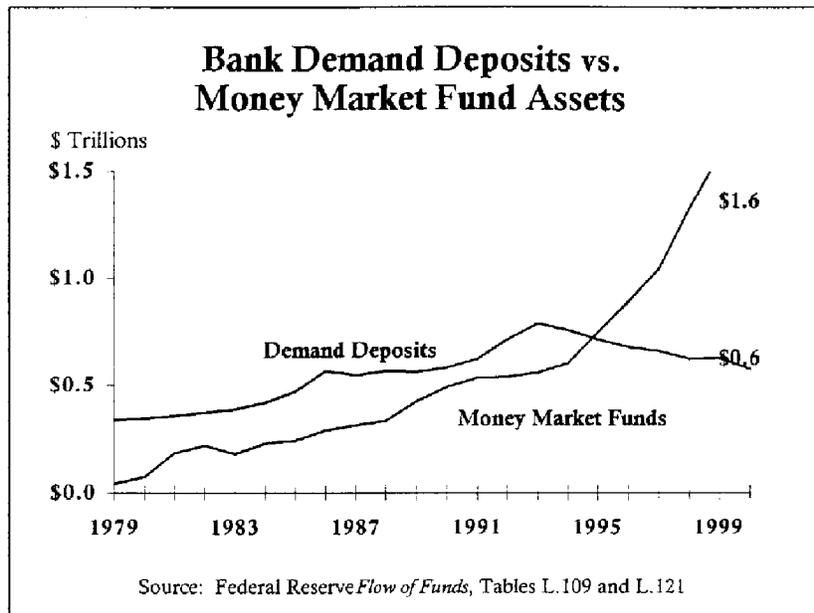
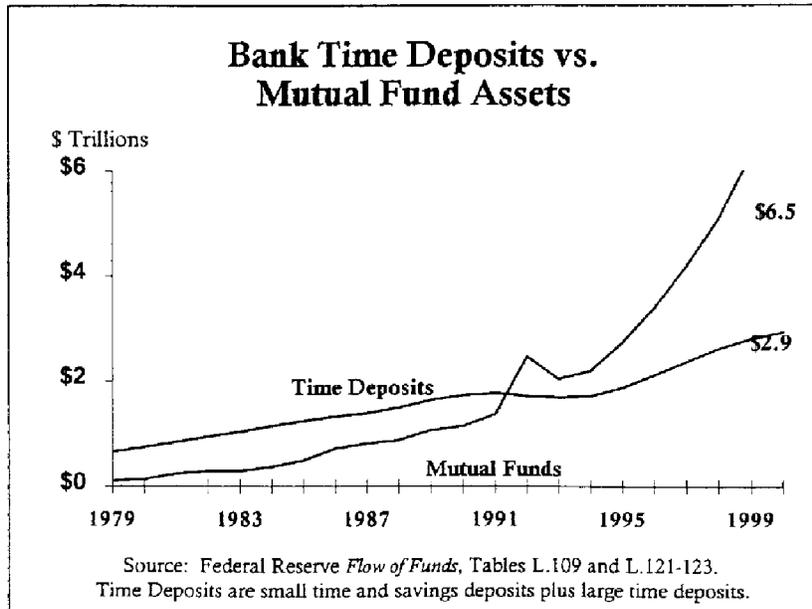


Chart 2

PREPARED STATEMENT OF HON. ORRIN G. HATCH

Thank you, Mr. Chairman, and thank you for holding this hearing today. As the nation focuses its attention on the debate about President Bush's tax cut plan, and its emphasis on tax relief for individuals, it is important that we not lose sight of the tax problems of a different, but very much related, facet of our economy. Our small businesses, banks, and farms comprise such an integral part of our communities and our lives that it is easy to take them for granted. These businesses, however, often form the very lifeblood of our economy, especially in smaller and rural communities, such as most of those in my home state of Utah.

As I expect will be made very clear here today, America's small businesses and farms face some unique and critical problems as our nation and the economy transform themselves into the new century. In too many cases, we are talking about problems so serious that they go the very question of survival of these smaller enterprises.

Small businesses are inherently risky. Unfortunately, newly created small businesses face a tremendously high rate of failure, particularly in the first year or two. While it is not our job as legislators to guarantee that every small business survives, I believe it is our job to ensure that the best possible environment for success exists. This means that our tax and regulatory policies should be as friendly to small businesses as possible. This means there should be a level playing field between small and larger businesses, and it means there should not be artificial barriers that limit growth potential.

Mr. Chairman, I am particularly glad this hearing will focus in part on the problems of S corporations. As you know, I have long been interested in trying to improve and simplify the tax rules for the more than 2.5 million S corporations in America. We made some progress on this in the 1996 tax act, but much more needs to be done. I particularly look forward to hearing what our witnesses have to say about ways we should change the S corporation rules.

PREPARED STATEMENT OF HON. JOHN F. KERRY

Thank you, Mr. Chairman for holding this important hearing on small business and agriculture issues. I believe that this hearing will provide important information on how the tax code can be effectively used to assist small businesses and family farmers in their development. I want to take this opportunity to express my appreciation to our witnesses today, especially Robert E. Berney, Chief Economist at the Office of Advocacy of the Small Business Administration and Joy Turner, a tax chair for the White House Conference on Small Business.

As the Ranking Member on the Senate Committee on Small Business, I know that small businesses have been the engine of economic growth both in my home state of Massachusetts and across the nation for the last decade. Our ability to develop entrepreneurship also has been an integral part of our efforts to create high wage jobs for America's future.

Nevertheless, I am very concerned that the Bush administration's tax and budget plans do not value the important role small business has played in our economy and could jeopardize its future growth. First, the Bush tax plan assists only those small businesses who file individual tax returns. This leaves behind millions of small businesses, which provided jobs and built our economy over the past decade, and will not receive any tax reduction. Sadly, the small businesses that will be left behind by the Bush tax plan currently provide the majority of small business federal tax revenue.

Second, the Bush administration's FY 2002 budget proposal dramatically increases taxes on certain small businesses. Specifically, the Bush budget plan would increase interest rates by 50 percent on small businesses which are victims of disasters and apply for disaster loans. It would also increase fees on small businesses which apply for 7(a) guaranteed business loans. When the government increases the costs of accessing credit, those are taxes, Mr. Chairman. Increasing taxes for some small businesses, in order to pay for tax cuts for other small businesses, is a bad way to strengthen our economy especially in the light of a recent Federal Reserve report that banks are tightening credit for small business. The report confirms that since January, 43 percent of financial institutions have put stricter standards on small business lending and many have forced small businesses to provide additional collateral to obtain a loan. Further, no banks reported an easing of lending standards for small businesses in the survey. Small businesses are the first to be hurt in a recession, and we need to do more to assist them, not hurt them by raising fees and eliminating services as the Bush administration is proposing.

Over the past generation, entrepreneurs and small businesses played a crucial role in developing innovative high technology products. The federal government has assisted entrepreneurs and small businesses in developing high technology research. Continuing this assistance is important for insuring that our nation leads the world in areas expected to generate the largest job growth at the best wages during this century. For example, the Small Business Innovation Research Program (SBIR) attacks the twin problems of small business—access to capital and commercialization of basic research—by directing millions of dollars of Federal research grants and contracts to small business at no additional cost to the federal government. The Research and Experimentation Tax Credit was developed in 1981 to provide an important financial incentive to increase research investments by all businesses from one year to the next. I am hopeful that working together we can make the Research and Experimentation Tax Credit permanent during the 107th Congress.

Income from small businesses is subject to federal taxation like other income, however, small businesses are not always treated equally by the tax code. For example, currently the self-employed can only deduct 60 percent of their health insurance costs. While this deduction is scheduled to reach 100 percent in 2003, large corporations can already deduct 100 percent of their health insurance costs for all of their employees. I am hopeful that this disparity can be resolved during the 107th Congress. At the same time, along with former Senator Dale Bumpers, I successfully enacted legislation to provide shareholders who invest in qualified small business stock to receive a 50 percent exclusion on their capital gains taxes. I believe that we should consider increasing this exclusion and go one step further by eliminating capital gains taxes for shareholders in qualified small businesses that are involved in critical technologies.

In 1999, employer-sponsored pension plans covered only 33 percent of full time workers in firms with fewer than 25 employees and only 57 percent in firms with 25 to 99 employees. That compares with an average of 81 percent in firms with more than 100 employees. We must do more to insure that workers in small businesses have the same access to pensions and retirement plans that their counter-

parts in big businesses have. This will help small businesses retain workers and help them develop their businesses in a more stable environment.

