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C, K, OR S: EXPLORING THE ALPHABET SOUP OF SMALL BUSINESS CHOICES IN ADVANCE OF TAX REFORM

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C, K, OR S: EXPLORING THE ALPHABET SOUP OF SMALL BUSINESS CHOICES IN ADVANCE OF TAX REFORM

THURSDAY, JUNE 5, 2008

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

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Wyden, Salazar, Grassley, and Snowe.

Also present: Democratic staff: Bill Dauster, Deputy Staff Director and General Counsel; Cathy Koch, Senior Advisor, Tax and Economics; and Rebecca Baxter, Tax Counsel. Republican staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Jim Lyons, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

The poet Archibald MacLeish once wrote, "The business of the law is to make sense of the confusion of life, to reduce it to order, and at the same time to give it possibility, scope, even dignity."

Today we consider the laws governing the taxation of small businesses. Do those laws bring order out of confusion or do they bring confusion out of order? How far are they from the ideal of giving businesses possibility, scope, or even dignity?

Small businesses play an important role in keeping our economy strong. They are a vital source of job creation, economic opportunity, and technological innovation. There are about 26 million small businesses in America. Businesses with fewer than 500 employees represent more than 99.9 percent of all American businesses.

Small businesses pay nearly half of total American private payroll. They have generated 60 to 80 percent of the new jobs annually over the last decade, and small businesses employ 40 percent of high-tech workers, such as scientists, engineers, and computer workers.

Small business is particularly important in rural States like mine in Montana. In our State, even the large businesses are generally small businesses. Rural communities generally do not have big corporate employers. Rural families rely on small businesses for jobs.

So I am happy today that we are looking at small business tax issues as we prepare for tax reform. The way that a business chooses to organize has a significant effect on its taxes. The principals of a business can choose to have their income taxed as part of individual income tax or they can choose to have their income taxed separately at the level of the business in corporate form.

The income of sole proprietorships, partnerships, and S corporations is all taxed as individual income, after it is allocated to the business owners. People call these types of businesses "pass-through entities."

Each of these pass-through entities has its own unique features. Some of these features can create barriers to growth and innovation. Others can provide financial advantages and incentives for the business to grow and create jobs.

When we think about tax reform, we have to consider whether the tax code meets all of these different models. We also have to keep in mind that the needs of different small businesses are different.

"One-size-fits-all" does not work when choosing a business model. The needs of a sole proprietorship may differ from those of an S corporation. We need to keep these differences in mind so that all businesses have a fair shake and can benefit from reform.

Today we will explore these differences. We will look at the way that the Federal Government taxes the income of domestic non-corporate businesses. We will seek to identify the benefits to the American economy provided by partnerships and other pass-through entities.

And we will examine entity classifications. We will hear about the background of current entity classifications, the purpose behind each classification, and the issues and problems that arise from them.

The witnesses we have here today have a breadth of knowledge and experience dealing with business entity choices. They know the effect that taxes have on small business. And they know the way that small businesses choose to do business.

So let us examine the laws governing the taxation of small businesses. Let us try to bring some order to the confusion. And let us work toward the goals of giving businesses possibility, scope, and even dignity.*

Senator Grassley?

OPENING STATEMENT OF HON. CHUCK GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Thank you very much, Mr. Chairman. I am glad to be with you on a subject that we always hear about from our constituents at town meetings, why don't you get rid of this tax system? The trouble is, nobody really has their mind made up about what ought to take its place. Today we are looking at business, whereas most of my comments come from people who pay taxes as individuals.

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*For more information, *see also,* "Tax Reform: Selected Federal Tax Issues Relating to Small Business and Choice of Entity," Joint Committee on Taxation staff report, June 4, 2008 (JCX–48–08), *http://www.jct.gov/publications.html?func=startdown&id=1291.*

Taxpayers have a wide variety of entities to choose from when starting a small business. These small business owners can operate as a limited liability company, as an S corporation, a partnership, a limited liability partnership, sole proprietorship, or a farm sole proprietorship. And over the years the number of entities keeps increasing. The tax laws relating to small businesses have also grown increasingly complex over time.

Some of this complexity exists because we give partnerships a lot of flexibility when allocating income, losses, and deductions to partners. However, a lot of the complexity found in the partnership tax rules arose in response to abuse by partnerships that were trying to unfairly take advantage of rules.

In response to this complexity, a lot of taxpayers' gut reaction happened to be that the tax system should be simplified. However, taxpayers usually want the tax system simplified unless it means that they have to pay more taxes. Another thing that taxpayers care about is having the freedom to conduct their business the way that they want, so the wide variety of entity choices currently available allows small business owners much freedom.

One of these choices, the limited liability company, has become increasingly popular. The LLC offers the best of all worlds: limited liability, a single-level tax, and great flexibility in allocating income deduction losses. Even though an LLC provided these attractive features, people were originally hesitant to form an LLC because the case law relating to LLCs was not as developed as the case law relating to S corporations and partnerships. However, as this case law has developed, small business owners have used the LLC with greater legal certainty.

Similarly, the LLP has been utilized to a greater degree in recent years. I should also note that the S corporation remains a very popular entity choice for new businesses. With the growing number of entity choices comes, of course, complexity. This complexity imposes large administrative costs on hardworking business owners who must comply with these complicated laws.

Also, the complexity means small business owners cannot be confident that they received all the benefits coming to them or that they have not paid more than they owe. When looking at simplifying our tax laws for small businesses, then, we must consider the fact that taxpayers like having choices and flexibility in arranging business affairs and they do not want to get hit with a tax increase just for the sake of simplification.

While we all agree something should be done and we should be open-minded about reform, I would like to remind everyone that, if we allow the bipartisan tax relief plans of 2001 and 2003 to expire in 2010, it will result in a huge tax increase, particularly on small businesses.

We just had the Treasury Department publish a paper titled "Topics Related to the President's Tax Relief," released just last week. About 74 percent of tax returns that will benefit this year from lowering the top rate from 39.6 percent to 35 percent are flow-through business owners. Also, about 82 percent of the $29 billion in tax relief this year from lowering the top rate will be received by flow-through business owners.

If we fail to act to prevent this bipartisan tax relief from expiring at the end of 2010, we will be taking money from the pockets of small business owners. This is money these small business owners could use to hire more workers or spend in our economy on goods and services.

According to the U.S. Small Business Administration, small businesses employed over 58 million workers in 2005, which is more than all other firms combined. Our small business owners, including farmers, are of course the backbone of the economy. We should not break our economy's backbone by hammering it with dramatic tax increases.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator, very much.

Our first witness is Dr. Douglas Shackelford. He teaches taxation at the University of North Carolina at Chapel Hill, and is a research associate at the National Bureau of Economic Research.

The second witness is Dr. Eric Toder. Dr. Toder is a senior fellow at the Urban-Brookings Tax Policy Center, and just recently worked as Director of the Office of Research at the IRS.

Then we have Mr. Samuel Starr, who is the tax matters partner for PricewaterhouseCoopers, and is a professor of law at Georgetown.

Finally, Mr. Dewey Martin, who is the owner of a tax practice and a tenured professor and chair of the Accounting Department at Husson College in Bangor, ME.

Thank you all for coming. We customarily have all of your statements included in the record automatically, and ask that you speak for about 5 minutes.

Dr. Shackelford?

STATEMENT OF DR. DOUGLAS A. SHACKELFORD, MEADE H. WILLIS DISTINGUISHED PROFESSOR OF TAXATION AND ACCOUNTING, UNC KENAN-FLAGLER BUSINESS SCHOOL, CHAPEL HILL, NC

Dr. SHACKELFORD. Senator Baucus, Ranking Member Grassley, and other members of the committee, thank you for inviting me to testify on this hearing on small business tax reform.

One of the most important decisions that businesses face is choosing their legal organizational form. There are many organizational forms that a business may choose, including pass-through entities. Pass-through means that the entity serves as the conduit through which the profits of the business pass-through to the investor's tax return, escaping taxation at the entity level.

Pass-through entities include sole proprietorships, general partnerships, limited liability partnerships, S corporations, and limited liability corporations, or LLCs. Every pass-through entity has different requirements. Presently, the most popular pass-through entity for new companies is the LLC.

Another organizational form is the C corporation. The profits of a C corporation are taxed first at the corporate level, and then shareholders are taxed when they receive dividends. Only C corporations face double taxation, that is, both entity and investor taxation, since pass-through entities are only taxed at the investor level.

Since the purpose of this hearing is to focus on small business tax reform, and specifically the entity choices that small businesses face, I will focus my comments on this principal tax difference between C corporations and pass-through entities, that is, whether the income of the business is taxed at the entity level. To demonstrate the cost of double taxation in the C corporate form, assume a 35-percent corporate tax rate, a 15-percent dividend tax rate, and a 35-percent individual tax rate, which are our current maximum tax rates.

If the C corporation earns $1 of income, it pays 35 cents in tax. If it pays the remaining 65 cents as the dividend, its shareholders are left with slightly more than 55 cents. In contrast, if a privately held firm adopts the pass-through entity, its investors are taxed on the entire $1, leaving its investors with 65 cents. No further tax is levied on the pass-through entity or its investors.

This difference of nearly a dime, or 10 percent, in after-tax returns to investors provides a major tax incentive to avoid the C corporate organizational form. Even if the C corporation never pays dividends, fully avoiding the investor-level taxes, it still pays the same 35 cents of tax at the corporate level alone that the investors in the pass-through pay in total. Therefore, at best the C corporate form yields the same after-tax outcomes as the pass-through entities.

Given these incremental tax costs to C corporations, it is not surprising that pass-throughs have naturally evolved to provide the benefits of the corporate form—for example, legal liability—while avoiding the corporation's double taxation.

Furthermore, the demand for a simple level of taxation is so strong that privately held C corporations commonly distribute their profits in a tax-deductible manner—for example, year-end bonuses—to mitigate their entity level tax, a form of what I call "homemade pass-through."

Here is my bottom line. If you do not intend to address the primary tax issue motivating pass-through entities, that is, double taxation, then I recommend making no changes. Each of the pass-through entities has different nuances that appeal to businesses in different situations. They are well understood in the legal and accounting communities. Changing the rules that apply to business entities will likely create additional unnecessary transition costs for small business. Of course, as always, there may be minor tweaks, either legislative or regulatory, that would marginally improve the system.

Let me close with three final thoughts. First, note that double taxation only applies to dividends. All of the payments to shareholders and stakeholders of the firm, such as interest and compensation, pass through, that is, they are deductible at the entity level and only taxed to the recipient.

Second, publicly traded businesses are always taxed as a C corporation and thus must face double taxation. Consequently, our present tax policy levels higher taxes on firms simply because they access the public capital markets. If the purpose of this distinction is to provide tax relief to small business, it is a clumsy means because, while almost all small businesses are privately held, not all privately held firms are small. There are many large businesses

that are privately held and enjoy favorable pass-through status compared with their publicly traded competitors.

Third, pass-through entities are even more advantageous when business generates taxable losses which often occur in the early years for the business. In the C corporation the losses are carried forward until positive taxable income is generated, if ever. With the pass-through, the investors can immediately use the losses from their business to offset other income that they may have.

Thank you very much.

The CHAIRMAN. Thank you, Dr. Shackelford.

[The prepared statement of Dr. Shackelford appears in the appendix.]

The CHAIRMAN. Dr. Toder?

STATEMENT OF DR. ERIC J. TODER, SENIOR FELLOW, URBAN INSTITUTE, WASHINGTON, DC

Dr. TODER. Chairman Baucus, Ranking Member Grassley, and members of the committee, thank you for inviting me to testify today on tax reform and small business.

A tax code that is fair, simple, and conducive to economic growth is in the interest of all businesses, large and small. Today I will discuss how provisions of the tax law affect how businesses organize themselves and whether economic activity occurs within small or large business enterprises, and then comment on how tax reform may affect these choices. I will just say parenthetically, I am only going to cover selected aspects of this very, very broad subject.

My testimony makes the following points. First, while several provisions of the tax law explicitly favor small business, such as section 179 expensing, more general provisions are much more important for determining business size and structure. Double taxation of corporate equity income encourages businesses to organize themselves as flow-through enterprises—partnerships, sole proprietorships, and subchapter S corporations—in favor of smaller over larger businesses which are more likely to be taxable corporations.

Changes in tax laws and regulations that make it easier for businesses to gain the advantage of limited liability without paying corporate tax have facilitated a large growth in the share of business receipts going to flow-through enterprises in the past decade.

Second, provisions that affect labor income and deductions also affect business structure. Small business owners benefit from being able to use more work-related deductions than employees of larger businesses, but working in the other direction, the tax exemption for health insurance favors larger businesses that are better able to pool employee health risks.

Third, the technology of tax compliance and administration affects small and large businesses differently. Small businesses face higher compliance costs per dollar of receipt than larger businesses, but also have more opportunities for non-compliance, especially if paid in cash. So, there are a lot of things going on that affect business structure.

I will comment on a few tax reforms under consideration that could affect these incentives. First, proposals to lower the corporate rate and finance the revenue loss by eliminating or reducing some business tax preferences would, on balance, reduce the relative tax

burden on corporations. Among business forms, taxable corporations alone would benefit directly from a corporate rate cut, while all forms of businesses would pay more tax if business preferences were scaled back.

Second, proposals to reduce or eliminate the double taxation of corporate dividends could have widely varying effects on the cost of corporate capital, income distribution, and economic growth and efficiency depending on how double-tax relief is designed, and I will not go into those details. But in all cases, double-tax relief would reduce the incentive to organize businesses as flow-through enterprises instead of taxable corporations, and also reduce incentives for corporations to finance themselves with debt instead of equity and to retain earnings instead of paying dividends.

Health care reform, now under consideration, as you know, will also involve major changes in Federal tax law. Although there are big philosophical differences between those who would rely mainly on mandates and regulations and those who would emphasize changing market incentives, both broad approaches to health reform would reduce the relative tax advantages to large employers that the current unlimited tax exemption of employer-provided premiums provides, and I think ultimately will reduce labor costs to small businesses.

In conclusion, the current income tax influences the distribution of businesses by size and forms of business organization in many ways, including many I have not mentioned. Lower tax rates, a broader tax base, removal of the double taxation of corporate dividends, and reform of our health care finance system would make the tax law more even-handed in its treatment of different businesses and encourage use of the most productive forms of business organization.

The CHAIRMAN. Could you say that last statement again, please?

Dr. TODER. I am sorry. Lower tax rates, a broader tax base, removal of the double taxation of corporate dividends, and reform of our health care finance system would make the tax law more even-handed in its treatment of different businesses, businesses of different sizes, and thereby encourage use of the most productive forms of business organization.