I believe that we should consider modifying the current but outdated depreciation rules to permit taxpayers to depreciate computer equipment and software over a two-year period. Under present law, computer equipment is generally depreciated over a five-year period and software is usually depreciated over three years. With the rapid advances in technology, these depreciation periods can result in small businesses exhausting their depreciation deductions well after the equipment or software is obsolete.

Many of our nation's farmers run small businesses, and I believe we should work to insure their long-term profitability. Some of the issues that this Committee may consider include extending the exemption for the estate and gift tax, disregarding the Alternate Minimum Tax when family farmers calculate their regular income taxes using income averaging and allowing them to use the cash method of accounting if their receipts do not exceed \$5 million.

Many of the same problems face small businesses and family farmers, I look forward to working with Chairman Grassley and Ranking Member Baucus on these issues that are so important and others that may be highlighted by our panelists today during the 107th Congress.

PREPARED STATEMENT OF BOB STALLMAN

Chairman Grassley, Ranking Member Baucus and distinguished committee members. My name is Bob Stallman. I am a rice and cattle producer from Columbus, Texas, and I serve as the elected president of the American Farm Bureau Federation. Thank you for this opportunity to talk about tax code changes to help "preserve and protect" farms and ranches.

Farm Bureau commends the committee for holding this hearing to focus attention on farm and ranch needs. While much of America has prospered over the last decade, this was not the case with American agriculture. As all of you know, many farmers and ranchers have suffered substantial financial losses over the last few years. There are many reasons for this and just as many possible solutions. Some of these solutions involve changes in the tax code.

We are pleased that you, Chairman Grassley, and you, Senator Baucus, have recognized many of these tax provisions and introduced them as S. 312. Farm Bureau supports S. 312, the Tax Empowerment and Relief for Farmers and Fishermen Act, and the legislation that carries the bill's components are freestanding measures.

Farm, Fishing and Ranch Risk Management Accounts (FFARRM)

S. 312 Tax Empowerment and Relief for Farmers and Fishermen Act—Section 2

S. 313 Farm, Fishing and Ranch Risk Management Act

Unpredictable weather and uncontrollable markets determine whether or not farmers and ranchers will be able to harvest a crop and the price they will receive for the commodities they are able to market. As a result, farmers and ranchers are never certain of their incomes. Serious financial problems arise in low-income years when not enough revenue is generated to cover farm expenses. Farmers and ranchers need new risk management tools that encourage savings as a means of stabilizing their incomes.

Farm Bureau supports the creation of Farm, Fishing and Ranch Risk Management Accounts (FFARRM) to help farmers and ranchers manage risk through savings. Using FFARRM Accounts, agricultural producers would be encouraged to save money in good economic times for the ultimate lean economic years.

Like other small businessmen, farmers and ranchers have predictable expenses. Each month they must pay for fuel, animal feed, equipment repairs, building maintenance, insurance, utilities, and payroll. They must plan for seasonal expenses such as taxes, seed, heat and fertilizer. And, must also budget for major purchases such as equipment, land and buildings.

While many expenses can be predicted and to some degree controlled, farm income is neither predictable nor controllable. Farmers and ranchers do not know from one year to the next if their gross income will exceed expenses or if their income will fall short of what they need to pay their bills.

FFARRM Accounts would encourage farmers and ranchers to save "for a rainy day" by deferring income tax, but not self-employment taxes, on up to 20 percent of their net farm income. Money could remain in the account for no more than five years and would be subject to income taxes at withdrawal while interest would be taxed as it is earned. Safeguards in the bill limit the use of FFARRM accounts to

bonafide farmers and ranchers and require that FFARRM funds be held in interest-bearing accounts.

Self-employment Taxes

S. 312 Tax Empowerment and Relief for Farmers and Fishermen Act—Sections 3 and 4

S. 315 Conservation Reserve Program Tax Fairness Act of 2001

S. 369

Most farmers and ranchers are self-employed. As you know, they currently pay self-employment (SE) tax at the rate of 15.3 percent on earned income. The self-employment tax does not ordinarily apply to rental income, because rental income represents a return on investment not on earned income.

In 1996, a tax court case (Mizell case) imposed new SE taxes on cash rental income received by some farmers and ranchers. As a result landlords, who are actively involved in a partnership or corporation that farms their land, must pay SE tax on rental income. The Mizell decision doesn't apply to any other group of taxpayers, which means that farmers are being taxed differently than other rental property owners. While a recent Eleventh Circuit appellate ruling (McNamara, Bot and Hennen) sided with farmers, additional IRS legal action could still occur and the obligation to pay SE taxes on cash rental income remains clouded.

Also in 1996, the tax court ruled (Wuebker Case) that Conservation Reserve Program (CRP) payments were considered rental payments and therefore would not be subject to the self-employment tax. USDA makes CRP payments to owners and operators of land who sign a rental agreement and agree to refrain from farming the enrolled property in order to conserve and improve the environmental resources of that land. CRP covers almost 34 million acres of environmentally-sensitive land.

But in March 2000, the Sixth Circuit Court of Appeals reversed the tax court's opinion, placing an additional tax burden of 15.3 percent on farmers for their CRP payments and allowing the Internal Revenue Service to retroactively collect these taxes from the last four years on farmers participating in CRP.

It is unfair to treat active farmers and ranchers differently from other taxpayers when imposing self-employment taxes on rental income. Because of the Mizell and Wuebker cases, the IRS now singles out farmers and ranchers as landlords liable for the self-employment tax. For other taxpayers who receive CRP payments and cash rental payments, and are not materially participating in a farming operation, the payments are considered to be rental income not subject to self-employment tax.

The CRP issue not only impacts farmers and ranchers, but also the environment. Self-employment tax on CRP payments may discourage farmers and ranchers from future participation in this program. Environmentally-sensitive acreage that has been taken out of production to protect its natural resources may be forced back into production if CRP payments are subject to self-employment taxes.

Farm Bureau believes that farmers and ranchers should be treated the same as other taxpayers and not have to pay self-employment taxes on unearned income like CRP payments and the cash rental of land.

Income Averaging and the Alternative Minimum Tax

S. 312 Tax Empowerment and Relief for Farmers and Fishermen Act—Section 8

Farm income averaging provides farmers and ranchers with a valuable tax management tool. The intended benefits of income averaging, however, are being eroded by the Alternative Minimum Tax (AMT) for some farmers and ranchers who use income averaging. Producers who stand to benefit the most from income averaging, those whose incomes vary greatly from year to year, are hurt most by AMT-imposed limits on farm and ranch income averaging.

Income averaging helps assure the long-term viability of production agriculture because farmers and ranchers are no longer overtaxed in profitable years leaving more funds to pay expenses and prepare for the next economic downturn. Without income averaging, farmers and ranchers pay more in taxes than people with steady incomes even though they both had the same aggregate earnings over time. By implementing income averaging, Congress ensured that effective tax rates would be the same for agriculture producers and other taxpayers.

Farm Bureau supports legislation to ensure that farmers and ranchers are able to take full benefit of income averaging without the added burden of paying the Alternative Minimum Tax.

Charitable Deduction for Contributions of Food Inventory

S. 312—Tax Empowerment and Relief for Farmers and Fishermen Act—Section 7

S. 37 Good Samaritan Hunger Relief Tax Incentive Act

Despite the wealth of our country, low food prices and ongoing government food assistance programs, some people still have difficulty purchasing food for a proper diet. Farm Bureau believes that tax policy should encourage individuals and companies to do all they can to help people in need. Farm Bureau supports legislation designed to increase donations to food banks, soup kitchens and other hunger relief charities by creating a charitable deduction for contributions of food inventories.

Small Ethanol Producer Credit

S. 312 Tax Empowerment and Relief for Farmers and Fishermen Act—Section 11

Farm Bureau has been an aggressive supporter of expanding the production and use of ethanol. The energy supply problems of the last few years have made ethanol an even more important part of the total energy supply for the country. The small ethanol producer credit program provides incentives for producers of alternative energy to boost production. The U.S. Department of Agriculture program will reimburse plants that increase production for the commodities used to make ethanol.

Changing the definition of a small ethanol producer would be a tremendous boost for small ethanol plant producers. It would give them an economic incentive to enhance the output of each plant that participates in the program. Currently the program covers 42 ethanol and 12 bio-diesel makers in 19 states. It is projected that these plants will increase ethanol production by 264 million gallons and boost bio-diesel production by 37 million gallons. Expanding the parameters to the next tier of plants, to producers of 60 million gallons, would almost double these numbers.