Thank you very much.

The CHAIRMAN. Thank you. That was very interesting.

[The prepared statement of Dr. Toder appears in the appendix.]

The CHAIRMAN. Mr. Starr?

STATEMENT OF SAMUEL P. STARR, TAX PARTNER, PRICEWATERHOUSECOOPERS, LLP; AND ADJUNCT PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Mr. STARR. Chairman Baucus, Ranking Member Grassley, Senator Snowe, Senator Salazar, good morning.

The CHAIRMAN. Good morning.

Mr. STARR. First, I thank the committee for the opportunity to testify before you on the way businesses choose to organize and the tax consequences that result from that choice. Second, I applaud the committee for exploring this issue, as it is economically significant to many taxpayers. My comments largely will focus on smaller

businesses and the tax issues surrounding their choice of business form. It is the smaller businesses that commonly use the pass-through tax regimes authorized under the code.

Over the past 2 decades, the percentage of businesses using the pass-through regimes, including sole proprietorships, has increased significantly. Data shows that larger businesses tend to operate in regular corporate form, while smaller businesses tend to choose pass-through forms like limited liability companies and S corporations.

A few of the more significant changes over the past 20 years contributing to this shift in favor of pass-through entities are: first, the differential between the marginal tax rate imposed on corporations and individual taxpayers has been narrowed or eliminated; second, the amount of the double tax imposed on corporate dividends has remained high until relatively recently; third, the enactment of the LLC statutes by all 50 States; and fourth, the adoption of the "check-the-box" regulations by the IRS which simplify entity classification and the movement into pass-through tax regimes.

An objective of our tax system should be to create tax parity among the various business forms so that one taxpayer is not disadvantaged over another simply because of its choice of business form. Because of the double tax imposed on regular corporate earnings—once at the corporate level, once on dividends—businesses that choose the regular corporation are disadvantaged compared to the single tax pass-through entities. Marginal income tax rates imposed on corporate and non-corporate taxpayers play an important role in what business form business owners decide to use.

For instance, if a small business operates in the LLC form, taxable as a partnership, the LLC's business earnings are reflected directly in the individual LLC member's taxable income. Therefore, small business owners can quickly find themselves at the current maximum 35-percent marginal income tax rate for individuals with as little as $358,000 of taxable income for married individuals filing jointly in 2008.

As marginal individual income tax rates change, small businesses react accordingly in their choice of business form. Significant shifts in marginal tax rates and the relative differential between the corporate and individual tax rates can likewise trigger significant shifts in choice of business entities.

The pass-through regimes effectively allow small business owners to integrate their businesses for Federal income tax purposes through a choice of an appropriate business form. For instance, the only practical exit from the corporate double tax is for the eligible regular corporation to make an S corporation election to treat itself as pass-through for income tax purposes. In this regard, the S corporation serves much the same purpose today as it did in 1958 when it was first adopted, allowing corporations to move into the single-tax regime to eliminate the distortive effect of the double tax on small businesses organized as corporations.

Over the years, Congress has enacted a number of improvements and refinements, making the S corporation easier to use and available to a broader base of taxpayers. In addition, the IRS has been very responsive to S corporation needs and has interpreted the S

corporation rules reasonably and fairly. For this, the S corporation community is grateful.

Over the last few decades, more small businesses have chosen to organize under the code's pass-through regimes. As noted earlier, a number of factors have contributed to this migration from the regular corporate form. Until the distortions created by the double tax can be resolved, the current pass-through regimes provide a valid integration function allowing for a more efficient tax system, at least to that segment of the economy that can use pass-through tax regimes. Therefore, subchapters K and S should continue to coexist while Congress works out a comprehensive corporate integration model.

Thank you for the opportunity to join you today at today's hearing. It is, indeed, an honor. This concludes my remarks.

The CHAIRMAN. Thank you, Mr. Starr, very much.

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

The CHAIRMAN. Mr. Martin, you bat clean-up here.

Mr. MARTIN. Well, as a fantasy baseball freak, I can appreciate that.

The CHAIRMAN. All right. Good.

STATEMENT OF DEWEY W. MARTIN, CPA, CMA, PROFESSOR AND CHAIR OF THE ACCOUNTING DEPARTMENT, HUSSON COLLEGE, HAMPDEN, ME

Mr. MARTIN. Chairman Baucus, Ranking Member Grassley, Senator Salazar, and from the great State of Maine, Senator Snowe, thank you for inviting me here today. It is an honor to be here.

I also want to thank the NFIB for their support in getting me here and helping me with my presentation.

If I appear uncomfortable to you, it is partly because, before I left Bangor yesterday, Homeland Security took my aftershave, my toothpaste, and my deodorant. [Laughter.]

The CHAIRMAN. I think that is because, if I am correct on this—maybe I am incorrect; I guess I am incorrect, now that I think about it—that in 9/11, the terrorists started from the Northeast before they went to New York.

Mr. MARTIN. Maine had a problem with that. I do not know how you bring down a plane with toothpaste. Somebody knows more about that than I.

The CHAIRMAN. I have the same problem in Bozeman, MT. I think the smaller airports are much, much more strict than the larger ones.

Mr. MARTIN. This one was.

The CHAIRMAN. Yes.

Mr. MARTIN. My comments come from a background of 37 years in a public accounting practice, focusing in great part on tax law because that is why my clients want me to come in the door. I have a very small client base of about 280 clients, 90 percent of whom are pass-through entities, very few C corporations. The double taxation of income at the C corporation and the dividends being taxed at the shareholder level has already been addressed, but one point that has not been addressed which affects the small business community significantly is when a business changes hands, that the C

corporation sells their assets and then distributes the proceeds to their shareholders.

There is also significant double taxation on those two transactions, and now we are not talking about maybe a couple thousand dollars a year in tax costs, we could be talking about hundreds of thousands or more in tax costs because of the elimination of what used to be called the Kimbell-Diamond Rule back in the Tax Reform Act of 1986. That is a very significant issue with regard to C corporation taxation. That is the primary reason why I attempt to funnel my clients towards a pass-through entity. About the only advantage today, to me, for C corporation status is fringe benefits. They still have to follow ERISA, they still have to follow discrimination rules, but they do not have a lot of the other problems that the pass-through entities have with fringe benefits.

As has already been said, most partnerships formed today are LLCs. A lot of attorneys that I deal with are recommending LLCs to sole owners, and I am just sorry I do not go along with that recommendation, so a lot of times I do not recommend that they do that, for simplicity's sake.

Partnerships do allow the free flow of cash in and out. It is very easy to do, the cash going in, the cash going out when any partner needs it. That is a very important way to handle an individual's personal cash flow advantages, and a lot of the partnerships that I have as clients are real estate developers that have big money going in, big money going out, and the partnership form works for them.

But subchapter K in the Internal Revenue Code is virtually unintelligible. Luckily, we have had a lot of support from the IRS in helping us with how to do things, but it is some of the toughest tax law there is to deal with. No double taxation of income or on liquidation for partnership. One thing that bothers me with the partnerships is that they are not allowed to have wages, and I happen to think that partnerships ought to be allowed to have wages. My clients who are partners would like to have withholding taken out of their pay so that they have less of an issue with estimated tax payments, and I think that would be a simplification that would help things.

An S corporation is very easy to set up. I have clients who set them up themselves. The attorneys in the audience would not like for me to say that, but they can easily do it themselves in Maine, and I encourage them to do so. Easy transfer of ownership. LLC has easy transfer of ownership as well.

But in terms of succession planning, it is very easy for me to go to a client and say, all right, transfer this number of shares to your children December 31 to January 1 to take care of the gift tax exclusion. It is very easy to do with S corporations. There is no double taxation on income or liquidation, as long as you do not run afoul of the built-in gains tax problem, which I have run afoul of several times.

Just a note on the way the IRS has ruled that we have to handle health insurance for shareholders of S corporations. Someone needs to take a look at that. I do not have one client who understands how that is supposed to be done.

Another thing that I think that ought to be fixed is the basis for S corporation shares for guaranteed loans. Right now, the S corporation shareholder does not have basis for loan guarantees, only for direct loans. Partnerships do, and I think S corporation shareholders should as well.

My client base basically does not have accountants: I am their accountant. I effectively function as their part-time comptroller for their businesses. I do not have one client that has someone, I would say, qualified as an accountant. I also do not have one client that has a human resource person, so I pretty much answer most of the human resource questions. That is a shame. Their retirement plan issues, their health plan issues, and how to deal with them, the myriad of the tax laws, is very, very difficult for them to deal with. Complexity is the single biggest problem for my small business clients.

In closing, I would like to say, remember that small business has generated 60 to 80 percent of all the net new jobs over the last decade, so please consider small business when enacting any tax law changes.

Oh. And just as an aside, please enact the extenders before December. [Laughter.]

Thank you for inviting me, and thank you for listening.

The CHAIRMAN. Thank you very much, Mr. Martin. We deeply appreciate your approach.

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

The CHAIRMAN. I just have a general question, but I think it is a fairly important one. I suspect that the next President will submit a major health reform proposal to the country, whether it is Barack Obama or John McCain. At the same time, we have a potential collision coming down the track in the tax code with the 2001 and 2003 provisions expiring, Federal estate tax zeroed in 2010, AMT, $10,000 down the road in 2010. So there is going to be kind of a nexus between the two, health care reform and tax reform.

I would like your impressions, your thoughts, your recommendations on how we think about that intersection, I guess, with respect to small business. That is, health reform and how small businesses can provide health insurance for themselves, their employees, along with tax reform. I know you have not had a lot of time to think about all that, but Dr. Toder, you made some comment along those lines. I would like each of you to just give us some basic recommendations as we approach health reform and tax reform.

Some of you alluded to the employer-provided exclusion for health care costs. Many of you suggest that that is too high, particularly because there is no limit on it currently. Some of you suggest that that tends to favor big business, the current law, as opposed to small business.

So I would just like your thoughts on how we might begin to approach that. I will begin with you, Dr. Toder, because you raised the subject.

Dr. TODER. Well, I am being punished for raising the subject.

The CHAIRMAN. No, no. [Laughter.] You are being rewarded for raising the subject.

Dr. TODER. That is a difficult question. Let me say, I am not a detailed expert on health care reform, so you will have to go somewhere else for those answers, maybe within your own committee.

The CHAIRMAN. Right. I am just thinking, your general thoughts.

Dr. TODER. But in general, it is clear that the way most Americans get health care is through their employers. The employer deduction that we have now is a key aspect of the tax code that makes that possible, so, even though it favors large businesses over small businesses, I think just simply getting rid of it, or severely curtailing it without doing anything else would be very inadvisable.

The CHAIRMAN. And why does it favor large businesses?

Dr. TODER. Well, basically because, if you are a small business in today's insurance market and you have only a small number of employees, it is very difficult to get good rates. It is very difficult with the risk pooling situation that we have. So it is really much more efficient if you can have a large pool of people who are working for you for reasons other than their need for health insurance, and then you can get an adequate group in which to buy coverage. So, having that kind of agglomeration is very advantageous.

Now, that would be true without the tax code in place, but the tax code we have has encouraged Americans to get health care coverage through their employers as opposed to through other ways. So to the extent that that has happened, it has made it a little easier for large employers. Now, large employers are also concerned about rising health care costs.

The CHAIRMAN. You are talking about the pooling availability, the larger number with respect to big business?

Dr. TODER. Yes. Yes. Right. And if you look at the data, the health insurance coverage is much higher in large business.

The CHAIRMAN. Who wants to go next? Mr. Starr?

Mr. STARR. I will comment that, although I am not a health care expert, I would recommend that whatever we do with respect to health reform, that it be a reform proposal that would create parity across all business forms. You want to treat all taxpayers equally, large and small, and basically create parity between them.

The CHAIRMAN. Any thoughts on how we do that? What is the discrimination now, as you see it?

Mr. STARR. No. Right now I think there is not discrimination against any of the business forms. There would be a concern on my part if you went into health care reform that potentially might not take into account the fact that we need to have parity among all entities, large and small.

The CHAIRMAN. All right.

Mr. Martin?

Mr. MARTIN. My issue with health care is the complexity of the options that are available: flexible spending accounts, cafeteria plans, health reimbursement arrangements, health savings accounts. It is extremely hard for small business to figure out which one is the right option. The big corporation has the human resource officer and they decide, this is what we are going to do.

If you allow partnerships to have partners be employees and you allow S corporation shareholders to have fringe benefits like C corporation employees do and have those partner employees have the

same fringe benefits, we would kind of have an equal playing field, and these same type of plans will work for all those entities.

The complexity of dealing with choice of entity is affected by what is available for health insurance options. We have benefits expiring, the estate tax, in 2010, December 31. If your grandparent is plugged in, there is no estate tax if they die December 31, there is an estate tax if they die January 1. Hopefully we will enact some laws so there are not any post-mortem plannings about whether we pull the plug or not because of the estate tax. Interesting classroom discussions.

The CHAIRMAN. Right. Yes. But figuring on all the complexity in health care plans, is there that much difference between the plans or the options, or on the margin is there that much difference? I understand all the complexity and it causes a lot of businessmen to pull their hair out, it is so complex, and you too when you are working with them.

Mr. MARTIN. Right.

The CHAIRMAN. But I am just curious whether, given all that, and given our system in which there is going to be complexity because different health insurance companies are going to offer different plans, different options, and so forth, is it tolerable? Could you deal with it? That is my question.

Mr. MARTIN. We have to deal with it. I am the one who deals with it for my clients because they do not have anybody who can deal with it. It does not have to be as complex as it is. I do not know why we need to have HSAs and HRAs. I think those fringe benefit plans can be boiled down into one account. I happen to be a big fan of HSAs because it encourages individuals to manage their own health care with their own money, and I think that is a good thing to be doing.

The CHAIRMAN. Well, we are trying to do that in another area, and that is in education. There are so many different ways to——

Mr. MARTIN. Boy, is that the truth.

The CHAIRMAN. Yes. And trying to make it that much more simple by boiling them down into a couple——

Mr. MARTIN. That would be wonderful.

The CHAIRMAN. All right.

Dr. Shackelford? My time has expired, but go ahead. Just very briefly, the interplay between the two, any recommendation you might have?

Dr. SHACKELFORD. I will be very quick because I do not have much to add to what they have said. I cannot even understand my own health care options, and I would say that I am glad I am sitting behind this desk instead of behind your desk, given the tsunami of tax issues that are coming, and health care, and the other issues in the very near future.

The CHAIRMAN. Thank you. [Laughter.]

Senator Grassley?