Other Tax Issues Important to Farmers and Ranchers

S. 362

Farming and ranching is a capital-intensive industry that requires huge investments in buildings, equipment and land to produce food and fiber. When they sell a farm asset, agriculture producers pay capital gains taxes on the amount that asset has increased in value while they owned it. This tax can be huge because on the average, farmers and ranchers own their land for 30 years during which it increases in value five to six times.

To remain efficient and profitable, farmers and ranchers must constantly adapt their businesses to produce the goods wanted by American and overseas consumers. Because capital gains taxes are imposed when buildings, breeding livestock and farmland is sold, producers are discouraged from selling unneeded assets to adapt and upgrade their operations.

Capital gains taxes also threaten the transfer of farmland between agricultural producers. Capital gains taxes increase the price of land making it more difficult for children to take over farms while their parents are still alive. The tax makes it harder for farmers to acquire land to expand so that additional family members can enter the business. In addition, capital gains taxes make it more difficult for family members who want to keep farming to buy out their non-farming relatives who may have inherited part of the farm.

Congress increased the homeowner exclusion in 1997 and made the benefit usable once every two years. While these improvements were very helpful for homeowners, the benefits for farmers and ranchers are limited. Unlike homeowners who tend to buy and sell homes multiple times during their lives, farmers tend to live in their homes until they leave their farms. And, unlike many taxpayers whose homes represent their most valuable asset, a house on a working farm has a low value because it can't be easily separated from the farm operation.

Farm Bureau supports, S. 362, legislation to expand the \$500,000 per couple homeowner capital gains exclusion to include farmland. A broadening of this exemption will insert a measure of equity into the tax code. We also believe that the maximum capital gains tax rates should be reduced to no more than 15 percent. Enactment of these provisions will allow assets to move to their best and most productive use.

S. 275 Estate Tax Elimination Act of 2001

No Farm Bureau statement on taxes would be complete without a statement on death taxes. Eliminating death taxes is the top tax priority of our organization. Families own 99 percent of our nation's farms and ranches and unless death taxes are repealed, many of these family farms are at risk. The impact of death taxes, with rates as high as 55 percent, is so severe that its imposition can destroy farm businesses. When this happens open space can be lost, surviving family members can be displaced, employees can lose their jobs and rural communities can lose their economic base. Farm Bureau has endorsed S. 275 because it eliminates death taxes

immediately while preserving the stepped-up basis for assets worth \$2.8 million/per person, \$5.6 million/per couple.

PREPARED STATEMENT OF JOY J. TURNER

Chairman Grassley and members of the Senate Finance Committee, it is an honor to have the opportunity to discuss issues that relate to the small business community. Small business is often referred to as the engine of our economy. I am pleased to know that it is of great interest to this committee as well.

Thank you for this opportunity to provide my statement on behalf of myself as a small business owner and a small business consultant. Today I am also speaking on behalf of the Regional Tax Chairs of the White House Conference on Small Business and of the more than two thousand delegates to the last White House Conference on Small Business. I sincerely appreciate your interest in our concerns and in light of our current depressed economy; it is encouraging that small business is receiving some focused and timely attention. I hope that your committee and the 107th congress will be able to put into place, measures to protect and preserve small business.

As an active advocate for small business from a diverse background, I am speaking first from a personal vantage point. I am the owner of a small business, really a micro business, an accounting, tax and small business consulting company. I hold two degrees in accounting, a minor in business management. My postgraduate work includes specialization in taxation, advanced accounting and financial planning for which I hold certificates. Each year I am committed to earning up to twenty-four continuing professional education credits in tax and accounting subjects.

My work with small business has been varied, as small businesses are unique in nature. I provide tax consulting and preparation services, business consulting and accounting services to start-ups and established small businesses. My work allows me the privilege of having an ongoing up close and personal relationship with small business owners.

In structured classroom environments, I provide training and guidance for entrepreneurs from the stage of inception of an idea to actually completing the business plan. Here I discovered that small business owners need a lot of handholding to 'walk' through the maze of tax compliance and regulatory red tape. At first, their attention and interest is primarily on how to get another client, how to pay the rent and how to make the payroll if they have one. They wear many hats and fill many roles. I believe that Congress needs to make things easier for them.

I have operated my business as a sole proprietor since 1978. At that time, while a staff accountant with a large corporation, I was frequently approached by co-workers and other regular everyday working people, such as, the building janitor, cafeteria line workers, bus drivers, commercial retail vendors, and even my then dentist who were experiencing such difficulties with their tax situations. I felt compelled to try to help these people through all the red tape and inequities as I began to see the many complexities and the unfairness of the current tax code.

Over time, personal references led small business owners to seek my assistance and advice. They were literally drowning in a sea of complex tax laws and incomprehensible regulatory requirements. I began my business on a part-time basis and later after completing twenty-six years with a fortune top-ten corporation, I started a full time small business. This is my twenty-fourth year.

For ten years, concurrently, I served as a volunteer member of the Internal Revenue Service's cadre of instructors who provided workshops and community outreach sessions. The taxpayer education department of the Service was very selective in choosing outside professionals and I was honored when I was chosen each year. I taught the Small Business Tax Workshops and other subjects. The workshops were designed to help small business owners to comply with tax law. I realized then that our tax laws were just too complex for the average and even above average citizen to understand for full compliance. I also felt that the penalties were very unfair for those who did not understand the law and could not afford to hire professional assistance. I decided that someone needed to do something to help educate the people.

My experience exceeds twenty years of managing corporate functions in Corporate Accounting, Federal Taxes (domestic and foreign) and Corporate Finance. This corporate background has provided me an invaluable insight and a clear inner vision in which to observe and measure the differences in small and large business operations.

In a large corporate structure so much is taken for granted. The very same nearly invisible benefits and provisions, especially in tax and regulatory areas, may gen-

erate life or death decisions in a small concern. Economies of scale are beneficial to large businesses but may impact small businesses adversely. Something as simple as inventory purchases may be made in bulk for cost savings in a large concern. A small concern may not have the cash flow to afford large upfront purchases, then they are faced with storage and security issues that are very different.

Hiring, training and retaining employees, incurring risk and unlimited liability, plus the burdens of taxation and regulatory are major differences. While I do not intend to compare or illustrate the differences between small and large businesses, I merely want to point out that there are dramatic differences in the day to day requirements for starting and keeping a small business alive and thriving than what is required in a large corporate (self-perpetuating) publicly traded ongoing concern.

According to Small Business Administration (SBA) research data, small businesses represent 99% of all employers, those with fewer than 500 workers employ 53 percent of the private work force, contribute 47 percent of all sales in the country and are responsible for 51% of the private gross domestic product. Industries dominated by small firms contributed a major share of the 3.1 million new jobs created in 1998. Over the 1990–1995 period, small firms with fewer than 500 employees created 76 percent of net new jobs. Small firms provide most initial on-the-job training. These trained workers often go on to work for larger firms. Small firms with fewer than 500 employees provide 75 percent of net new jobs.

Small firms produce 55 percent of innovations, but large firms receive 26 percent of their research and development dollars from the federal government. Small firms receive only 11 percent. Small firms obtain more patents per sales dollar and seem to have more discoveries than large firms, since large firms are more likely to patent a discovery. Considering that small businesses are the primary creators of jobs in our economy, and the indispensable innovators, they deserve targeted protection and specific measures for preservation.

Although, there were remarkable increases in the number of women and minority owned firms in the last decade, their ability to compete is significantly reduced without improvements in fair and equitable contracting practices. Credit card use is higher than normal in these groups due to difficulty in securing financing and accessing capital. Their contributions to the economy are significant. Women owned firms generated \$3.1 trillion in revenues and employed 23.8 million employees in the 1987–1997 period. Over the same decade, minority owned firms generated \$495 billion in revenues and employed nearly 4 million people in 1997 alone. More than 60 percent of women owned businesses started in the home.

It is interesting to note that 53% of small businesses are home-based, yet at the local legislative levels, many cannot operate legally under existing municipal codes and regulations. According to U. S. Department of labor research statistics, sixty percent of new firms begin at home. Jobs generated by small firms are more likely to be filled by younger workers, older workers, former welfare recipients and women. Many of these workers prefer or are only able to work on a part-time basis, and thus can be more easily accommodated by small employers. About three-quarters of new business owners are also employed in a wage-and-salary job at startup. During the most recent recession, it was the small businesses of the nation that rallied, kept going, and added new jobs to the economy.

Environmental factors and supportive infrastructures conducive to the livelihood of large corporations are very different or nonexistent for small businesses. There are no tax abatements, jobs incentives, or means of leveraging credit available to small private companies. Also, the negative effect of tax and regulatory burdens can often be experienced by publicly traded corporations with little or no direct impact to the shareholder and least of all to the well paid executives who run the firm. A small business may be so impacted by a large environmental fine or tax penalty so as to threaten or interrupt its lifecycle. SBA sponsored research indicates that about 21 million Americans—17percent of all U. S. non-agricultural workers—are engaged in some entrepreneurial activity, including both full-time and part-time entrepreneurship. These are the innovators of U. S. inventions and jobs.

During the startup phase in the lifecycle of a small business, the goal is to survive. At this point a small business needs straight-forward and accurate information, and the ease of securing it. They really need cash flow and lower tax burdens. They need fewer regulatory burdens. Complicated business manuals, complex and confusing tax codes discourage the new business owner. Attempting to identify scarce sources of capital and jumping through the hoops to get it often cause one who may have become a successful business owner to change their plans and just get a job. If our economy is to flourish and expand, it must be built by small business.

During the second stage of a small business cycle, the difficulties lie mostly in financing people, products, and developing markets for more business. At this point, a business owner must make hard decisions to expand, to hire people or to hire more people. Inventory becomes a problem, getting it is difficult without cash, safeguarding it requires cash. Access to growth capital and the ease of securing it becomes critical.

The second and third stages of small business development are generally thought to be the most difficult. The third stage allows for greater accountability, and clearly defined goals of management. Building assets during this stage is difficult and costly. Tax credits geared toward small businesses are very much needed at this stage.

The stage of maturity or fourth stage of small business development determines the survivability of a company. There are enough employees to get the job done. The executives should now be running the company by administrative monitoring tools and methods. This is generally the jumping off point for the next millionaire company. In this technological era, many have jumped from a small to large classification in an earlier stage. This rapid leap brings it's own set of problems.

My next point of view comes from working with the third White House Conference on Small Business. When it was convened in 1995, close to four thousand small business people closed down shop and attended the conference. It was that important. The purpose of the conference was to provide an opportunity for the small business community to make its views known and to have input to the administration and to congress.

There were sixty major issues that the White House Conference Delegates determined to be of urgency to small business. They were in the areas of Capital Formation, Community Development, Environmental Policy, Human Capital, International Trade, Main Street, Procurement, Regulation and Paperwork, Taxation, Technology and the Information Revolution. The top sixty issues that were of extreme importance to the small business community included eleven tax issues.

Six years later, the White House Conference Regional Tax Chairs (Tax Chairs), who are also small business owners, continue to represent the 2000 delegates to the 1995 White House Conference on Small Business. The Tax Chairs were elected by the delegate body and given the responsibility for advancing implementation of the Conference's recommendations with regard to the tax issues and reporting progress back to the delegates.

During the past six years, the Tax Chairs have had a strong relationship with Congress and have diligently worked with each of the important committees to address small business concerns. Tax Chairs have testified on numerous occasions concerning the goals and priorities of the nations small businesses. We believe that you listened to us in the past and it is reflected in the tax and small business legislation that came out of previous congressional sessions, i.e., Small Business Jobs Protection Act of 1996, The Small Business Tax Reform Act of 1997, The Minimum Wage Bill and others.

There is much more that needs to be done to help small business. Currently, the Tax Chairs are looking for the development of an adequate and fair Tax Bill. Several proposed bills are on the table. They each have some good provisions within them for small businesses. Elements of a good tax bill are included in S. 189 "Small Business Works Act of 2001" and the Small Employer Tax Relief Act of 2001 (SETRAII) H. R. 1027.

Tax Issues that we continue to support on behalf of small business owners are covered in detail in the attachment to this writing. We recognize that many of them are addressed in the current tax proposals.

We would like Congress to consider acting quickly on the following outstanding small business issues. I have added my personal insight to the Independent Contractor issue. Excerpts from a letter that the Tax Chairs sent to the Ways and Means Committee hearing on the subject of Estate Tax are included under that title. All other issues are clearly defined and discussed in the attachment.

Clarification of the Independent Contractor Definition:

The White House Conference issue to receive the most votes of all sixty was the issue of redefining the independent contractor. Business people shared many horror stories of what had happened to them or other business owners during audits and reclassifications. Some were put out of business as a result of the assessment of fines and penalties due to incorrect classifications even when fraudulent intent was not present.

The current law addresses the question "who is an employee?" rather than "who is an independent contractor?" This is a south-north focus on the issue, when what is required is a reverse point of view. In other words, let's first clearly determine who is an independent contractor, anyone else must be an employee. At the present

time, the Internal Revenue Service seems to favor any classification to employee rather than to independent contractor. This is usually an economical decision. The fines and penalties are revenue producers for the Service but have not led to increased compliance.

In my business, I provide ongoing financial consulting and guidance to business and individual clients. I use the services of Independent Contractors when necessary and I am often hired out as an Independent Contractor. I market my accounting and business consulting services as an independent contractor. As an independent contractor, I have been adversely affected by the twenty factors test as it now stands and is administered by the Internal Revenue Service. (Revenue Ruling 87-41 defines a twenty-factor control test based on common law principles.)

Due to the nature of the work that I am educated, trained and skilled to perform, I am best able to provide my services to small business clients as an independent contractor. As an accountant and business consultant, I must maintain principles of independence of thought and action. The small business clients whom I service are small or micro businesses, start-ups or sometimes just people with flourishing ideas. They cannot afford to hire me as an employee nor do I want to give up the control and independence required to competently complete certain types of jobs.

Estate Tax Reform:

The Tax Chairs recently sent a letter to Chairman Thomas of the House Committee on Ways and Means, for the hearing on Estate Tax, that discussed our outlook on the President's Tax Proposal. Following are excerpts that reflect our concerns:

The President has proposed a tax relief measure that incorporates full repeal of the estate tax, phased in over a period of years, and making permanent the tax credit for research and experimentation. We are gratified his proposal addresses these elements of tax relief which the Conference delegates recommended to Congress, and which we have personally recommended to your Committee in past testimony.

We have said in the past that the White House Conference endorsed full repeal of the estate tax, but the delegates have been grateful for any changes that reduce the tax that heirs to a business might pay at the death of a principal owner in order to preserve what is the single largest source of new job opportunities in America, the small business. The passage of a small business from one generation to the next also has a positive impact on the community, promoting stable employment, long-term community support of community groups, and an active interest in maintaining the quality of education and life in the "neighborhood." Whatever could be done to increase the exclusion or move family-owned business or farm property out from under the estate tax is welcomed.

The President's proposal does not appear to specify how property that passes to heirs is to be treated for tax purposes. The Congress will decide whether the property receives a stepped up basis, or whether the old basis is carried over to the heirs. Several members of our White House Conference group are concerned about the complexity and difficulty of keeping adequate records to support a carry-over basis. The country has been down this road before and the tax practitioner's within our group still get severe headaches whenever they recall the difficulty of reconstructing the basis of business (or other) property that has been in a family for a lifetime.

If the revenue were necessary to make the President's tax plan feasible, we would urge the committee to raise the threshold for property excluded from any estate tax to a sufficient level to ensure that most small businesses are completely excluded. In the alternative, we ask the committee to consider some simplified system of evaluating the basis of property (a safe harbor) that will not require weeks or months of evaluation and paperwork.

The fourth Small Business Conference is considerably overdue. We hope that this congress will review proposals that were submitted and discussed in the previous congress. Several of the Tax Chairs are at present actively working with staff members to help this to happen.

A real opportunity exist for the 107th Congress to take positive action on issues that are vital to the survival of small business. There are still many important things that a bi-partisan Congress can do to help small business.

The White House Conference on Small Business Tax Issue Chairs welcome the opportunity to continue our work with Congress to suggest ideas that would help the nation's small business community. We hope Congress continues to listen to the recommendations of small businesses and analyze all legislative proposals for their impact on small businesses and their employees. Small businesses, after all, provide the majority of new jobs for our economy.

Attached is a copy of the latest "Tax Action Plan" of the White House Conference on Small Business Regional Tax Chairs for you and your staff to review. Thank you for your time and attention to the needs of small business.