Senator GRASSLEY. I have several paragraphs of background information here that talk about how, when the tax bill of 2001 and 2003 expire, how taxes are going to go up. I want to get immediately to the question for at least two or three of you to answer. You do not have to repeat each other, but I would like to have more than one view.

As you know, the vast majority of our small businesses are taxed on their business income at the individual owner's level because the vast majority of our small businesses are operated as either sole proprietorships or pass-through entities.

If we let these tax relief provisions expire at the end of 2010, what effect would these tax hikes have on small businesses? Somebody jump in, and maybe a couple of you comment. Do not fight over it. [Laughter.] Mr. Martin?

Mr. MARTIN. The only way a business can grow its business is with cash, and, if we take more money out of their pocket, out of the business owner's pocket and put it into government's stream of revenues, then we have less money to expand the business and add more employees.

Senator GRASSLEY. All right.

Dr. Toder, you were going to jump in.

Dr. TODER. Sure. I would just like to share a little data with you, because there are a lot of numbers that are thrown around. One number which I think you cited in your statement is—and I have a comparable number—in the top two tax brackets, 78 percent of tax units report some form of business income. However, many of those people are not small business people in the sense that you would normally think. Only about 40 percent of those have business income that is above half of adjusted gross income.

Another thing that we need to consider is, when you look across the scope of people who have business incomes, many of them would not be affected by increases in the top brackets. In fact, while only less than half of 1 percent of tax units are in the two top brackets, more business units are, but it is still a small number. Only 1.4 percent of tax units with some business income are in the top two brackets and 2 percent of tax units with over 50 percent of AGI from business income are in the top two tax brackets.

So while certainly a rise in the tax rate will burden high-income individuals if those top tax rates' cuts expire and many of those high-income individuals have some business income, it is also the case that most people with small business income are not in those tax brackets.

Senator GRASSLEY. Let me clarify that I was citing Treasury Department figures when I gave those figures out.

Dr. TODER. No, no. That is absolutely right. I think it is just a question of what figures are cited. As I said, our figures on the percent of high-income taxpayers who report some business income are very close to the Treasury's, Senator. I am not contesting those figures; I am just saying that there are different ways of looking at this.

Senator GRASSLEY. Next, for Professor Starr about general partners of various forms of partnerships paying self-employment tax. It is uncertain under current law whether a member of an LLC is treated as a general partner or a limited partner. With respect to S corporations, in contrast to LLCs, wages are subject to employment tax. Only the amounts an S corporation pays its shareholders as compensation are wages for those shareholders.

We had the Joint Committee on Taxation putting two proposals before us to modify the employment tax provisions for S corpora-

tions, LLCs, and partnerships. The Bar Association has had some recommendations.

So my question to you is, what changes would you recommend to employment tax laws governing S corporations, LLCs, and partnerships?

Mr. STARR. Thank you, Senator.

First, I would clarify for purposes of the Internal Revenue Code what is a general partner and what is a limited partner for purposes of the self-employment tax. Right now, we have proposed regulations from the IRS that give us guidance, but they are only proposed regulations. It is important to know whether you have a general partner. If you have a general partner, that general partner, under our current rules, is subject to the self-employment tax on all their earnings.

If you have a limited partner under our current code, they are only subject to self-employment tax to the extent that they receive guarantee payments for services rendered. Under the current rules, we just are not clear with respect to an LLC member, for example, whether they are a general partner or whether they are an LLC member.

Aside from that issue, I would also recommend that the committee consider the AICPA–American Bar Association proposal whereby we would create parity between the pass-through entities with respect to the self-employment tax. I recognize that S corporations and their shareholder-employees are paying employment taxes on their wages.

I think a similar rule in the area of partnerships and in the LLC arena would be very workable. In other words, you would subject to self-employment tax, in an LLC or in a partnership, the amount of payments to that partner for services rendered. To the extent that income coming to that partner is attributable to capital, it would not be subject to self-employment tax, very much akin to the S corporation regime.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Salazar?

Senator SALAZAR. Thank you, Chairman Baucus and Senator Grassley.

My sense from the testimony of the panel is that you like these pass-through entities, that they have worked well. They have been around for a long time, the subchapter S, subchapter K partnerships, the LLCs, et cetera.

So my question to you is—and if you would take about 15 seconds, each of you, to respond—if there was one thing that you would do to try to improve these pass-through entities under the tax code, what would the one thing be? I will ask you to just take 15 seconds to do that.

Why don't we start on this side of the table since you are closer to me, Mr. Martin?

Mr. MARTIN. Well, the critical part is simplification. Mr. Starr's statement a minute ago about symmetry between the taxation of self-employment income at the different pass-through entity level would be huge for my clients.

Senator SALAZAR. So self-employment income for the different entities.

Mr. MARTIN. Symmetry. Right.

Senator SALAZAR. All right.

Mr. STARR. Senator Salazar, I was going to say the same thing. So, thank you, Mr. Martin. I think we need to fix the self-employment tax issue with respect to pass-through entities.

Senator SALAZAR. All right.

Dr. Toder?

Dr. TODER. Actually, I was also thinking the self-employment tax and the different treatment of sub-S and corporations is an issue that needs to be addressed.

Senator SALAZAR. All right.

Dr. Shackelford?

Dr. SHACKELFORD. I think what you are trying to achieve is a corporation without double taxation, so I believe in the liberalization of the rules that will get you there more quickly. If I look at something that has evolved over time, the S corporation has gone from a very restrictive entity to a less restrictive, and I think you should continue down that path. One example would be relaxing the current restriction that you can only have one class of stock. That would be an improvement.

Senator SALAZAR. Let me ask a question, following up on Senator Baucus's questions related to health care. It is a big issue here in Washington. It is a big issue related to small business because everybody struggles with health care, but I think particularly small business, trying to figure out whether they can afford it, whether they cannot.

So as we look at taxation matters with respect to health care benefits and changes in that area, what advice would you give us to make sure that we do not run afoul of the great desire that I think most small businesses have to provide health insurance to their employees? Dr. Toder, you are the one who raised it in your summation. You said "lower tax rates, eliminate double tax, a broader tax base," but you said "reform of the health care system" on taxation is something we might be able to do.

Why don't each of you take a stab at that?

Dr. TODER. All right. I thought I got away with that with Senator Baucus. [Laughter.] I think what ultimately you need to do is some combination of individual mandates and subsidies, that basically without some kind of incentive—whether it is through individual mandates or some kind of reform where everybody has access to insurance on an equal basis, and the system is not dependent on the group of employees you happen to be associated with—you are going to have problems down the road. So if you are going to blow up the current system, you need to put something in its place.

Senator SALAZAR. Would you agree that we ought to blow up the current system and eliminate employer-based health insurance and the tax deductibility that is the incentive for that to be created, in connection with some conversations I have been having with one of my wonderful colleagues on this committee?

Dr. TODER. I think, ultimately, the current system is going to erode. If you want to take a stab at that, my only caution would be, and this is my personal view, I would hope we would eventually get to a situation where we have universal, or near universal, health insurance coverage for Americans. We are the only ad-

vanced nation that does not have that. That is not going to happen within the current framework.

Senator SALAZAR. All right.

Are there other members of the panel who want to respond to that question?

Dr. SHACKELFORD. I think you have to ask, how did we get to where we are, that one had to be an employee or an employer to have health care? I think if you go back to that, I believe if we started from scratch and we did not have wage and price controls many generations ago, we would not have ended up where we are.

Blowing up the system is a radical concept and would impact every person in the country. I do not really know how we get from where we are to there in that kind of radical mode. It seems to me there have to be some incremental steps that would get us toward a better policy.

Senator SALAZAR. All right. Thank you very much.

Dr. TODER. I do not disagree with that.

The CHAIRMAN. Thank you all very much. This is a provocative conversation here.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman. We welcome all of our panelists, and most especially a fellow Mainer, Mr. Martin. Thank you for being here. I would say, Mr. Chairman, he has the depth and breadth of experience, both as a certified public accountant, a certified management accountant, and he also is chair of the Accounting Department at Husson College, and he is in State and national leadership with NFIB. He has been named SBA Champion of the Year for Small Business as an accountant in Maine, New England, and nationally. So I want to welcome you.

The CHAIRMAN. I might say too, he reminds me of a Montanan. [Laughter.]

Senator SNOWE. He does, eh? [Laughter.] Straightforward, right?

The CHAIRMAN. Straightforward. I think he is somewhere between Maine and Montana.

Senator SNOWE. Exactly. Thank you. So I welcome you here today, Mr. Martin. Thank you for being here.

I want to begin with respect to exactly what we should focus on in terms of simplification. Obviously there are a number of initiatives that you have already discussed that are so critically important to small businesses. I am Ranking Member of the Small Business Committee, and previously chair, so I hear the common and most frequent complaint about the complexity of the code, and also the cost of compliance.

There are some critical issues that are so important to the vitality of small business and to this country. So we could use the reform of the tax code as a means by which to make sure that we preserve this sector of the economy that is the net job generator in America. So what would you recommend in terms of where we should do no harm and where we can provide simplicity with respect to some of the tax initiatives?

For example, we have small business expensing. That one is set to expire in 2010, very critical, frankly, for small businesses. It is going to go from $250,000 that is in the economic stimulus package that was recently enacted down to $25,000 by 2010. The tax issue.

They have an option of a calendar year versus another year. They do now, but it is obviously very costly.

Offering the cafeteria plans. Again, it is very complex to offer simple cafeteria plans because they have to comply with anti-discrimination rules that are very complex for small businesses.

So where should we focus our attention, to make sure that we preserve what we have, or change—consolidating the pass-through entities? Should there be some kind of approach to consolidate these entities by ensuring that we maintain the flexibility and the advantages that they offer depending on which entity that they choose? Mr. Martin?

Mr. MARTIN. Well, I have addressed the fringe benefit issue. I wholeheartedly agree with you, it is way too complex and needs to be simplified. I think there are some other areas. The section 179 direct expensing. We need to come to a number and leave it there for a while so that businesses can plan. It does not make sense for them to have to call me every December and say, how much can I expense this year?

Consistency is a big thing. The cash basis method of accounting. We have revenue rulings that say some businesses that have $1 million in sales, some businesses that have $10 million in sales, can use a cash method. I think any business that has $10 million or less in gross receipts ought to be able to use the cash method of accounting, recognizing that an inventory cannot be deducted until it is sold. That single exemption would be a huge simplification.

In the proprietorship arena, the home office deduction should be simplified. It would be very easy just to write a law that says $10 a square foot. You still have to meet other rules to deduct it, but the recordkeeping associated with it is huge. So, $10 a square foot for a home office, and then they do not have to keep all those records.

Senator SNOWE. Mr. Starr?

Mr. STARR. I would like to comment on the idea of potentially simplifying the code and the small business owners' compliance by consolidating the two pass-through regimes. I personally believe that, as the code stands now, it is important to leave those two regimes outstanding to co-exist with one another because I think it creates tax efficiencies for the small business owner. The choice, the option to choose subchapter K, go subchapter S, I think is important for tax efficiencies.

Senator SNOWE. Dr. Toder?

Dr. TODER. I do not really have much to add on this.

Senator SNOWE. Dr. Shackelford?

Dr. SHACKELFORD. Yes. I was just jotting down a few things that they have already said. I think cash accounting. You can expand that.

Senator SNOWE. With $10 million? I know Senator Bond had that legislation introduced as $10 million that would be the basis.

Dr. SHACKELFORD. I do not really have a figure in mind.

Senator SNOWE. All right.

Dr. SHACKELFORD. But more is better than less. I think widespread expensing makes lots of sense. I think, though I would respect the way some of my fellow panelists make their living, I

think almost anything that reduces the need for an accountant or lawyer to help you with your taxes is good policy.

Now, having said that, there is a point at which you cross the line—and it is not very far—until you have to have professional help. When you have the sort of entities we are looking at here, that is not a layman's job, and never can be.

My fear on the "do no harm" thing is that, if you go in and you create a new entity, or even if you reduce the ones you have, you may create more complexity than you do simplification. One of the good things about these that we have is that there is a long history that has gotten us to where we are and that in some sense brings simplification.

Senator SNOWE. Well, I just mentioned "do no harm" because I was serving in the U.S. House of Representatives when we engaged in the last tax reform effort that ostensibly was supposed to be tax simplification, and obviously we learned, unfortunately, otherwise. It created a lot of unintended consequences. Since then we have had 15,000 different changes to the tax code, and we have had 100 different pieces of legislation during that period of time since, so obviously that is a real hardship, particularly for small businesses, but for all Americans, frankly.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Snowe.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman. This has been a great panel.

Let me ask this health care issue a different way, and it plays off, I think, a couple of the comments. When I think about the employer-employee relationship in health care, the way I would characterize the future is trying to find a way to modernize that employer-employee relationship rather than to "blow" it up. I have been listening to some of these characterizations. It really relates to the point that you made, Dr. Shackelford, that we got into the wage and price controls and there was no way to do it, so we essentially said, let us just tie health care and employment together.

My question to you, Dr. Toder, is, if we create more options for employers and employees—which is what we have sought to do in the Healthy Americans Act, now with 14 sponsors, 7 Democrats and 7 Republicans—and we say, look, employers can continue to offer coverage if they choose to, but we are not going to automatically tie health care and employment together the way we pretty much did in the 1940s, would that not be one way to start the process of leveling the playing field for the small business person? Because it seems to me that that would be one way to start us down the road of an approach that worked for both employers and for workers.

Dr. Toder?

Dr. TODER. Well, I guess it really depends on what you mean by choice. As I understand what you are trying to do, it is to have some kind of a mandate to purchase insurance coupled with subsidies for those with low incomes who could not otherwise afford it, and then say to them, they can get insurance wherever they can. Obviously you would need to, as I think you do, combine that with some kind of insurance market arrangements that would ensure

that insurance companies are not cherry-picking and just picking the healthy people to sell insurance to. So this is a complex process. I think what you do if you do go that way, you are expanding choices, but you then are in some sense taking away the employer position as the dominant——

Senator WYDEN. No, we are not. We have filed an amendment, Senator Grassley and I, the Ranking Republican here, that specifically says that, if the employer wants to keep doing what they are doing, they can keep doing it. If the worker wants to stay with the employer, they can stay with them. We are simply creating more options for both the employer and for the employee.

I think you made a very thoughtful comment about how we need to level the playing field for the small business person, and that is why it seems to me, if we do not automatically say that we have to tether health care and employment together, we start moving in the direction you are talking about.

Dr. TODER. Well, I think you are right: you are creating more options. But in some sense, in creating those options you are taking away the advantage large employers have as a supplier of health insurance, so you are radically changing the system in doing that.

Senator WYDEN. I do not want to repeat myself, but we are not. The fact is, if——

Dr. TODER. It might be a good way to do it.