The White House Conference Tax Chairs—

Region 1	Debbi Jo Horton	E. Providence, Rhode Island
Region 2	Joy Turner	Piscataway, New Jersey
Region 3	Jill Gansler	Baltimore, Maryland
Region 4	Jack Oppenheimer	Orlando, Florida
Region 5	Paul Hense	Grand Rapids, Michigan
Region 6	Tommy Bargsley	Austin, Texas
Region 7	Edith Quick	St. Louis, Missouri
Region 8	Jim Turner	Salt Lake City, Utah
Region 9	Sandra Abalos	Phoenix, Arizona
Region 10	Eric Blackledge	Corvallis, Oregon

Attachment

WHITE HOUSE CONFERENCE ON SMALL BUSINESS

TAX ACTION PLAN

A NOTE ABOUT THIS PLAN: This TAX ACTION PLAN was developed and published by the Regional Tax Issue Chairs representing the 2000 delegates to the White House Conference on Small Business. These priorities were developed with the input and active assistance of thousands of small business people who were Delegates to the last White House Conference on Small Business. Because federal tax laws impact every small business, it is critical to the growth and progress of the small business community that the law reflect sound public policy and fundamental fairness while imposing as little administrative burden as possible.

A NOTE ABOUT THE TAX CHAIRS - The Tax Chairs were elected by Delegates from each region of the country, and given the responsibility for advancing implementation of the Conference's recommendations on tax issues and reporting progress back to the delegates. The Tax Chairs have testified before Congress on ten occasions, and meet periodically with the staffs of the Ways and Means Committee, the Finance Committee, and the House and Senate Small Business Committees to help further develop clarifying legislation. In addition, the Tax Chairs have worked with IRS Commissioner and the Office of Tax Policy at Treasury to create policies that are helpful to small businesses.

TAX SIMPLIFICATION IS KEY

The unifying thread running through all the recommendations of the White House Conference is a desire to reduce the overall complexity of government for small businesses. The key to simplification for small businesses is the tax code. Allocating and reporting income taxes and payroll taxes is the one common experience of every business and may be the only interaction that most businesses have with the federal government. Simplifying the tax process would, therefore, improve the situation for every small business. Federal government studies demonstrate that it costs small businesses considerably more, as a percentage of revenue, to comply with the tax laws than it costs large businesses.

The conclusion is that small businesses are at a significant competitive disadvantage from the start due to governmental requirements. For this reason, the Tax Chairs fully support the restructuring passed by Congress and implemented by the IRS, and urge that the focus remain on helping small businesses comply with the law and reducing the administrative burdens the tax system imposes.

One of the major recommendations of the White House Conference urged Congress to concentrate on creating a simpler and fairer tax system. The Conference attendees did not specify what that system should be, but the overriding principle, whether the entire system is overhauled or the existing system is streamlined, is that each proposal be thoroughly analyzed for its impact on small business. New systems that increase the tax or the record keeping burdens on small business, prolong the existing problem.

Within the context of the current tax code, the following items top the list of the recommendations made by the delegates to the White House Conference and are items we believe can be addressed in the bills before Congress. Each item reduces the complexity of the Code or extends to small businesses reasonable incentives to ensure that government requirements do not interfere with their competitiveness

100% HEALTH CARE DEDUCTION FOR THE SELF-EMPLOYED

The tax issue chairs are gratified with the progress that has been made to achieve the full deduction of health care expenses for the self-employed, but remain disappointed that equity will still be phased in over 5 years. Equal treatment with large businesses should dictate that small businesses be able to deduct 100% of the cost immediately. The White House Conference recommendation called for the immediate increase to 100% and that **the cost be deducted from the business income, prior to the calculation of the self-employment tax**. Although there is some tax loss, the immediate increase helps serve the policy goal of providing health insurance for as many people as possible. When there is a reduced tax incentive for a small employer to buy health insurance for themselves and their family, (note that 1.4 million children of self-employed individuals have no health coverage), they may decide to forgo offering it to their employees as well. In other types of businesses such as C-corporations, the health insurance of the principals in the business has always been fully deductible. The Tax Chairs feel tax based decisions should not be substituted for sound business judgment in the selection of business structure. The 107th Congress and President Bush should enact legislation to allow immediate full deductibility at the business level as a matter of equity for all business owners.

ESTATE TAX REFORM

One of the strongest recommendations of the White House Conference on Small Business was a call for the repeal of the estate tax. The Taxpayer Relief Act of 1997 included a provision that provides some help for a qualifying small business (in cases where the value of the small business is over half of the gross estate.) While this is welcome relief, more needs to be done to protect businesses from being dismantled at the death of the principal. The passage of a small business from one generation to the next has a positive impact on the community, promoting stable employment, long-term support of community groups, and an active interest in maintaining the quality of education and community infrastructure.

If outright repeal is viewed as too costly, proposals that provide for a more effective targeted reduction of the tax burden on small business assets would be helpful. By focusing the legislation, Congress can provide relief directly to farms and small family businesses with a relatively small loss of revenue. The Congress should adopt a tax policy that moves the country toward the positive goal of sustaining the economic vitality of a small business and away from a policy that requires expensive and complex estate plans and insurance. The reality today is that elaborate and costly estate plans must often be developed to protect a family business, which

drains assets from productive business investment. Without such complex plans, there is no assurance that the business will survive to serve the next generation of owners and workers.

EXPENSING

Internal Revenue Code §179 Expensing - The expensing limit of IRC §179 will be gradually increased to \$25,000 (by the year 2003) from its current level as a result of the Small Business Job Protection Act passed by Congress in 1996. We appreciate the attention Congress gave to this issue, but would urge greater increases and quicker implementation. The Tax Chairs would support, for example, the increase of the expensing limit to \$30,000 effective in full immediately. Expensing is one of the most useful tax simplifiers for small business, but its use still remains limited. In addition, Congress did not correspondingly raise the \$200,000 phase-out limit on purchases. These days, one piece of machinery (even for a very small business) can exceed this limit, effectively eliminating many small businesses from any benefits.

Expensing Extended to Costs of Fixing Up Property – The Tax Chairs support using expensing provisions to cover property fix up and improvement costs. Small business store owners should be able to expense the costs of improving their store front or the building which houses their shop to remain competitive and to help ensure that the shops “on the downtown square” remain an attractive shopping destination for the community. Legislation such as S. 1341, The Main Street Business Incentive Act, which was introduced in the last Congress, could provide substantial assistance to small business for a reasonable cost.

Software Expensing - One area where the Tax Chairs feel Congress could make a tremendous contribution is to allow expensing in the year a business purchases standard software for business purposes. It is practically impossible to determine what the useful life of software will be. With the pace of technology, useful life gets shorter and shorter as better products that exploit hardware advances seem to hit the market continuously.

FULL DEDUCTION FOR MEALS AND ENTERTAINMENT

The White House Conference on Small Business recommended restoration of the full deduction for meals and entertainment directly connected to business. Although no legislation has yet received the support necessary for enactment of full deductibility, the Tax Chairs would support any increase in deductibility as a step in the right direction. Provisions that would raise deductibility to 60% or 80% would be valuable to small businesses. This issue is very important to those whose business depend on networking contacts or personal presentations to close the deal. Often times the “shop floor” or the kitchen table are unsuitable for marketing and negotiations and the best alternative is in a food serving establishment. The tax chairs believe that reasonable limits could be agreed upon to prevent abuse.

NO INCREASE OF PAYROLL TAX

The payroll tax can be especially burdensome on a small businesses because it is a regressive tax which must be paid whether or not the business makes any profit. The White House Conference was concerned that increasing the payroll tax not be viewed as a “quick and painless fix” for structural deficiencies in federal employment benefits trusts. The Conference recognized the

importance of public confidence in the programs but felt the problem should be addressed directly. Other correction proposals, such as fund diversification or partial privatization, should also be analyzed for their potential impact on small business.

CLARIFICATION OF THE INDEPENDENT CONTRACTOR DEFINITION

Resolving the long-standing employee vs. independent contractor controversy was the number one recommendation of the White House Conference on Small Business. The current vague standard leads to retroactive reclassifications by the IRS and substantial tax assessments plus interest and penalties. For example, the IRS assessed almost \$750 million using such reclassifications between 1987 and 1994. While there have been a number of improvements in "safe harbors" to reduce overzealous enforcement, as long as the standard remains unclear, worker classification is a problem. There must be a clear standard defining the difference between an employee and an independent contractor so that a business can utilize contract service providers with confidence. The Tax Chairs have worked with key House and Senate Committee staff members and Administration Officials to indicate the types of legislation that would set a clear standard to provide security for small businesses while protecting the rights of workers who are properly classified as employees. The Tax Chairs believe that a reasonable consensus can be reached on this issue and should be adopted in the 107th Congress.

ALTERNATIVE MINIMUM TAX REFORM

In connection with the White House Conference on Small Business, one of the final 60 recommendations made by the delegates to the President and Congress included an overall desire for a simplification of the tax code, particularly as it related to small business. However, with the passage of provisions such as Section 1202, lower individual income tax rates, various new tax credits and other similar legislation, without a corresponding update of the alternative minimum tax provisions, these newer provisions are having the unintended effect of subjecting middle income taxpayers, and particularly small business owners to its impact and significantly eliminating some of the benefits intended to be provided from the tax provisions mentioned earlier.

Accordingly, the White House Conference Tax Chairs urge the Members to seriously address alterations to the Alternative Minimum Tax rules so that tax incentive provision can have the benefit that Congress intended.

SupplementMAIN STREET, USA

The real view of Main Street, USA is best seen through the eyes of those who 'live' there. So recently, as I often do, I polled each small business owner with whom I had contact for several days. These to me are the business people who really are "Main Street, USA". I asked each one, if you were talking to congress right now what would you say is your most important concern in determining the health of your business?

The doctor, who employees 25 people said his concerns were tax reform, payroll taxes and regulatory reform. If his patients could get better medical insurance coverage and improved medical tax deductions, he could offer more and better service to more people. Several of his self employed patients needed immediate medical care and could not afford it. One had stopped coming for treatment, another was trying to borrow money to pay for needed treatment.

The printer was quite disturbed that he had not been able to get additional capital to expand his plant. His family owned business has been in our town over eighty years, he employed 15 people but couldn't get a business loan large enough to expand. He felt stifled. His rent had become too high for his level of receipts. He moved into a smaller, less expensive building and now services less people with less employees.

The dentist said if his patients could improve their economic status, then his business would improve. He employs a staff of twenty. When the economy looks bleak, people stop getting the necessary dental treatment that they need. He felt that his clients needed tax reductions and better insurance coverage. He also had concerns about the paperwork and regulatory red-tape associated with getting paid by the insurance companies. This, he said adversely impacted his cash flow but the insurance companies hold his payments longer than he would be allowed to do for his accounts payable.

The CEO of a minority-owned advertising specialty firm said corporate restructurings and internal changes including layoffs seem to have diminished the commitment of corporate America to minority vendors. He said, "The business is not there," even though companies claim they are committed to contracting opportunities. "They talk a good game but they still are really not doing what they say."

The husband and wife team were quite disturbed that business opportunities were not available to them as a small business and they could not afford to bid on larger, bundled contracts. Their concerns also included tax compliance issues and all the paperwork they have to be concerned with when they should be out securing business. Corporations that procure goods and services are not aware of the added value of using the service of Minority Vendors. In spite of existing programs, there is no commitment of corporate America to use Minority Vendors. As the executive said, they talk a good game but don't do anything.

An owner of a CPA firm had this to say, "The issue of pensions and health care is as important to small business as the issue of tax cuts. A small business has a terrible time paying for health care that is not deductible for self-employment tax purposes. Established businesses have a difficult time funding retirement due to restrictions on owners in funding pensions."

The owners of several family-owned Funeral Home establishments expressed immediate concerns about cash flow, independent contractor reclassifications, and the red tape associated with accounting for inventory and OSHA requirements. While they recognize the need for extreme safety measures in their businesses, they felt that small one or two person businesses should have more flexibility than larger conglomerates and corporations. They were very concerned about the possibility of current Estate Taxes that could cause their heirs to lose the family business.

A computer software specialist was concerned about the cost and complexity he is incurring because of the need to incorporate his one man consulting business. He was one of many independent contractors with whom I spoke (or work with) who had experienced the "incorporate or get no work" rule put upon them by large corporations when he sought work projects or sub-contracting opportunities from them. Corporations don't want to run the risk of having contractors reclassified as employees long after the work has been done. This certainly shows the need of the small business community to have a clearer definition of what determines who is an independent contractor.

COMMUNICATIONS

STATEMENT OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES

On behalf of America's farmer cooperatives and their nearly 1.6 million farmer owners, the National Council of Farmer Cooperatives (NCFC) wants to take this opportunity to express our appreciation for the steps this Committee is taking in bringing to the forefront the discussion on the needs of rural America, especially with regard to the availability of technical assistance and tax incentives that will help farmers help themselves and the communities in which they live.

Additionally, we recognize and appreciate the efforts over the past few years by this Congress in approving much needed economic and disaster assistance in response to low commodity prices and adverse weather conditions in many parts of the country. For many farmers and ranchers, the emergency assistance has been the difference between survival and going out of business. However, it appears that given the current economic outlook, similar assistance may again be needed this year. Accordingly, we strongly support such action as may be necessary.

At the same time, we believe it is critical that action be taken that will lead to long-term sustained economic recovery, improved farm income and risk management, increased market opportunities, and growth in exports for U.S. agriculture. It is within this framework that current farm policies and related programs should be reviewed and evaluated, as well as strengthened.

We also strongly recommend a number of additional actions that can and should be taken to address not only the near-term challenges facing U.S. agriculture, but also to help achieve the long-term objectives outlined above. Critically important is strengthening the ability of farmers to join together in cooperative self-help efforts to improve their income, manage their risk, and compete more effectively in a rapidly changing global economy. A high priority should be given to ensuring that public policies and programs relating to agriculture are directed toward achieving this goal.

A positive first step to help achieve the long-term goals would be the adoption of a number of tax initiatives included in the *Tax Empowerment and Relief for Farmers and Fisherman Act* (TERFF) introduced as S. 312 by Senator Charles E. Grassley (R-IA), and Senator Max Baucus (D-MT), Chairman and Ranking Member of the U.S. Senate Finance Committee respectively.

The "TERFF" bill includes four tax provisions that will assist farmer cooperatives and a number of tax provisions that will be generally beneficial to farmers. The provisions are needed to help farmers, through cooperative efforts, become more involved in value-added production, processing and marketing activities beyond the farm gate, which will help farmers increase their incomes by capitalizing on new market opportunities.

To achieve this, farmers and their cooperatives must have in place policies and programs, including adequate tax incentives, to help attract needed capital and investment.

On the issue of tax incentives, the NCFC supports and is working for the inclusion of S. 312 into an upcoming tax bill.

Farmer Cooperative Priorities in the 107th Congress are as follows:

1. A provision to modify the dividend allocation rule that, if modified, will help cooperatives raise equity by allowing for the payment of dividends on preferred stock without penalty, while at the same time increasing the amount of patronage dividends paid to farmer members;

2. a provision to expand the definition of cooperative marketing to include value-added processing through animals;

3. a provision to extend the declaratory judgment procedures of IRS §7428 to §521 farmer cooperatives; and

4. a provision that will allow the 10 cents credit for small cooperative processors of renewable fuels to be passed to the farmer owners.

As cooperatives look to the 21st Century, it is important for the industry to continue to give value to its farmer owners. Following is a brief summary of the tax provisions included in S. 312 that will assist farmers through their cooperatives.

Section 9: Cooperative Marketing to Include Value-Added Processing through Animals—Tax-exempt cooperatives (Section 521) are cooperatives of farmers, fruit growers and like organizations organized and operated on a cooperative basis for the purpose of marketing the products of members or other producers and then returning the net margins to members.

The IRS has taken the position that a cooperative is not marketing the products of members or other producers where the cooperative adds value through the use of animals (e.g., farmers send corn to a cooperative, which is fed to chickens which produce the eggs and the cooperative markets the eggs).

The bill provides that marketing products of members or other producers includes feeding products of members or other producers to cattle, hogs, fish, chickens or other animals and selling the resulting animals or animal products.

Section 10: Extends Declaratory Judgment Procedures to Section 521 Farmer Cooperatives—Under current law there is limited access to judicial review of disputes regarding the initial or continuing qualification of Section 521 farmer cooperatives. The current remedies include filing a petition in U.S. Tax Court for relief following a notice of deficiency or to pay a tax and sue for a refund in an U.S. district court of the U.S. Court of Federal Claims.