Senator WYDEN. If Intel and Microsoft and large employers want to keep doing what they are doing, the amendment I filed with Senator Grassley says absolutely nothing changes. Absolutely nothing. But in giving particularly more options to small employers, which is, I think, a very important point that all of you have made, it seems to me we get the upside of what you are talking about of trying to help the small employer without the down side of "blowing" something up.

But you all have been very good. This has been a great panel. Dr. Shackelford, thank you for bringing up the history here, because what we are doing in 2008 does not make a lot of sense for 1948. I want any employer in America who wants to keep doing exactly what they are doing to have the chance to do it, and Senator Grassley and I made that explicit. We filed a separate amendment so there was not any confusion about it. But I hope that we will also walk away saying we have to modernize this relationship, and we will be asking the counsel of you four on how to do it.

Mr. Chairman, this has been a great panel, a great series of hearings on tax reform. Thank you.

The CHAIRMAN. Thank you, Senator.

I would like you to comment on the 1986 tax reform changes and the degree to which it helped or hurt small business, and what has happened. Who wants to go first?

Mr. STARR. I will jump in. The Tax Reform Act of 1986. I thought at that time—I was very actively engaged with clients—that it was beneficial to small businesses. For example, there were a number of "incentives" in the Tax Reform Act that turned out in favor of moving from the double-tax regime, the regular corporation, to making S corporation elections, which helped closely held private businesses to move out of the double tax into a single-tax regime.

The CHAIRMAN. Now, since 1986 has there been erosion or have there been more changes that helped?

Mr. STARR. I would say, net-net, since 1986, over the past 20 years all the changes, I would say, pretty much have favored moving into the pass-through regime. So I do not think we have actually eroded since 1986; we have progressed since 1986.

The CHAIRMAN. All right.

Anyone else? Dr. Toder, what do you think?

Dr. TODER. Well, I think I would comment on the 1986 Act as, it was enormously beneficial to the economy to drop the rates and eliminate many of the tax shelters. I think anything that is good for the economy is probably good for small businesses as well. So beyond that, I do not think I have much to add to what Mr. Starr said.

The CHAIRMAN. Dr. Shackelford?

Dr. SHACKELFORD. I agree. I think it was a great advancement. I would add that it did trigger an extraordinary shift from C corporations to S corporations in a relatively short period immediately following the enactment, and it was because you suddenly went from a regime that potentially favored C corporations or did not particularly disadvantage them, to a situation where the C corporation was highly disadvantaged because you had a 28-percent rate for individuals, you had a 34-percent rate for corporations, plus an additional rate on the dividends.

Whether that is good or bad for the economy is different from whether it is good or bad for small business. It was definitely good for privately held businesses and those who could opt for flow-through relative to businesses that did not have that option.

The CHAIRMAN. You had said earlier that you see a trend, a shift toward flow-throughs, S corporations and whatnot, and there is more opportunity. It is easier to form and it is advantageous to small business. Could you comment on that a little more, please?

Dr. SHACKELFORD. Well, I think what has happened is, everybody wants to get to a flow-through status. They do not want the double taxation of corporations. We do not have an integrated corporate and individual tax system right now, so companies are looking, business is looking, for opportunities to get to what we should have, which is a single level of taxation.

The CHAIRMAN. And you are implying that we should continue down that road?

Dr. SHACKELFORD. I'm sorry?

The CHAIRMAN. You are implying that we should continue down that road?

Dr. SHACKELFORD. Yes.

The CHAIRMAN. All right.

Mr. STARR. I would say that we ought to move as quickly as we can to a corporate integrated tax system. I think that would be a first priority for tax reform: an integrated tax system.

The CHAIRMAN. And how would that work? I am a little confused.

Mr. STARR. There are a number of different models out there in terms of what would be an integrated tax system. You could have an exclusion of the dividend at the individual level. You could have a full deduction of the dividend at the corporate level. There are various approaches to an integrated system. I would say my reac-

tion is, I would be open to whatever the committee can consider, but I think as a first priority we would like to move towards an integrated tax system. Once we get that parity created between regular corporations and the pass-through regimes, I think then we can progress on other reform.

The CHAIRMAN. Mr. Martin?

Mr. MARTIN. Well, I think, first of all, what is good for small business, I think, is good for the economy, since small business creates the jobs. I guess I think the liberalization of the rules regarding S corporations has been very positive since 1986. The addition or increase in the number of shareholders that are allowed, the ability of some trusts to hold S corporation shares, have both been very beneficial. I think the second class, the preferred stock issue, is a great thought for Dr. Shackelford. That would be a big increase as well.

I think the pass-through entities—I do not even talk to my clients about C corporations any more. I only talk to them about S's and pass-through entities.

The CHAIRMAN. And what is the down side of moving in that direction? That is, do we shift more towards changes in the law which make it easier to form as a non-C corporation? Are there any disadvantages?

Dr. TODER. I think what you have done is leveled the playing field among different types of small business organizations and reduced the transaction costs in going into an S corporation or limited liability form, and I think that is terrific for small business. But what has happened is, you have really sharpened the difference between the taxation of small businesses and the taxation of publicly traded companies that have to face the double-tax regime.

So I think you need to ask yourself the question about whether it should be public policy to advantage one type of business over another, and I think at some level you have made things more neutral among different types of small business, but on the other hand you have set out this publicly traded corporation more by itself than in terms of a heavily taxed plan.

The CHAIRMAN. My time has expired. I see Senator Snowe maybe is not totally prepared to ask a question yet, so let me ask one more, unless she is ready right now. Are you ready now?

Senator SNOWE. Go ahead.

The CHAIRMAN. All right.

Different subject: tax gap. Many say, and I think Treasury has said, or IRS has said, that maybe our tax gap is, who knows, $300 or $400 billion a year annually, and about $60 to $80 billion might be payroll tax, that is, taxes legally owed but not paid. Some say, gee, a lot of that is small business and a lot of that is a cash-based economy. Your thoughts about simplification and changes to help small business and help with the nexus of the tap gap.

Mr. STARR. I would not suggest necessarily that the small businesses are contributing to the tax gap, but I would suggest that, if we could give them more clarity in the area of the self-employment tax, employment taxes, parity between the entities, that would help them with their tax compliance and maybe ultimately would contribute to what we call the tax gap.

The CHAIRMAN. All right.

Dr. Shackelford?

Dr. SHACKELFORD. I think we have to recognize that some of the tax gap is caused by the fact that the Schedule C, or the sole proprietorship form and what flows there, there are an awful lot of opportunities for non-compliance: there is barter, there is the person who comes to your house and is willing to do various tasks as long as you pay in cash, and similar type things.

Now, I am not implying that that is the entire tax gap, but there certainly are opportunities there for avoidance of taxes that are not necessarily around when you have basically a reporting system, as we do with wages, interest, or dividends.

The CHAIRMAN. I think the basic question is, how do we have small business, but in a way also kind of plug up the gap a little bit? Mr. Martin?

Mr. MARTIN. I think a lot of the tax gap is illegal income. I do not know how you approach that. That is a completely different issue.

The CHAIRMAN. Right.

Mr. MARTIN. My experience is that most of the unreported income, which is what the IRS and I am sure you folks want to get at, is from individuals making payments to businesses where the individual does not have to report that payment to anyone. And I hesitate to say that, because I know that would lead to some kind of reporting mechanism.

The CHAIRMAN. Right.

Mr. MARTIN. And frankly, one of the scariest things I read about recently was the credit card reporting process that has been proposed. It just scares me to death. But I do not know. Child care payments. I think there is huge unreported income in child care that is being paid, and I do not know how you get to it.

The CHAIRMAN. Mr. Starr, any thoughts?

Mr. STARR. On the tax gap?

The CHAIRMAN. Yes. That is right, you did speak.

Mr. STARR. I did comment.

The CHAIRMAN. I had forgotten. Dr. Toder, did you speak?

Dr. TODER. On tax gap? No, I did not.

The CHAIRMAN. Would you like to? [Laughter.]

Dr. TODER. Sure. Certainly the IRS studies show that a large percentage of the tax gap comes from the Schedule Cs and sole proprietors and so forth, and a lot of it is cash income. It is extremely hard to get at that because, as another panelist said, you really are much more effective in compliance where you have document matching and you are not going to ask individuals to supply 1099s to the IRS every time they go to the store and buy a screwdriver. So, it is very difficult to get at.

I think there are some areas where the administration has proposals for somewhat more expanded document matching which would not be too burdensome that would help a little bit. I think somewhat greater audits of partnerships, more emphasis on that could help a little bit. I think, in addition, simplification certainly could do something about the very high compliance costs that small businesses face, so, even if it does not do that much for the gap, it will be helpful in other ways.

The CHAIRMAN. Thank you very much.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

To follow up on the issues regarding the 1986 Tax Act, obviously one of the major issues that evolved from that process was the Alternative Minimum Tax. As I well recall at the time, that was expanded and developed to obviously target those who were evading taxes at the high-income levels. Now it has become a mass tax, I mean, exponentially so. Just with the forecast between this year and next year and how many millions of Americans are going to be affected by the Alternative Minimum Tax, that obviously includes small businesses.

Can you talk, Mr. Martin, about what impact that has had on your clients, and all the other expiring provisions? I mean, we have 41 provisions that are set to expire this year, and many more between now and 2010 and even as far as 2020. What impact does that have on the certainty and predictability for small businesses to plan? If you think about it just in the immediate future beyond what we have in the extenders, you have the estate tax, we have expensing, and we have the marginal rates, all of which are scheduled to change between now and 2010. They are going to have a profound impact.

So can you speak to that issue, Mr. Martin, from your standpoint in dealing with your clients? And Mr. Starr, as well.

Mr. MARTIN. The AMT is a big hammer, and it is so complex. You really cannot tell when a client is going to have an AMT problem unless you run the whole tax return through software. It is virtually impossible to tell, it is so complex. And I do not have an easy solution. I am not a big fan of eliminating the AMT and eliminating the State income tax deduction to pay for it because I come from a State where that is huge.

But I think my recommendation would be to put in the exemption on a permanent basis and index it at some $75,000 level to get rid of the people you did not really intend to get with the AMT a long time ago. But index it. If it was indexed back when it was put into effect, we would not have that problem today, and it would be a creeping revenue problem instead of a massive one today.

Mr. STARR. Senator Snowe, I have never been a fan of the Alternative Minimum Tax. I was very technically engaged in the Alternative Minimum Tax in the late 1980s and early 1990s, and I was an early proponent of repeal at that time when it was not popular to suggest that. My personal opinion would be that we ought to have a broader tax base, and therefore we would not need to have an Alternative Minimum Tax.

Senator SNOWE. All right. Thank you.

Do you care to comment, Dr. Toder and Dr. Shackelford?

Dr. TODER. Well, the only thing I would say is, if you were designing a tax system from scratch, you would never have a provision like this in the law, and I think everyone knows that. The only problem is, since you kind of built the revenues from the expanding AMT into all of the budget projections, the question is how you pay for either indexing it or getting rid of it. But I would hope that you would try to seek a permanent solution sooner rather than later,

because the 1-year fixes are going to get more and more expensive. I think you know that.

Senator SNOWE. Yes.

Dr. SHACKELFORD. I agree with everything they said, but I will mention one thing. I would hate to be known as the defender of the AMT. I believe no one supports it. It does, however, have a broad base and a lower rate and there is so much to be said for that. The top rate is where it was in 1986. So it is almost like there are elements of the AMT that you should consider when you go through a total reform. Now, the components of income and expensing have no rationale and are really abysmal; however, get a broad base, which is what the AMT gives you—a broader base, I should say—and get a lower rate, which it also gives you.

Senator SNOWE. Thank you.

I would also like to ask a question on behalf of Ranking Member Grassley. Apparently 3 million American businesses are C corporations. Current law allows a conversion from C corporations to S corporations with no immediate tax consequences. On the other hand, if the C corporation converts into a partnership or an LLC, the C corporation is immediately taxed on all built-in gain at the time of conversion.

Should C corporations not be allowed to convert to a partnership or LLC with no tax consequences the same way they can convert into an S corporation? What are your views on that?

Mr. MARTIN. Yes, I think they should be allowed to convert to partnerships. And remember that it is only tax-free at an S corporation level if you do not sell any of those assets for 10 years, and that is pretty rare. If you have a cash basis entity, for example, that converts to an S corporation, they collect the receivables the next year, and then they do pay the tax. It is not a tax-free transaction. But, yes, I do agree that that should be a symmetry that we should adopt.

Senator SNOWE. Mr. Starr?

Mr. STARR. Senator, my comment there would be, if our clients were able to exit the regular double-tax regime without any tax, I am confident all my clients would be in favor of that.

Senator SNOWE. All right. You agree? All right. Thank you.

The CHAIRMAN. Thank you all very much. This has been very, very constructive. Some of the Senators may have questions which they will present to you, and I would urge you to respond very quickly.

The hearing is adjourned. Thank you.

[Whereupon, at 11:23 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement of Senator Chuck Grassley
Senate Finance Committee Hearing
"C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform"
Thursday, June 5, 2008

Taxpayers have a wide variety of entities to choose from when starting a small business. These small business owners can operate as a limited liability company, an S corporation, a partnership, a limited liability partnership, a sole proprietorship, or a farm sole proprietorship. The abbreviations for these entities, such as LLCs, LLPs, and LPs, look like they might be found in a bowl of alphabet soup rather than in our tax laws.

However, over the years, the number of entities keeps increasing. The tax laws relating to small businesses have also grown increasingly complex over time. For example, the partnership tax statutes and regulations are one of the most complex set of rules found in our tax laws. Considering how complex the rest of our tax laws are, that's saying something. Some of this complexity exists because we give partnerships a lot of flexibility when allocating income, losses, and deductions to their partners. However, a lot of the complexity found in the partnership tax rules arose in response to abuse by partnerships that were trying to unfairly take advantage of these rules.

Similarly, the tax rules for S corporations have grown more complex over the years. In response to this complexity, a lot of taxpayers' gut reactions are that the tax system should be simplified. However, taxpayers usually want the tax system simplified unless it means they have to pay more taxes. Another thing taxpayers care about is having the freedom to conduct their business the way they want. The wide variety of entity choices currently available allows small business owners much freedom in deciding how to structure their business.

One of these choices, the limited liability company, has become increasingly popular. The LLC offers the best of all worlds – limited liability, a single level of tax, and great flexibility in allocating income, deductions, and losses. Even though an LLC provided these attractive features, people were originally hesitant to form an LLC, because the case law relating to LLCs was not as developed as the case law relating to S corporations or partnerships. However, as this case law has developed, small business owners have used the LLC with greater legal certainty. Similarly, the LLP has been utilized to a greater degree in recent years. I should also note that the S corporation remains a very popular entity choice for new businesses.