The bills extends the limited declaratory judgment procedures, which generally permit a taxpayer to seek judicial review of an IRS determination prior to the issuance of a notice of deficiency and prior to payment of tax, to Section 521 cooperatives. For example, currently where the IRS denies an organization's application for recognition of exemption under Section 501(c)(3), or fails to act on an application, or revokes or adversely modifies its tax-exempt status, current law allows this organization to seek a declaratory judgment regarding its tax-exempt status. The bill extends similar treatment to Section 521 cooperatives.

Section 11: Small Ethanol Producer Credit—Small ethanol producers are allowed a 10-cents-per-gallon production income tax credit on up to 15 million gallons of production annually. This credit is in addition to the 54-cents-per-gallon benefit available for ethanol generally.

The 10-cents-per-gallon tax credit is currently not passed through to patrons of a cooperative, and the bill allows a cooperative to elect to allocate the small ethanol producer credits to its patrons.

The bill also provides that the small producer tax credit is not a "passive credit"; allows the credit to be claimed against the alternative minimum tax; and repeals the rule that amount of the credit is included in income.

Section 12: Payment of Dividends on Stock of Cooperatives without Reducing Patronage Dividends—Current Treasury regulations provide that cooperative net earnings are reduced by dividends paid on capital stock or other proprietary interests. The effect of this regulation creates three negatives for a cooperative: (a) it reduces the amount of earnings that a cooperatives can treat as patronage earnings; (b) it creates a third level of tax on the corporate earnings of a cooperative when dividends are paid; and (c) it creates a disincentive for cooperatives to raise equity capital in the marketplace.

S. 312 includes a provision that will modify the regulation and allow cooperatives to pay dividends on capital stock without being subject to three levels of tax and without having to reduce patronage paid to farmer members.

For these reasons, NCFC supports and is working for the inclusion of "TERFF" (S. 312) into an upcoming tax bill, and we look forward to working with the U.S. Senate Committee on Finance on this and other issues important to cooperatives.

* * *

NCFC is a nationwide association of cooperative businesses owned and controlled by farmers. Its membership includes nearly 70 major farm marketing, supply and credit cooperatives, plus the state councils of cooperatives in 31 states. NCFC's members, in turn, represent nearly 4,000 local cooperatives, with a combined membership that includes approximately 1.6 million farmers in the United States. NCFC members handle almost every type of agricultural commodity produced in the United States.

Farmer cooperatives are self-help organizations that were formed, and operate today, to meet the needs of farmers for reliable and fairly-priced sources of farm supplies (fertilizer, seed, feed, petroleum products, herbicides and pesticides), serv-

ices and credit, and to provide farmers assistance in effectively marketing the commodities that they produce. Some cooperatives focus on serving a single function—providing farm supplies to members (referred to as “supply cooperatives”), or helping members market a particular kind of crop (referred to as “marketing cooperatives”). Others perform several different functions for their members. Whatever their function, farmer cooperatives are an extension of the farming operations of their members. Their importance to agriculture is demonstrated by the fact that most American farmers are affiliated with one or more cooperatives.

STATEMENT OF DAN R. MASTROMARCO

Dear Mr. Chairman and Members of the Committee on Finance: I compliment you for focusing today’s hearing on family farms and small business issues, and welcome the chance to submit this written testimony. When America thinks of “Main Street U.S.A.” they undoubtedly visualize the family farms and businesses that have been integral fixtures on our cultural and economic landscape. Many in Congress properly pay tribute to these entrepreneurs as the lifeblood of our Nation’s economy; however, few policymakers really take the time to actively listen to their concerns as you are doing today, and fewer still proactively seek ways to relieve the burden of government taxes and regulatory costs upon them. I encourage you to systematically air the views of small business groups, and on a frequent basis. Distinguish your Chairmanship by being attentive to two groups most effected by tax policy problems and least able to absorb the costs of complexity or compliance burdens (or pass the resultant costs forward to consumers): small farmers and businesses.

In the spirit of a continuing dialogue on small business issues, I bring to your attention a “Main Street, U.S.A.” tax issue from the not-so-distant past—the “stealth tax.” To reacquaint Members of this Committee with the “stealth tax,” several years ago, a coalition of nearly 30 business organizations complained vigorously about what seemed a relatively obscure proposed rulemaking. The regulatory proposal, however, was aptly termed the “stealth tax” because it would have improperly and surreptitiously subjected the earnings of members of limited liability companies (LLCs), or partners of limited liability partnerships (LLPs) or limited partnerships (LPs) to the self-employment wage base, regardless of whether the earnings of these business owners constituted remuneration for services or simply returns on capital invested in the business. The chorus of complaints from the growing sector of small business resonated ever so loudly that the Congress properly reacted by enacting the first moratorium in more than twenty years—a moratorium that forbid the Treasury Department from finalizing the rule.

To be more specific, the “stealth tax” was contained in a Treasury Department proposed rulemaking of January 13, 1997 issued under Internal Revenue Code (IRC) Section 1402(a)(13). That rulemaking ostensibly sought to “clarify” current law by “eliminate[ing] uncertainty” in determining the self-employment tax base for limited partners and limited liability company (LLC) members. Undoubtedly, the proposal would have achieved “clarity.” That was probably a true statement. However, it would have clearly done so at the cost of arbitrariness. The “stealth tax” would have also improperly subjected the entire earnings of these small business owners to the self-employment wage base (i.e. to SECA taxes) if they either worked for more than 500 hours in the business or the business were a “service” sector business. Hence, the proposal would have applied the full 15.3 percent payroll taxes to returns on capital for many limited partners and LLC members if earnings were below the wage base. If net earnings of the small firm were above the wage base, it would have additionally resulted in a 2.9 percent rate increase on all income, as the Medicare tax was imposed on every dollar earned, not just earnings that constituted compensation for services. Of course, small firm owners who chose to operate as limited partnerships, or to take advantage of the fastest emerging forms of entity, LLCs, or LLPs, would have been treated differently than S Corporations and C Corporation owners for no apparent reason than the hapless pursuit of “clarity.”

The substance of the proposed rulemaking was bad enough, but the timing was worse. The underlying motive for the entire proposed rulemaking was called into question because it was promulgated on the heels of 1994 Clinton Administration legislative proposal which sought a similar result for the well established and most popular form of limited liability pass through entity—the S Corporation. The Clinton Administration legislative proposal would have similarly subjected all the earnings of certain S corporations to payroll taxes; this time as a revenue raiser to help pay for the Administration’s healthcare package. In that legislative proposal, the Administration may have failed to recognize that subjecting capital returns of S Corporations shareholders to employment taxes was bad tax policy, but at least they

recognized that such a monumental mistake would have to be proposed through legislation. In promulgating the proposed rulemaking known as the “stealth tax,” the Treasury Department appeared to try to effect through regulation for one constituency what they failed to effect through legislation for a like constituency. Moreover, they totally failed to comply with the Regulatory Flexibility Act, which would have ensured that the effects on small firms were taken in to consideration. They did so by labeling the rule “interpretative.” If the RFA were properly complied with, regulation writers might have been edified on the many problems with the proposal.

Congress imposed the “stealth tax” moratorium at the insistence of the coalition because the proposed regulation was unsound. A moratorium was indeed an uncommon step for the Congress to take; but it was needed to defeat an uncommonly bad proposed rule. Expanding the self-employment tax through a proposed rulemaking was neither the right process to provide guidance, nor the right guidance. At the same time, in promoting the moratorium both the coalition members and the Congressional supporters knew that legislative guidance would someday be required for the emerging number of LLC members. In enacting this moratorium, the two Chairmen of the tax-writing committees, Chairmen Bill Roth and Bill Archer, correctly observed that the issue of the proper definition of the SECA wage base resides with the Congress, and so advised the Department of Treasury.

The day to define a legislative solution to the “stealth tax” has arrived. The moratorium has now expired.

The story of the moratorium is an important lesson in the need for constant small business vigilance, but the post-moratorium events are equally important lessons in cooperation. In the ensuing years, the largest practitioners’ groups in the nation, particularly the American Institute of Certified Public Accountants (the latter led by Marc Hyman) and the American Bar Association, have assiduously worked with the small business community to propose a workable legislative solution with the complaints of the small business community in mind. Their proposal, which is attached, would effectively adopt what the coalition considered an acceptable solution and had recommended to Treasury.