With the growing number of entity choices comes growing complexity. This complexity imposes large administrative costs to hard-working small business owners who must comply with these complicated tax laws. Also, the complexity means small business owners can't be confident that they've received all the benefits coming to them, or that they haven't paid more than they owe. When looking at simplifying our tax laws for small businesses, we must also consider the fact that taxpayers like having choices and flexibility in arranging their business affairs, and they don't want to get hit with a tax increase just for the sake of simplification.

While we all agree something should be done and we should be open-minded about what reform would look like, I'd like to remind everyone that, if we allow the bipartisan tax relief plans of 2001 and 2003 to expire at the end of 2010, it will result in a huge tax increase on small businesses. According to the Treasury Department's publication titled "Topics Related to the President's Tax Relief" that was released last week, about 74 percent of the tax returns that will benefit this year from lowering the top tax rate from 39.6 percent to 35 percent are flow-through

business owners. Also, about 82 percent of the $29.2 billion in tax relief this year from lowering the top tax rate will be received by flow-through business owners.

If we fail to act to prevent this bipartisan tax relief from expiring at the end of 2010, we will be taking money from the pockets of small business owners. This is money these small business owners could use to hire more workers or spend in our economy on goods and services. According to the U.S. Small Business Administration, small businesses employed over 58 million workers in 2005, which is more than all other firms combined. Our small business owners, including our farmers, are the backbone of our economy. We should not break our economy's backbone by hammering it with a dramatic tax increase.

Another reason we should prevent the bipartisan tax relief plans of 2001 and 2003 from expiring is that the top individual rate and the top corporate rate are currently the same. When the top rates are different, taxpayers frequently attempt to unfairly take advantage of this difference.

Mr. Chairman, I look forward to the testimony from our distinguished panel. We have an accomplished cross-section of witnesses that includes professors, CPAs who have spent many years in the private sector working for small businesses, and a member of a think tank who has held high-level tax positions in the federal government. I appreciate all four witnesses' dedication to the debate about small business tax reform. I look forward to their testimony.

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB
The Voice of Small Business®

Testimony by Mr. Dewey Martin, CPA, CMA
Owner of Dewey Martin, CPA, CMA
Professor and Chair of the Accounting Department
Husson College, Hampden, ME

Senate Finance Committee Hearing
on the date of June 5, 2008
on the subject of

C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform

Good morning, Chairman Baucus, Ranking Member Grassley, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee continues its series of hearings on tax reform. The complexities of the current tax code are especially onerous on small businesses, so I appreciate that the Committee is interested in discussing this important issue from the perspective of a small business owner.

As a member of NFIB since 1990 and also serving on the NFIB Tax Advisory Board since 1996, I am honored to give a unique view from the eyes of a CPA about tax reform for small businesses. It is important for the Committee to hear from an active accountant who has worked with hundreds of small business owners in the past get the help they needed to keep up with the changing federal tax laws. I will provide a perspective from Main Street that can be used by the Committee to improve tax laws for the benefit of small business.

The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. The typical NFIB member employs about eight to ten employees with annual gross receipts of about $500,000. While there is no one definition of a small business, the problems our members confront relative to the tax code are representative of most small businesses. A few consistent concerns are raised regardless of the trade or industry in which the small business is engaged.

As part of representing small business owners the NFIB pays close attention to the concerns of our members and taxes consistently rates high on the list. The NFIB Research Foundation's Small Business Problems and Priorities consistently ranks tax issues, whether tax rates or complexity, at the top of the list.[1] In addition, the monthly Small Business Economic Trends (SBET) survey regularly ranks taxes as amongst the most important problems.[2]

Taxes and Small Business

Tax law matters to small business owners, and they adjust their business practice to changes in the law. Small businesses face distinct challenges directly related to the structure and management of a typical small business. Small businesses are not simply miniature versions of larger corporations. While tax law impacts each small business in a number of specific ways, there are a few key issues common to most small businesses. These issues are important to keep in mind when considering any changes to the tax laws.

The business and the business owner cannot be separated.

No matter what business structure the small business owner chooses, you cannot separate the business owner from the business. The majority of small businesses are organized as

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[1] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.

[2] In the latest Small Business Economic Trends Survey, taxes ranked first among important problems. *Small Business Economic Trends*, NFIB Research Foundation, Washington, DC, May 2008.

pass through entities, with nearly 75-percent choosing a pass through business structure.[3] This means that most small businesses will pay their taxes at the individual level rather than the corporate level.

The business structure is chosen for a variety of reasons. According to an NFIB Small Business Poll of the few businesses that changed their business structure, 39-percent of small businesses changed to avoid liability and 27-percent for tax reasons.[4] Liability and tax issues were the top two responses. From a tax perspective, the pass through model makes sense for the typical small business. A small business has fewer financial resources than a typical larger corporation, so to pay a double tax – first at the corporate level and then on wages or on a return of business investment - would be especially onerous.

While a business structure like a sole proprietor or a partnership will protect the business from double taxation, the liability protection that a C-Corp offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. The Tax Reform Act of 1986 made several changes to the taxation of S-Corps, reducing the tax liability for small businesses, but also providing the liability protection of a C-Corp. The passage of those changes has led to an explosion in the number of S-Corps. In 1985 22-percent of all corporations were S-Corps, by 1990 the figure has risen to 43-percent, and today the majority of corporations are S-Corps.[5]

For example, consider the kind of decisions a one-person retail business selling flowers out of a greenhouse from their home would make as the business starts and then if the business grows. At first it would be wise to choose a business structure such as a sole proprietorship, since the business probably has limited gross receipts and a single layer of tax is probably all the owner can afford. Under most state laws, setting up a corporation requires the establishment of a board of directors and with a one-person business this is unnecessary. A simple business structure fits a simple business such as this.

A few years later, the flower shop owner and a fellow business owner decide to go into business together and open a store on main street. To help operate the store, they decide to hire their first employee. The business has now matured to point where the owners might consider a more complicated structure than a sole proprietorship. They have a number of options including pass through entities like S-Corps, partnerships, or a Limited Liability Corporation (LLC) or they could set up a C-Corp.

The expanded shop is likely to do more business than the single flower shop owner, but probably not enough to sustain two levels of taxation. Again, choosing a business structure that limits their tax liability is a wise decision. In addition, now that they have

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[3] Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

[4] *Ibid.*

[5] *SOI Bulletin*, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data – table 13, Winter 1999-2000.

separate business space and an employee, the business will have additional expenses that they will need to account for. They also face greater liability risks and may want to protect their personal assets. This growing business probably would choose some form of pass through entity to avoid liability and to lower their tax burden.

About a quarter of small businesses are organized as a C-Corp. Even in the case of a small business organized as a C-Corp, you should not separate the business owner from the business. In many cases, the corporation pays down its annual receipts in business expenses and salary, such that the corporation itself has almost no tax liability.[6] In addition, while the law requires establishing a board of directors in the majority of cases the business sets the board up to meet the legal requirement and not necessarily as an entity to govern the business. [7]

While the variety of business structures may lead to additional rules in the code, various models provide the business owner with more flexibility and choice to organize their business in a way that best suits the needs of the business. Entities such as sole proprietorships and S-Corps can ensure that a small business is not overburdened with extra layers of taxation. In other cases, structures like C-Corps, S-Corps, and LLCs can protect the business owner from personal liability. In the end, the structures promote the maximum amount of flexibility to allow the business owner to make decisions based on the fundamentals of their business. If the business grows or changes, the different structures allow the business owner to adapt in such a way that the business continues to operate effectively.[8]

The importance of cash flow.
Cash flow is an especially difficult challenge for small businesses that is made worse by increasing taxes. One in five small businesses experiences a continuing cash flow problem and one in two businesses face regular cash flow problems.[9] This is a problem common to all small businesses and is just as true for a larger small business as it is for the smallest business.[10]

This is why lost revenue as a result of higher taxes when starting or expanding a business is such a problem. The most common source of capital for starting a business is personal income, in fact many small businesses are started with less than $10,000, and the most important source of capital for expanding a business is earnings retained from business profits, i.e. the amount of money kept after taxes.

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[6] *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.
[7] *Ibid.*
[8] Small businesses rarely change their business structure, with only about seven-percent of businesses making a change. The change is usually made in response to a major change in the business itself. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.
[9] *The Cash Flow Problem – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 1; Issue 3; 2001.
[10] *Ibid.*

Related to the cash flow challenge is the impact that payroll taxes have on small business operations. While the business's tax liability is directly related to its profitability, a payroll tax is levied no matter what the tax liability of the small business is. In many cases, payroll taxes are the highest taxes a lot of small businesses pay each year.[11] In an especially trying year, payroll taxes can exacerbate the small business cash flow challenge.

Keep it Simple.
The typical small business spends annually between 1.7 billion and 1.8 billion hours on tax compliance and $18 billion to $19 billion on compliance costs.[12] The result is that 88-percent of small business owners now hire a paid tax preparer to complete their returns.[13] Small business owners also spend on average $74.24 per hour on the paperwork associated with tax compliance – the highest paperwork cost imposed on small business by the federal government.[14] Unlike a larger business, the small business does not have a finance department or a staff of accountants and lawyers to focus on the nuances and changes in the tax laws. Nor does the typical small business have a full-time human resources specialist to keep up with the tax changes impacting health care and retirement plans.

The complicated and, in many ways unpredictable tax code, places a heavy burden on small business owners. In the end this leads to additional costs and takes money away from the day-to-day business operations or investing in and expanding their business. The current estate tax is a good example of this problem. Small business owners spend considerable resources ensuring that their business is passed on to the next generation. These challenges are only made more difficult with the fluctuating rates and exemptions under current law and the impending return of the full tax after 2010.

The confusing tax code leads to more errors, which we believe is the main cause of the tax gap amongst small business owners. The vast majority of small business owners comply with their tax obligations, but a direct correlation exists between the willingness and ability to comply and the small business owners actually meeting their tax obligations.

Tax Reform
As the Committee considers changes to the tax code, I would encourage you to keep these three principles in mind as you think about how tax law changes will impact small businesses. Not separating the business owner from the business, the importance that access to cash has on the operation of the small business, and simplifying the code will help to make the code more workable for small businesses.

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[11] William J. Dennis, *NFIB Small Business Policy Guide*, Washington, DC 2000.
[12] Donald DeLuca, Scott Silmar, John Guyton, Wu-Lang Lee, and John O'Hare, "Aggregate Estimates of Small Business Taxpayer Compliance Burden," Proceedings of the 2007 IRS Research Conference.
[13] *Tax Complexity and the IRS – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 6; Issue 6; 2006.
[14] *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 3; Issue 5; 2003.

With those principles in mind, I would like to point to a few items that are especially important to small businesses and reflect these three basic principles. First, low individual rates are important. Because cash flow is so important, keeping rates low will provide the small business with the access to the capital it needs to operate the business as well as to expand the business and create new jobs. Again, the personal income and after tax receipts are the largest sources of capital for small business, so keeping the individual rates low is important, especially at time when traditional capital markets are squeezed and the cost of operating the business is rising. Keeping individual rates low also recognizes the important connection that the business owner has to the business itself.

Congress can also look to a few successful reforms to continue to simplify the code for small businesses. Section 179 expensing is a good example of simplification and providing the small business with an immediate source of capital. By increasing the allowable expensing amount from $25,000 in 2003 to $125,000 in 2007 (for 2008 the amount was increased to $250,000 as part of the Economic Stimulus Bill), Congress has provided the majority of small business owners with an immediate deduction for almost any investment they make in their business.

Expensing also reduces the complexity of the tax code. Instead of following complicated depreciation schedules and keeping the paperwork associated with the investment, the business owner can simply claim the deduction in the year the item is purchased. As Congress considers specific issues in the code, making the higher section 179 amounts permanent would go a long way to reducing complexity and providing an important tax benefit to small business owners.

Creating a standard home office deduction is one change the Congress could make that would reflect the same benefits created by expensing. Home-based businesses are one of the fastest growing areas of small businesses, but the current deduction is especially complicated requiring the business owner to determine how much of the house is used for business and keep detailed records to substantiate the deduction. Instead a simple standard deduction recognizes the use of the home for business purposes and reduces the complexity of the current deduction. Many small business owners avoid the deduction because of the complications and the fear of a potential audit. The standard deduction would allow the business owner to claim a deduction he is entitled to, reduce the filing burden, and ultimately improve tax compliance.

Another example of simplification is allowing the use of cash accounting. Under current law, a taxpayer with less than $5 million in gross receipts is able to use cash accounting rather than accrual accounting. The cash accounting method is much easier for small business owners to follow and more closely matches the way that a small business owner will keep his books. The Senate has already passed legislation to allow the use of cash accounting for small businesses with less than $10 million in gross receipts and I would encourage you to consider the expanded use of cash accounting as a simple but important change to the tax code.

Finally, more certainty in the code will help to reduce compliance and planning burdens on small businesses. Looming tax changes, such as the expiration of the 2001 laws like the estate tax and the lower individual rates, make business planning more difficult. Likewise, annual tax extenders and Alternative Minimum Tax (AMT) patches create even more uncertainty. This is especially true for tax prepares and makes tax planning for a client even more of a challenge and increases the potentially for errors. A more certain tax code will help to promote prudent business planning and decisions and improve compliance.

Conclusion

Small businesses truly are the engine of economic growth. This isn't just a slogan as small businesses created 60- to 80-percent of the net new jobs over the last decade. Small business owners are risk takers and entrepreneurs.

The current tax code has become a confusing and unpredictable challenge for the vast majority of small business owners. Our tax laws should not deter or hinder the ability of small business owners to create or expand their businesses. Taxes are a major issue for all small business owners. Tax law can dictate the business decision that an owner will make, whether it is the type of structure to adopt or whether to make an investment.

After decades of patchwork changes to the tax code, Congress needs to make major adjustments to our tax laws to reduce complexity and confusion and encourage business growth. I appreciate that the Senate Finance Committee is taking a serious look at reforming the tax code and urge you to keep in mind the unique challenges that face small businesses.

C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform
Statement of Senator Roberts
June 5, 2008

Thank you, Mr. Chairman, for holding this hearing to look at the complexity of the tax code facing our nation's small businesses.

I think Mr. Martin said it best when he spoke about the vital role of small businesses in the economy. They are the country's economic driver and job creator.

A quick look at the numbers shows the impact America's small businesses have on our economy – 99.7 percent of all employers in the U.S. are small businesses.