Under their proposal, a general proscription against subjecting returns on capital to the self-employment tax base is set forth. Second, two safe harbors are specified for purposes of determining the earnings subject to employment taxes. The key safe harbor is the “reasonable compensation” standard. It is anticipated that this standard would obtain for virtually all limited liability pass through entities. S corporations are not covered in this legislative proposal, but are effectively provided a “reasonable compensation” standard by policy and C corporations are subject to a “reasonable compensation” standard by IRC section 162. To add greater clarity, the legislative proposal would advance a second safe harbor. Under this latter safe harbor, the taxpayer can effectively exclude returns below a certain threshold (150 percent of the highest applicable federal rate based on the fair market on his or her initial investment).

The Coalition to Stop New Small Business Payroll Taxes, and our members who have reviewed the proposal, including the National Small Business United, the Small Business Survival Committee, the Small Business Council of America, Empower America and others, join with the AICPA in recommending this solution to you.

We do so for four reasons. First, this change will harmonize the employment tax wage base of all limited liability pass-through organizations, as well as eliminate the unnecessary distinctions between the tax bases for these organizations and for C Corporations. The change will bring significant simplification and equity.

Second, the change will adopt the correct answer to the policy question that gave rise to the moratorium. The employment tax wage base should be limited to wages and net earnings from self-employment, and not expanded to include returns on capital by business owners. The proposed solution advanced by ABA and AICPA recognizes this overriding policy objective for limited partnerships, and entities treated as partnerships, including LLCs and LLPs. While it is true that the self-employed’s income is fully subject to the SECA wage base today, and a good argument can be made that the self-employed should not be subject to self employment taxes on their returns to capital, the solution advanced here is limited in scope and does not seek to correct a policy issues that was not germane to the proposed rulemaking or the moratorium.

Third, the adoption of this legislative proposal will fill a vacuum of guidance as to the wage base of earnings from self-employment. Expiration of the moratorium means that there is no guidance for the proper treatment of earnings for these entities. Today, as noted, there is virtually no standard on the level of LLC member or LLP partner earnings that are subject to the employment tax wage base. Consequently, practitioners are not able to properly advise their clients on a basic tenet

of taxation, the proper base. Moreover, a lack of guidance today does not protect small firms against regulatory “clarification” in the years to come. The paucity of guidance encourage selective enforcement, as well as abusive positions that reward aggressive taxpayers over taxpayers those struggling to impose their own reasonable standard. A vacuum does not answer the underlying policy issue any more than was the proposed rule that sought to fill that vacuum by expanding the employment wage base.

Fourth, finding a solution will respect the wishes of the two past tax-writing Chairmen who pledged to resolve this issue in the legislative format.

While no revenue estimate has yet been conducted on the proposal, the proposal should carry minimal revenue cost or even a small gain. This will depend a great deal on the baseline selected for the calculations; however, as current law offers no guidance on the proposed SECA wage base, it is clear that the baseline today may reflect liberal taxpayer positions in the future.

I greatly appreciate your considering this “good government” proposal as a sound way to close a chapter on an unfortunate issue. The moratorium was a necessary device—a tourniquet—used at the time as an emergency stopgap to a poorly conceived rulemaking. The legislative guidance provided through the joint efforts of the small business community and AICPA and ABA can provide the right permanent answer, harmonize employment tax treatment and simplify this area of law. The “stealth tax” issue may serve as one reminder to Members of Congress of the constant vigilance small firms must show against poorly designed tax policy; but it is also an issue that exemplifies how the business community and the Congress work together to find a viable solution. I encourage you to support their consensus solution.

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

The U.S. Chamber of Commerce appreciates this opportunity to express its views on tax reform for small businesses. The U.S. Chamber is the world’s largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

THE NEED FOR SMALL BUSINESS TAX REFORM

Over the past decade 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 raising our standard of living. Small enterprises and startups form the foundation for our future economic prosperity. It is in the best interests of our country that small businesses be encouraged and nurtured through the promotion of tax policies that allow them the opportunity to reinvest more resources in their continued growth, rather than in the expansion of big government. This can be manifested in a number of ways, several of which are presented as follows:

Reduce Marginal Tax Rates, Including Those on Capital Gains and Dividends

Many economists believe that reducing marginal tax rates, including those levied on dividends and gains from the sales of capital assets, will stimulate economic growth. Putting more funds in the hands of taxpayers will increase purchases of goods and services, and the resulting increase in demand will help businesses to grow. Furthermore, 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.

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. The estate and gift tax runs contrary to this basic philosophy. It is a burdensome tax that heavily penalizes savings and investment, especially in family-owned businesses. It should be repealed.

Accelerate the Cost Recovery of Business Assets, and Increase the Small Business Equipment Expensing Allowance

Under current law, businesses can annually expense up to \$24,000 of equipment purchases. This allowance is scheduled to increase to \$25,000 for 2003 and later years. In general, businesses investing more than the annual expensing allowance must recover the cost of their expenditures over several years through the depreciation system. Inflation, however, erodes the present value of future depreciation deductions.

This injustice can be remedied through the full expensing of business equipment, or, at the very least, a further increase and/or acceleration of the "Section 179" equipment expensing allowance. Such measures would spur additional investment in business assets and lead to increased productivity and more jobs.

Repeal the Corporate and Individual 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. Additionally, the 1997 Act did not increase the exemption amount for individuals, leaving more and more middle-income individuals vulnerable to the AMT.

Repealing the AMT would spur capital investment within the business community, thereby creating more jobs. The AMT system needs to be made less complex and easier to comply with.

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 on 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 key in many fields where it takes years of research before a product can be brought to the market.

Accelerate the Implementation of the 100-Percent Health Insurance Deduction

Under present law, self-employed individuals may only deduct a portion of their health insurance expenses for themselves, their spouse, and their dependents. The deductible percentage is currently 60 percent. Moreover, the deduction for health insurance expenses of self-employed individuals is not available for any month in which the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or their spouse.

While employees exclude from income 100 percent of employer-provided health insurance, self-employed individuals who provide their own health insurance are disadvantaged by the tax code, as their deduction is limited. Self-employed individuals should be put on an equal footing with employees, and the tax law should be amended to immediately provide full deductibility for the health insurance that they provide for themselves.

Allow Small Businesses with Inventory to Use the Cash Method of Accounting

Many businesses that maintain small or nominal amounts of inventory prefer to use the cash method of accounting instead of the accrual method. However, the Internal Revenue Service challenges the use of the cash method in many instances and the burden of proof then shifts to the taxpayer to establish that the cash method clearly reflects income. Meeting the burden of proof can be costly and time consuming to taxpayers being challenged, leaving little recourse except to accede to IRS determinations.

It is appropriate for certain businesses, in particular small businesses, to report their taxable incomes using the cash method of accounting, even if they maintain some inventory, and the IRS' ability to challenge the use of the cash method should be constrained.

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 either 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.

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. In recent Congresses, objective criteria were proposed to determine who is not an employee. These criteria would have been significantly clearer and easier to apply than the existing subjective 20-factor test and “Section 530” safe harbor rules.

The worker classification rules should be clarified and thoughtfully reformed to increase flexibility in the use of the independent contractor designation, while resisting any hasty, poorly-conceived efforts that may harm the thousands of businesses and workers around the country that have relied on the current law for more than two decades.

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.

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's 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.

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 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 af-

fordable 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 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 offer retirement plans.

Furthermore, legislation is 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.

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.

Expand and Permanently Extend the Exclusion for Employer-Provided Educational Assistance

Payments received by an employee for tuition, fees, books and supplies under an employer's educational assistance program may be excluded from gross income up to \$5,250 per year. The exclusion applies with respect to undergraduate courses. In the past, the exclusion also applied to graduate-level courses.

Educational assistance provided to employees help to develop an educated, skilled workforce, thus improving its productivity. Changes in the tax law should better support employers' efforts to enable their workers to continue to learn, and the tax system should favor those efforts with proper incentives, such as the exclusion from income for this assistance.

Efforts should be made to make permanent the exclusion for employer-provided educational assistance, increase the amount of the exclusion to keep pace with escalating educational costs, and to extend it to graduate courses, as well.

CONCLUSION

In order to buoy American business, providing business tax relief must be a top Congressional priority. While business has been investing in research, building plants, buying equipment, expanding its markets, creating jobs and developing the workforce, this has happened against the backdrop of federal taxes increasing as a percent of the Gross Domestic Product and the federal tax code becoming ever more complex and burdensome.

If business—and small business, in particular—is to continue to lead the economy, taxes must be cut and the federal tax code must be changed to encourage work, saving, and investment. Implementation of the reforms previously set forth will go a long way toward these ends.

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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. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 85 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.