In Kansas, 97 percent of all firms are small businesses. Small businesses created between 60 to 80 percent of all new jobs over the past decade. As a committee, we should take a hard look at the tax laws that affect America's job creators.

I particularly appreciate the testimony of Mr. Martin in that he outlines liability and tax issues as the top two priorities facing small business owners today. According to his testimony, the complexity of the tax code is costing our Main Street small business owners in Kansas and across the country almost $75 an hour on paperwork alone. These are substantial costs that add up quickly and eat in to the profits and operating expenses of these small firms. Small business owners could be using this money to reinvest in and expand their company and hire new workers rather than spending it on complying with an overly burdensome tax code.

We have some big decisions to make in tackling the confusing tax code and its affect on small businesses. I appreciate the testimony from the witnesses today and their suggestions about what we can do as part of tax reform to help folks running their own business.

OPENING STATEMENT
Senator Ken Salazar
Finance Committee Hearing: "C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform"
June 5, 2008

Thank you, Chairman Baucus and Ranking Member Grassley, for holding today's hearing.

This is the third hearing this Committee has held to examine issues related to fundamental tax reform. This morning, we will take a harder look at the system of entity classifications that govern the taxation of small- and medium-sized businesses of different kinds.

First, I want to reiterate my gratitude to the Chairman and Ranking Member for their commitment to a thoughtful and thorough review of issues and challenges related to tax reform. As I have stated at our previous hearings on this issue, I strongly believe the tax code must be made more simple and fair, that it must create economic conditions that will allow our businesses to thrive; and that it must meet our budgetary demands. I also firmly believe that for any effort to overhaul our tax system to be successful, it must be bipartisan.

The hearings we have held and will continue to hold this year will help to make our efforts to enact tax reform in the next Congress easier, more bipartisan, and more effective.

Second, I want to emphasize how important the issues we will examine today are to me and to my state of Colorado.

Like many of the other states represented on this Committee, Colorado is a state whose economy relies on small businesses. Small businesses make up over 98 percent of all the businesses in my state and businesses with fewer than 50 employees comprise almost 30 percent of the Colorado workforce. Small businesses are the lifeblood of the Colorado and the national economy, and we must do everything we can to ensure our tax laws do not serve as a stumbling block to success.

It is worth pointing out that I have some personal experience with the challenges small businesses face. My wife, Hope, owned and operated a Dairy Queen, which she sold in 2006. While Hope is a shrewd businesswoman who made good decisions, her experience demonstrated to me why many businesses struggle to turn a profit – or fail to even get off the ground – as a result of complicated tax laws.

While I can certainly understand the benefit of providing small- and medium-sized businesses with a wide range of options for how to structure themselves in an effort to enable them to choose an arrangement – and a tax status – that best suits their needs, there is a point at which the system can become too complicated and consequently serve to prevent, rather than facilitate, economic growth and dynamism.

With that in mind, I am eager to hear from our panel of witnesses about whether our current system of entity classification makes sense, and, if not, how we can make it simpler, more efficient, and more business-friendly.

Thank you.

Business Entities and Small Business Tax Reform

Douglas A. Shackelford
Meade H. Willis Distinguished Professor of Taxation
Kenan-Flagler Business School
University of North Carolina at Chapel Hill

Testimony before the United States Senate Committee on Finance
June 5, 2008

I thank Herman Spence for helpful comments and discussion and Katie McDermott and Kevin Markle for valuable research assistance. All errors are my own.

Executive Summary

One of the most important decisions that a business faces is choosing its legal organizational form. There are many organizational forms that a business may choose, including pass-through entities. "Pass-through" means that the entity serves as a conduit through which the profits of the business pass through to the investors' tax returns, escaping taxation at the entity level. Pass-through entities include: sole proprietorships, partnerships, limited liability partnerships (LLPs), S corporations, and limited liability companies (LLCs). Every pass-through entity has different requirements. The most popular pass-through for new companies is the LLC. Comparisons between the LLC and other entities are detailed below.

Another organizational form is a C corporation. The profits of a C corporation are taxed at the corporate level and then shareholders are taxed when they receive dividends. Only C corporations face "double taxation," i.e., both entity and investor taxation, since pass-through entities are only taxed at the investor level.

To demonstrate the costs of double taxation in a C corporate form, assume a 35 percent corporate tax rate, a 15 percent dividend tax rate, and a 35 percent individual tax rate (the current maximum tax rates). If a C corporation earns one dollar of income, it pays 35 cents in taxes. If it pays the remaining 65 cents as a dividend, its shareholders are left with 55.25 cents [$1(1-0.35)(1-0.15)]. In contrast, if a privately-held firm adopts a pass-through entity, its investors are taxed on the entire one dollar, leaving its investors with 65 cents. No further tax is levied on the pass-through entity. This difference of 9.75 (65-55.25) cents in after-tax returns to investors provides a major tax incentive to avoid the C corporate organizational form. Even if the C corporation never pays dividends, fully avoiding the investor-level taxes, it still pays the same 35 cents of tax at the corporate level that the investors in the pass-through entity pay. Therefore, at best, the C corporate form yields the same after-tax outcome as the pass-through entities.

The pass-through entities further dominate C corporations if the business generates losses, as is common in the early years of a business. In the C corporation, the losses are carried forward until taxable income is generated, if ever. With a pass-through, the investors often can use the losses in the business to offset other income, such as wages, interest income, or dividends.

Only privately-held businesses, i.e., those whose interests are not easily transferable because of the lack of a secondary market, can choose a pass-through entity and avoid double taxation. As a result, privately-held businesses rarely opt for the C corporate form. Some older privately-held businesses may have begun operations as a C corporation, when pass-through options were limited. However, as pass-through options evolved over time, many of the C corporations restructured to avoid the entity tax.

In contrast to privately-held businesses, all publicly-traded businesses (including publicly traded partnerships) are required to use the C corporate form. Consequently, the additional taxes associated with the C corporate status can be considered a special levy for accessing the public capital markets.

Some might favor lower taxation for privately-traded firms as a benefit to small business. Note, however, that while almost all small businesses are privately-held, not all privately-held firms are small. There are many large businesses that are privately-held. Nonetheless, because of their corporate form, these large privately-held firms face lower taxes than their publicly traded competitors. In other words, the option to avoid double taxation depends on trading status, not the size of the firm.

At the risk of gross simplification from ignoring a host of tax details, a pass-through entity can be considered a C corporation, where all of the profits are paid out as dividends and the dividends are fully deductible for the corporation. This deductibility would eliminate any taxable income at the corporate level. Restated, the lack of dividend deductibility for C corporations is their cost for using the public capital markets.

Since there is no justification for taxing private and public businesses differently, I recommend that C corporations be treated the same as pass-through entities for tax purposes. One way to (largely) equate the tax treatments is to permit C corporations to deduct dividends. This would effectively provide them with the same (or similar) tax treatment as pass-through entities. Dividend deductibility would eliminate the primary reason for the various pass-through entities (i.e., double taxation). It also would restore equity between public and private firms, simplify tax planning, compliance and administration, e.g., debt and equity distinctions, and reduce the legal and accounting costs that both small and large businesses face in structuring their organizational form. It would also treat dividend payments the same as other payments to

stakeholders of the firm (e.g., interest and compensation), which are deductible at the entity level and only taxable to the recipient.

If dividend deductibility is not an option, I recommend taxation of all organizational forms (including the current pass-through entities) at the entity level coupled with tax exemption at the investor level, e.g., a reduction of the dividend tax rate to zero. This would shift the burden of tax compliance from investors to the entity. An administrative advantage of this approach is that there are far fewer entities than investors. A disadvantage of this approach is that there are economies of scale in tax evasion, i.e., it is easier for one entity to avoid a single large tax bill than for many investors to shelter small portions of the firm's income. The advantages and disadvantages to both corporate-level dividend deductibility and investor-level dividend exclusion are well understood in the tax community but beyond the scope of my testimony.

If you do not intend to address the primary issue motivating pass-through entities, i.e., double taxation, then I recommend making no changes. Each of the pass-through entities has different nuances that appeal to businesses in different situations. They are well understood in the legal and accounting communities. Changing the rules that apply to pass-through entities without addressing their underlying cause—double taxation—may create additional, unnecessary costs for privately-held firms.

Review and Comparison of Entity Classifications

The remainder of my testimony reviews the primary entity classifications, their genesis, advantages, and disadvantages.[1] Three organizational forms have the longest existence: the sole proprietorship, the (general) partnership, and the C corporation. Over time, other entities were created to marry the tax advantages of the sole proprietorship and partnership with the limited liability and other legal advantages of the C corporation. Limited Partnerships (LPs) developed in the early 1900s, protecting partners who were uninvolved in the management of the business from unlimited liability. Federal statute in 1958 created the first corporation with pass-through taxation, the S corporation. Today, most small business entrepreneurs opt for the limited liability company (LLC), whose popularity dates back to a 1988 Internal Revenue Service ruling, in

[1] Entity treatment varies across states. Throughout thisy testimony, I assume that North Carolina state law applies.

which the IRS affirmed that it would treat LLCs as pass-through entities for tax purposes.[2] Since LLCs have become the entity of choice for many new, privately-held businesses, I will discuss the alternative entity options by comparing them with LLCs.

LLCs

LLCs are hybrid entities that are neither partnerships nor corporations under state law. They offer all shareholders limited liability (i.e., protection from personal liability for debts) and can elect to be taxed as a partnership under present tax law. If treated as a partnership for tax purposes, the LLC offers the advantages of pass-through taxation and limited liability.

The LLC dates back to a limited liability company act in Wyoming in 1977. However, it was not widely adopted until some of the uncertainty of the new organizational form was eliminated with the 1988 IRS issuance of a revenue ruling stating that it would treat a Wyoming-style LLC as a partnership for tax purposes. Since then, the LLC has become recognized as the entity that best blends the advantages of pass-through taxation with legal advantages of a corporation.

LLCs compared with Sole Proprietorships and General Partnerships

A sole proprietorship (general partnership) is an unincorporated business owned and completely controlled by (more than) one person. It is formed without any formality and no documents need to be filed. Because sole proprietorships and general partnerships expose all investors to unlimited liability, LLCs dominate them from a legal perspective. As a result, sole proprietorships and general partnerships are rare. A danger to investors who start a business without addressing the choice of entity is that they will have chosen a sole proprietorship or general partnership by default (and, thus, be exposed to unlimited liability).

LLCs compared with C corporations

As discussed above, the primary advantage of an LLC (and all other pass-through entities) over a C corporation is that an LLC avoids double taxation. Furthermore, the use of an

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[2] Note that some states, e.g., Texas and California, tax LLCs in an unfavorable manner. LLCs also face some disadvantages arising from treaties, including the Canadian/U.S. Tax Treaty.

LLC permits losses to pass-through to the investors (subject to various restrictions) while the use of a C corporation does not.

The disadvantage of double taxation tends to dominate any advantages of the C corporate form compared with the LLC. However, C corporations enjoy a few advantages compared with LLCs:

- C corporations can provide employees/shareholders with certain tax-free fringe benefits that LLCs cannot provide.
- The graduated tax rates for the first $100,000 of C corporate profit may enable it to provide a lower tax than an LLC whose earnings are uniformly taxed at the investors' potentially higher tax rates.
- Unlike an LLC, a C corporation can engage in a tax-free reorganization with another corporation.
- Unlike a C corporation, investors in LLCs may have to file tax returns in each state in which the company does business.

LLCs compared with S corporations

Before 1958, investors were limited to the corporate or partnership organizational form and the corresponding tradeoff between double taxation and unlimited liability. In 1958, subchapter S was added to the tax code, introducing limited liability corporations with pass-through taxation. Since their inception, S corporations have had restrictive ownership provisions. Presently, S corporations cannot have more than one class of stock, more than 100 shareholders, or any shareholders who are foreign persons, corporations, partnerships or certain trusts. These restrictions are a major disadvantage for the S corporation compared with the relatively unrestricted LLCs.

LLCs also dominate S corporations along several technical dimensions, including:

- Unlike LLCs, the basis of an S corporation's assets cannot be stepped-up to fair market value upon a sale of stock or the death of a shareholder.
- Unlike LLCs, S shareholders do not include third-party debt in the bases of their stock (which limits the investor's ability to utilize losses).
- An employee who receives S corporate stock is immediately taxed upon the receipt or the vesting of the stock, but a member in an LLC can receive a profits-only interest without being taxed.

On the other hand, S corporations have a few advantages compared with LLCs:

- An S corporation may face lower FICA taxes than an LLC faces because there is some uncertainty about how self-employment taxes should apply to investors in LLCs.
- An S corporation can engage in a tax-free reorganization with a publicly traded company, but an LLC cannot.
- For several technical non-tax reasons, an S corporation may be more suitable than an LLC for start-up companies intending to engage quickly in an IPO or obtain venture capital investments.

LLCs compared with Limited Partnerships (LPs)

LPs provide limited liability for partners who do not participate in the management of the firm. LPs have a long history, dating back to at least the 1916 Uniform Limited Partnership Act (ULPA). Compared with LLCs, there are two key disadvantages of LPs: (1) there must be at least one general partner who faces unlimited liability, and (2) limited partners cannot participate in the management of the partnership. Over time, to avoid having any investor face unlimited liability, LPs began using an S corporation as the general partner. In some states, limited liability limited partnerships (LLLPs) arose, providing limited liability for all general partners. Nonetheless, LLCs dominate LLLPs because general partners in LLLPs may still be liable for their own negligence or malpractice and limited partners still cannot participate in management. Neither restriction applies to LLCs.

Senator Olympia J. Snowe
Senate Finance Committee
Statement to Introduce Dewey Martin
June 5, 2008

Thank you, Chairman Baucus. I would like to warmly welcome Mr. Martin, who has generously agreed to fly down from my home state of Maine, to join us here today. I am truly looking forward to Mr. Martin's testimony on how the tax code impacts small businesses, the true backbone of our nation's economy, given the variety of perspectives he brings to the Committee.

First, as a Certified Public Accountant and a Certified Management Accountant, Mr. Martin assists small businesses to satisfy their tax obligations as he works in private practice in Hampden, a charming Maine Community on the beautiful Penobscot River. As a quick aside, Hampden is perhaps best known for being the place where President Abraham Lincoln's vice president, Hannibal Hamlin, lived from 1833 to 1848 during the time he operated a law practice and served in the U.S. House of Representatives.

Not only does Mr. Martin bring an impressive real-world perspective on small business taxation, but he also has significant academic experience as Chair of the Accounting Department at Husson College in Bangor. This blend of experience should prove particularly informative to the Committee, which is really looking at ways to simplify the tax code for small businesses from all angles – both practical and theoretical. While we must ensure that any legislation we pass will be easy to implement by accountants all over the country, we must also ensure that we are innovative and consider "out-of-the-box" proposals to enable small businesses to pay their taxes as efficiently as possible.

Finally, it shouldn't go unnoticed that others have recognized Mr. Martin's keen insight and willingness to serve in the interest of sound public policy. He serves on the NFIB Maine Leadership Council and NFIB's National Federal Tax Advisory Board. He was named NFIB Small Business Champion of Maine in 2006, the SBA Accountant of the Year for Maine and New England in 2001 and 2000 Public Service Awardee by the Maine Society of CPAs. He was appointed by Governor King to the 1995 Maine Study Commission on Interstate Banking and in 1991, *my husband* when he served as Governor of Maine, had the foresight to appoint Mr. Martin to the Maine State Retirement Study Commission. Mr. Martin also participated in the 1986 White House Conference on Small Business which is coincidently the last time Congress took up and enacted into law significant tax reform.

I thank Mr. Martin for his service and look forward to his testimony along with the other panelist today.

Thank you, Mr. Chairman.

Testimony

Samuel P. Starr
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Adjunct Professor of Law,
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Before the
Committee on Finance
United States Senate

C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform

June 5, 2008

*Partner, PricewaterhouseCoopers LLP. Employment is shown for identification purposes only. The views expressed do not necessarily represent those of PricewaterhouseCoopers or its partners and principals.

I. Introduction

Good morning. First, I thank the Committee for the opportunity to testify before you on the way businesses choose to organize, and the tax consequences that result from that choice. Second, I applaud the Committee for exploring this issue, as it is economically significant to many taxpayers, and the tax consequences often drive what business entities taxpayers use for their business operations. My comments largely will focus on smaller businesses and the tax issues surrounding their choice of business form. Smaller businesses commonly use business forms that are taxed under the Code's pass-through regimes.

One goal and objective of the tax system should be to create tax parity among the various business forms so that one taxpayer is not disadvantaged over another, from a tax perspective, simply because of its choice of business form. Because of the double tax imposed on regular corporate earnings, taxpayers that choose the regular corporation as their form of business are disadvantaged compared to the single-tax, pass-through regimes. I believe that tax reform efforts need to focus on eliminating this double tax, and its distortive effect on choice of entity. By adopting an acceptable corporate integration model under which income from regular corporations would be subject to a single level of tax, all business income generally would be subject to a single level of tax. Then, it should be possible to rationalize the various pass-through regimes with the adopted corporate integration model.

II. Some Background about the Popular Business Forms

Choice of business entity is first and foremost a business decision, but it is heavily influenced by the differing tax and liability consequences of using one business form rather than another. Factors affecting choice of entity are constantly in a state of flux. As new changes in federal and state laws are enacted, the pendulum swings back and forth in favor of one entity over another. For example, for many years, the regular corporate form was preferred by many businesses because of the limited liability offered to shareholders. However, when limited liability company (LLC) statutes were enacted by the 50 states, and the federal tax treatment of LLCs was clarified by the IRS, the LLC has become the preferred business form for many start-up businesses.

Regular corporations, partnerships, and sole proprietorships were the traditional business forms at the beginning of the 20th century. Regular

corporations have long been subject to a double tax under the federal income tax laws--once on their corporate earnings and once on dividends paid to shareholders.[1] This compares with partnerships and sole proprietorships, whose earnings are taxed directly to the partners or the sole proprietor, respectively. General partnerships and sole proprietorships do not offer liability protection to their owners as does the regular corporation. This trade-off--the double tax on regular corporations while enjoying limited liability, and the single tax of the general partnership and the sole proprietorship but lacking liability protection--have made choice of business entity very difficult for small business owners over the years.

As one of its first steps to allow limited liability without a double tax, Congress enacted Subchapter S in 1958 for small businesses to use. This new subchapter allowed eligible corporations to elect to become "small business corporations," [2] today more commonly referred to as "S corporations". As originally enacted, small business corporations were singly taxed, but were not true pass-through entities like partnerships. However, like regular corporations, they offered their shareholders limited liability protection.

By enacting Subchapter S, Congress sought to eliminate the impact of federal taxes on the choice of business entity, and to give small businesses a simpler form of taxation. Thus, the rationale at the time was to treat small business corporations similar to partnerships, i.e., subject to one level of tax at the shareholder level. Although Congress wanted to encourage eligible corporations to convert to small business corporations, a corporate-level toll charge was imposed on recognized capital gains for three years after the Subchapter S election went into effect.

For almost 25 years, Subchapter S remained a relative backwater in the Internal Revenue Code and largely went underutilized by many small business owners. To eliminate traps for the unwary, Congress enacted the Subchapter S Revision of 1982 (SSRA '82) and made Subchapter S a true

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[1] Regular corporations currently are subject to a graduated corporate income tax schedule, beginning at a 15 percent tax rate on the first $50,000 of income and 25% on the next $25,000 of income. At higher levels of income, the benefit of these lower rates is taken away through higher marginal rates that reach 39 percent. For corporations with income exceeding $18.3 million, the applicable tax rate is 35 percent. If dividends are paid, the individual shareholders pay a maximum 15% tax on this income through 2010. Under present law, in 2011 and thereafter, dividends will be taxable at the applicable individual ordinary income tax rates in effect at that time.

[2] P.L. 86-866, Sec. 64, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 254, 298-305. Section 64 of this Act added former Sections 1371 through 1377 as the original Subchapter S.

pass-through regime.[3] Although the Subchapter S regime is now pass-through like Subchapter K that applies to partnerships, the two subchapters have remained separate and distinct until present day. Most tax practitioners would agree that, although the two regimes are similar in that they provide pass-through taxation to their respective owners, the two subchapters are very different in how business income is allocated to the owners, and thus, how the income is ultimately taxed.

Importantly, Congress has continued over the years to modify and amend Subchapter S to make it more flexible and simpler to use in response to its concern regarding the taxation of smaller businesses.

In 1978, little noticed at the time, Wyoming enacted the first limited liability company statute offering LLC members protection from entity-level liabilities much like the liability protection of regular corporations. However, the tax status of LLCs remained uncertain until the IRS confirmed in Rev. Rul. 88-76[4] that under the old four-factor test for classifying business entities as partnerships, LLCs formed under the Wyoming statute could qualify for partnership tax status.

The IRS ruling was a watershed event because it motivated all the 50 states to enact LLC statutes so as not to be left behind their neighbors in attracting businesses to their state economies. Given the new-found popularity of the LLC, the move from regular corporate form to the LLC-partnership pass-through regime was off and running.

In 1997, prompted in large part by the enactment of the 50 state LLC statutes, the IRS issued its so-called "check-the-box" regulations, which offered another significant push towards using the partnership pass-through regime. Under these rules, an eligible entity, which would include partnerships and LLCs with more than one owner, defaults into partnership taxation without having to file a formal election. Furthermore, if the eligible entity has only one owner, then the entity generally is disregarded under the Internal Revenue Code, and is treated as part of its direct owner for federal income tax purposes. The simplicity of the check-the-box rules in entity tax classification has provided yet another incentive for taxpayers to use the

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[3] P.L. 97-354, Sec. 2, 97th Cong., 2d Sess. (1982), 1982-2 C.B. 702. Section 2 replaced the former Suchapter S with existing Sections 1361 through 1379.

[4] 1988-2 C.B. 360, obsoleted by Rev. Rul. 98-37, 1998-2 C.B. 133 (the check-the-box regulations made classification rulings of this type obsolete because taxpayers either default or elect into the desired tax classification for their business entities).

non-corporate LLC and partnership business forms by providing easy access to the partnership pass-through tax regime.

III. Growth in the Use of Pass-Through Entities

As discussed in the previous section, changes in federal and state laws over the past two decades have favored the single-taxed, pass-through regime. Therefore, those business forms that fit into this regime--sole proprietorships, partnerships, limited liability companies, and S corporations--have as a group experienced remarkable growth. The percentage of businesses using pass-through regimes (including sole proprietorships) has increased from 85% in 1986 to 93% in 2005, and the percentage of business income earned through pass-through regimes has increased from 41% to 51% over the same period (see Table 1).[5]

These data show the growth in pass-through entities as well as well as the lower average income of businesses organized as pass-though entities.[6] Said differently, larger businesses tend to operate in regular corporate form, while smaller businesses tend to choose pass-through regimes when they can.

In 2003, among the largest corporations (those with business receipts of $50 million or greater), regular corporations were the most prevalent (constituting 52 percent of all businesses with business receipts of $50 million or greater), followed by S corporations (30 percent of all businesses with business receipts of $50 million or greater), partnerships (17 percent of all businesses with business receipts of $50 million or greater), and sole proprietorships (less than 1 percent of all businesses with business receipts of $50 million or greater).[7] Although there has been a distinct shift to the pass-through regime, larger businesses still are operated in regular corporate form, particularly those that require access to public capital markets.

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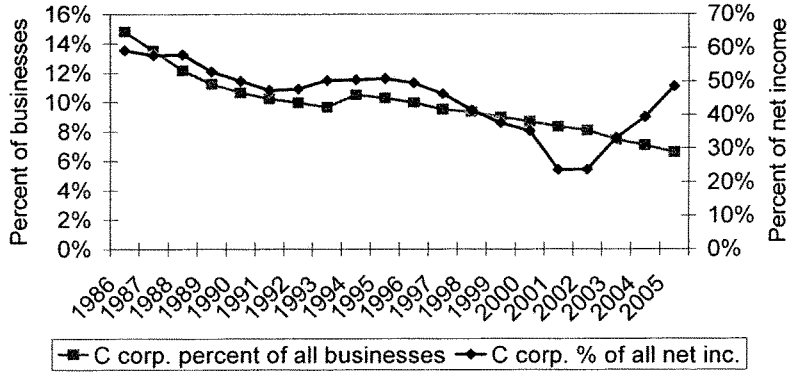
[5] See, Peter R. Merrill, "The Corporate Tax Conundrum", *Tax Notes*, (October 8, 2007) pp. 174-176.

[6] In 2003, IRS data show that the average amount of business income subject to tax reported by regular corporations was $339,000 as compared to $64,000 for S corporations, $127,000 for partnerships, and $11,000 for sole proprietorships.

[7] IRS Integrated Business Data at http://www.irs.gov/taxstats/bustaxstats/article/0,,id+152029,00.html.

Table I
C CORP. SHARE OF ALL BUSINESSES AND ALL NET INCOME (LESS DEFICIT)



Source: IRS Statistics of Income

What has caused this shift in favor of pass-through entities? Although not a comprehensive list, here are a few of the more significant changes over the past twenty years that have favored the pass-through regime: (1) the differential between the marginal tax rates imposed on corporations and individual taxpayers has been narrowed or eliminated; (2) the amount of double tax imposed on corporate dividends has remained high until relatively recently; (3) the enactment of LLC statutes in the 50 states; and (4) the adoption of the check-the-box regulations by the IRS which simplify entity classification for federal income tax purposes.

IV. Marginal Income Tax Rates Play an Important Role in Choice of Business Form

Marginal income tax rates imposed on corporate and non-corporate taxpayers play an important role in what business form business owners decide to use. The top existing federal marginal income tax rate imposed on regular corporations (35%), along with the double tax imposed on regular corporate earnings when dividends are paid to shareholders (15%), makes doing business in the regular corporate form significantly more expensive than operating in a pass-through regime with individual owners (who are

taxed at individual rates no higher than 35%). This additional income tax burden puts the regular corporation at an unfair advantage.[8]

Now that over half of business income is earned through pass-through entities, changes in individual marginal tax rates directly affect incentives for investment and entrepreneurial activity. If a small business operates in the LLC form taxable as a partnership, the LLC's business earnings are reflected directly in the individual LLC members' taxable incomes. Small business persons can quickly find themselves at the current maximum 35% marginal income tax rate for individuals (e.g., $357,700 taxable income for married filing jointly in 2008) by including their business income on their personal income tax returns.

As marginal individual income tax rates change, small businesses react accordingly in their choice of business form. Significant shifts in marginal tax rates, and the relative differential between the corporate and individual tax rates, can likewise trigger significant shifts in choice of business form. If we had more tax parity in the Code, so that all entities were taxed relatively the same, changes in marginal rates would not have the consequential effects that they do today.

Tax reform should move in the direction of tax parity by integrating the corporate tax to eliminate as much as possible the distortions under the existing Code. Many economists and tax attorneys believe an integrated tax structure with a single level of taxation for all businesses would be preferable to the current double tax on C-corporation earnings.[9] In 1992, the U.S. Treasury Department issued a report on Integration of the Individual and Corporate Tax Systems.[10] The report concluded that integration of corporate earnings would make taxation of investment more uniform across sectors of the economy, create more parity in the tax treatment of debt and equity, minimize the distortion of deciding whether to retain or distribute

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[8] Prior to the Tax Reform Act of 1986, the 46 percent top corporate income tax rate was lower than the 50 percent top individual income tax rate. Following the Tax Reform Act of 1986, the 28 percent top individual income tax rate was lower than the 34 percent top corporate income tax rate, which increased the tax incentive to avoid use of regular corporations. As referenced above, the top individual and corporate income tax rates are both 35 percent and, since 2003, Congress has reduced the double taxation of corporate income distributed as dividends by lowering the top individual income tax rate on dividends to 15 percent.

[9] Gary Guenther, "Small Business Tax Benefits: Overview and Economic Rationales," CRS Report for Congress, Congressional Research Service, RL32254, March 3, 2008.

[10] U.S. Department of Treasury, "Integration of the Individual and Corporate Tax Systems," January 1992.

earnings, and create a tax system that taxes capital income once, i.e., eliminate the double tax.

V. Using Pass-Through Entities to Achieve Integration

The pass-through regimes effectively allow small business owners to integrate their business operations for federal income tax purposes through self-help elections and choice of appropriate business form.

Converting a regular corporation into a partnership or sole proprietorships generally is not very practical from a tax point of view. It certainly does not avoid the double tax. In fact, the conversion more than likely will accelerate the double tax under a constructive liquidation. More specifically, moving assets out of corporate solution triggers a double-tax on asset appreciation with gain recognition, but with no cash proceeds to pay the tax.

As matter of mechanics, current state conversion statutes make it easy to convert a regular corporation to another statutory form of doing business. However, business owners need to be careful not to trigger the double tax on what would be constructively treated as a liquidation of their corporations. Such conversions, assuming they would be unintended, could turn into a disaster to an unsuspecting small business owner in regular corporate form.

The only practical exit from the corporate double tax is for an eligible regular corporation to make an S corporation election to treat itself as pass-through for income tax purposes. In this regard, the S corporation serves much the same purpose today as it did in 1958 when it was first adopted--allowing corporations to move into the single tax regime to eliminate the distortive affect of the double tax on small businesses organized as corporations.

Converting to S corporation status is not without tax consequence. If assets held on conversion from regular corporate status to S corporation status are sold within the first 10 years after the conversion date, any built-in gain in those assets measured at the time of conversion is subject to a corporate level tax, and the gain is taxed again at the shareholder level. This built-in or gain tax acts as a substitute for collecting the double tax at conversion by allowing taxpayers the ability to pay the double tax when they have the wherewithal to pay, at the time the assets are sold for liquid proceeds.

To be clear, the S corporation election serves an important function under the current Code as a self-help mechanism for existing regular corporations to move from the double tax into a pass-through regime. Although S corporation earnings are passed through to the shareholders, the corporation's assets remain in corporate solution. This means if appreciated S corporation assets are distributed to the shareholders, a corporate level gain is triggered which flows up to the shareholders to be taxed one time at the shareholder level (and possibly twice if the distribution occurs during the built-in gains recognition period). This incidence of tax occurs not on a sale of the assets, but on distribution to the shareholders, and therefore, there are no proceeds available from the distribution transaction to pay the tax.

In this regard, the S corporation is not as favorable an option as either the partnership, or the LLC taxed as a partnership, because with these entities appreciated assets generally can be distributed to the partners under Subchapter K, without gain recognition at the partnership or partner level. The fact that S corporation assets are still in corporate solution inhibits conversions of S corporations into partnerships, and into LLCs taxed as partnerships.

VI. Structural Simplification of the Code--Now or Later?

The current Code supports several different pass-through, or single-tax regimes.[11] Subchapter K and Subchapter S are the pass-through regimes that apply to partnerships and S corporations, respectively. The character of income and deduction items incurred by these entities is preserved as these items flow up, and are taxed, to their owners. Although both Subchapter K and Subchapter S are pure pass-through provisions, the two regimes are quite different in their application. Recent changes to Subchapter S have made it more useful and available to a broader group of shareholders, but fundamentally, its rules are easier to comply with than the tax rules that apply to partnerships.

While Subchapter S may be easier to comply with, most tax practitioners would assert that Subchapter K is far more flexible, and therefore, more attractive for the small business owner. However, with all its flexibility, the partnership form brings incremental complexity. Arguably, Subchapter K's complexity is elective on the part of its owners. For example, if the partners

[11] REITs and RICs are subject to a single-level of tax on their earnings through a distribution deduction at the entity level, as opposed to the pass-through of their earnings to their shareholders. These investment vehicles are uniquely focused in their purpose, and are not used by small businesses.

are satisfied with allocating their income and deduction items "straight-up" without any special allocations, their tax compliance generally will be much easier and akin to that of Subchapter S. On the other hand, no matter how simple the partnership's structure is, the Subchapter K rules bring to bear a great deal of complexity not present in Subchapter S. Many small business owners just are not ready to deal with that complexity on a day-to-day basis.[12]

Therefore, under the existing Code, it is important that taxpayers have the choice of using either the Subchapter S or the Subchapter K pass-through regimes. Giving small business owners this choice works to their advantage. When Congress is ready to fully integrate the Code, at that time it would be appropriate to rationalize the pass-through regimes with the adopted corporate integration model.

VII. Specific Recommendations for Congressional Consideration

A. Statutory Guidance is Needed for Classifying LLC Members as Either General or Limited Partners

The Code does not reflect any specific guidance regarding LLCs. This is appropriate as LLCs are state law entities that can be classified for tax purposes as partnerships, associations, or disregarded entities under the check-the-box regulations. With that said, there are a number of areas in the Code where the status of a general partner or limited partner is important in determining tax consequences. One area of significant importance is the treatment of general and limited partners under the self-employment (SE) tax rules.[13] General partners are subject to SE tax on their earnings, whereas limited partners are only subject to SE tax to the extent of guaranteed payments for services rendered.

We do not have authoritative guidance on whether LLC members are general or limited partners for SE tax purposes. The IRS has released proposed regulations that would treat any partner in an entity classified as a partnership (including an LLC) as a general partner if: (1) the individual has

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[12] Aside from special allocations on income and deduction items under Section 704(b), small business owners face complicated built-in gain property rules (Section 704(c)), disguised sale rules (Section 707(a)(2)(B)); partnership terminations (Section 708(b)); character recognition of gain or loss (Section 741) and hot assets (Section 751); and allocation of entity liabilities to partner basis (Section 752), to name a few.

[13] IRC Sections 1401 and 1402(a)(13). Other areas of concern where distinctions are made between general partners and limited partners are: Section 448 (cash method of accounting); Section 465 (at-risk); Section 469 (passive activity losses); and Section 736 (liquidating a partner's interest).

personal liability, (2) the individual has authority to contract on behalf of the partnership, or (3) the individual participates in the partnership's trade or business for more than 500 hours during the partnership's tax year.[14] This is proposed guidance, and thus, not definitive.

It would be helpful if Congress could address this issue as we are seeing an increasing number of LLCs classified as partnerships, and there is a lack of clarity around whether the LLC members should be subject to the SE tax, and, if so, to what extent.

B. Partnership Income Attributable to Capital Should Be Excluded from Self-Employment Tax

In the S corporation world, wages paid to shareholder-employees are subject to FICA taxes. An S corporation's distributive earnings are not subject to any employment taxes simply because the self-employment (SE) tax does not apply in a corporation-employee relationship.[15] If an S corporation shareholder-employee's wages are "too low", the IRS can challenge this compensation and re-characterize distributive earnings as wages. To avoid this concern, taxpayers are best advised to pay themselves a reasonable salary based on comparable wages for the services rendered in their locale. The portion of the S corporation earnings not paid out as wages remains outside the employment tax system, and is, in effect, earnings on return of capital.

On the other hand, in the partnership world, a general partner's distributive share of earnings generally is entirely subject to the SE tax. Congress should consider excluding a general partner's share of partnership income from the SE tax to the extent the earnings are attributable to capital. Therefore, the amount that would be in excess of what would constitute reasonable compensation for services rendered by the partner for the partnership would not be subject to the SE tax. Such a proposal, if enacted, would generally put general partners on par with shareholder-employees of S corporations.[16]

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[14] Prop. Reg. Section 1.1402(a)-2(h).
[15] Rev. Rul. 59-221, 1959-1 C.B. 225. Also see, e.g., Radtke, 895 F 2d 1196 (7th Cir. 1990), Spicer Accounting, 918 F 2d 90 (9th Cir. 1990).
[16] See H. R. 4137, 108th Cong. 2d Sess., Section 3 (introduced by Mr. Houghton). A similar proposal was recommended by the ABA Section of Taxation, "Tax Rules Governing Self-Employment Income of Limited Liability Companies and Partnerships," May 29, 2002.

C. Partners as Employees of Their Own Partnerships

With the growth of partnerships and LLCs treated as partnerships, owners want to treat themselves as employees of their own business entities. The motivation frequently has nothing to do with employment taxes, and all to do with tax compliance issues. Many partners simply prefer the income tax withholding system on their earnings, versus time-intensive quarterly estimated tax payments.

Congress could help clarify the situation and permit certain partners also to be employees of their partnerships. Perhaps it would be appropriate to allow non-manager partners (those without the authority to bind the partnership) to also be employees of their partnership. This dual status would permit income tax withholding on their wages for services rendered. The distributive share of their partnership income would be subject to quarterly estimated tax payments, but the risk of underpayments of tax will have been reduced.

This proposal couples nicely with the above proposal to exclude partnership income attributable to capital from the SE tax. To the extent a partner is an employee compensated reasonably for services rendered, the empoyer-employee FICA taxes will be paid. Excess earnings would be attributable to capital, and exempt from SE tax, but subject to quarterly estimated income taxes with less risk for underpayment penalties.

D. S Corporation Reforms

As mentioned earlier, Congress has been quite attentive to Subchapter S over the years. A number of improvements and refinements have been enacted making the S corporation easier to use and available to a broader base of taxpayers. In addition, the IRS has been very responsive to S corporation needs, and has interpreted the S corporation rules reasonably and fairly. Personally, I commend the IRS for its efforts to provide guidance to the S corporation community. For the most part, they have done an outstanding job.

One area of legislative concern that could be considered is the one-class of stock restriction imposed on S corporations. This restriction is intended to keep Subchapter S simple. However, it limits S corporation access to capital. Congress could consider modifying the one-class-of stock rule by permitting S corporations to issue a preferred stock. In general, such stock

would be stock that is not convertible, and would not participate in corporate growth to any significant extent. Payments on the preferred stock would be treated as interest. In essence, the preferred stock would be similar to a straight debt instrument, and therefore, would be treated as such under this proposal.[17] Allowing for a preferred stock restricted in this manner would give the S corporation small business owner one more option in seeking capital to fund business operations.

VIII. Conclusion

Over the last two decades, more small businesses have chosen to organize under one of the Code's pass-through regimes. As noted earlier, a number of factors have contributed to this migration from the regular corporate form of doing business. The most significant factors are the increase in the relative tax disadvantage from operating as a regular corporation as well as the ability to obtain limited liability protection through entities subject to pass-through taxation. To reduce existing distortions in the Code affecting choice of entity, Congress should consider undertaking true corporate integration to eliminate the double tax. Once this regime is agreed and relative parity is achieved, it would be appropriate to look to the pass-through regimes, and rationalize them with the adopted corporate integration model.

Until the distortions created by the double tax can be resolved, the current pass-through regimes provide a valid self-help integration function which allows for a more efficient tax system (at least to the segment of the economy that can use these pass-through tax regimes). Subchapters K and S should continue to co-exist under the existing Code awaiting corporate integration.

Thank you for the opportunity to join you in today's hearing.

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[17] The Senate Finance Committee has considered this proposal in the past. See, Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S and Home Office Deductions* (JCS-16-95), May 24, 1995, at page 29.

Statement of

Eric J. Toder
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Before the
Senate Committee on Finance

Tax Reform and Taxation of Small Business

June 5, 2008

Views expressed are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders. I thank Roberton Williams for helpful comments.

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

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

Small Business and the Current Tax System

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

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

Provisions that Favor Smaller over Larger Businesses

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

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

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

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

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

Effects of More General Provisions—Costs of Capital

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

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

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

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

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

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

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

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

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

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

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

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

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

Effects of More General Provisions—Labor Costs

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

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

Technology of Tax Compliance and Administration

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

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

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

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

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

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

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

Effects of Tax Reforms

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

Corporate Tax Rates and Base Broadening

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

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

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

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

Elimination of Double Taxation of Corporate Dividends

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

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

Health Care Reform

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

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

Introduction of a Consumption Tax

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

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

Conclusion

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

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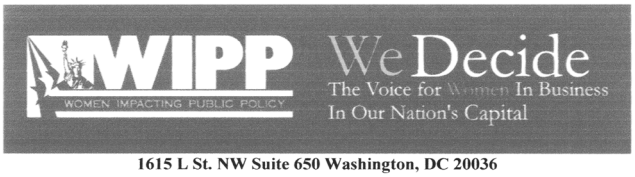
[6] Michael J. Graetz, *100 Million Unnecessary Returns—A Simple, Fair, and Competitive Tax Plan for the United States*, Yale University Press, New Haven CT, 2008.

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

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

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

COMMUNICATION



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Statement of

Women Impacting Public Policy

Submitted to the

U.S. Senate Committee on Finance

"Fundamentals of Tax Change: C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform"

June 5, 2008

Women Impacting Public Policy (WIPP) is pleased to submit this statement to the Senate Finance Committee. WIPP is a bipartisan public policy organization representing well over a half million women and minorities in business nationwide and 45 business associations. The topic of the hearing "C, K, or S: Exploring the Alphabet Soup of Small Business Choices in Advance of Tax Reform," resonates strongly throughout our membership. The complexity of the tax code and the lack of parity between the various organizational designations have been of serious concern for small business owners.

The effect of tax policy on small business must be taken into account when enacting any changes in the tax code. Small businesses already face difficulty in maneuvering through complex tax laws and currently bear exceedingly high tax compliance costs. The SBA Office of Advocacy estimates that small firms with fewer than 20 employees annually spend 45% more per employee than larger firms to comply with federal regulations and 67% more per employee on tax compliance than their larger counterparts. For example, an employer with less than 20 employees will spend a total of $1,304 per employee as compared to employers with 500 or more employees which incur $780 per employee to comply with Federal taxes.

A study sponsored by the IRS found that small businesses spend between 1.7 and 1.8 million hours and between $15.0 billion and $16.4 billion in out-of-pocket expenses in preparing and filing tax returns. If one values the time of small-business employees engaged in tax preparation activities at $45.40 per hour and about $90,800 per year, the small-business compliance burden falls between $92 billion and $100 billion per year, which is almost as large as the total compliance burden for all individual income taxpayers. According to the 2005 SBA report to the President, "one reason for the high per-employee cost to small businesses is the level of complexity in the tax code. There is a substantial burden in paperwork and recordkeeping for any firm with a payroll, even before the first paycheck is cut."

WIPP believes the tax code should level the playing field for all small businesses no matter how a business is organized. In WIPP's recent annual survey, 81 percent of WIPP members believe the tax structure is in need of comprehensive reform. The tax code should be reformed to allow sole-proprietors to deduct health insurance costs as a business expense and allow them to forego payroll (FICA) taxes on these expenses.

Additionally, simplification of the tax code would be extremely beneficial to small businesses. By reducing the complexity of the code, this would increase access to capital for small businesses and help them to take advantage of beneficial tax deductions. One example of a current tax benefit that works for small businesses is Section 179 expensing. Acceleration of Section 179 expensing in the Economic Stimulus package provides small businesses with an immediate deduction for almost all business investments. Increased expensing reduces complexity in the tax code by eliminating paperwork and the long process, saving small businesses time and a significant amount of money.

An example of a tax deduction that should be enacted is the creation of a standard home office deduction which will eliminate the burden of keeping detailed records and which also

translates into time and money spent for a small business. In a recent analysis by the SBA office of Advocacy, more than half of the small businesses in the U.S. are home-based. A standard home office deduction would greatly assist in simplifying tax preparation for our Nation's home-based entrepreneurs and also encourage these small businesses to take advantage of this important tax deduction.

Small businesses, as defined by the SBA size standards, make up over 99 percent of all U.S. businesses and employ over one-half of the American workforce. Furthermore, according to the SBA Office of Advocacy, small businesses have created nearly 60-80% of the net new jobs annually over the last decade.

WIPP looks forward to working with the Committee in insuring a tax code that supports these businesses and aids in their growth and expansion, which is key to the vitality of our Nation's economy.