



Options for Small Business Tax Reform

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TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS GROWTH

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Chairman Risch, Ranking Member Shaheen, and Members of the Committee, thank you for inviting me to appear today to discuss the impact of the tax system on small business and options for reform. The views I express are my own and should not be attributed to the Tax Policy Center, the Urban Institute, their boards, or their funders.

There is a broad consensus that the current system for taxing businesses is in dire need of reform. The US tax system was last overhauled in 1986, and the current system, especially as it applies to business income, is woefully out of date. Three decades of changing business practices, increased globalization, and expanding aggressiveness in tax planning activities have led us to a situation where we have very many critics of the current business tax system and precious few defenders.

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Complaints about the business tax system include a maximum statutory corporate income tax rate that is among the highest in the world; a large array of special tax provisions that permits many firm to pay an effective tax rate far below the statutory rate; incentives for US-based multinational firms to shift profits abroad and to claim they are permanently reinvested there; an incentive for multinational firms (both domestic and foreign-parented) to locate deductions in the United States and income in lower-taxed jurisdictions; incentives for certain firms to organize as pass-through entities in order to avoid corporate-level taxation; and immense amounts of complexity that make compliance difficult and raise questions about the tax system's administrability and fairness.

Tax reform should address some of or all these complaints. Ideally, it would do so without creating offsetting problems elsewhere that overshadow any progress made in the name of reform.

My testimony today has four parts:

1. a review of the principles of tax policy, to provide a set of agreed-upon goals to guide any reform effort;
2. some basic findings about businesses in the United States to ground the tax reform discussion in fact;
3. a discussion of how the tax system affects smaller businesses and how a tax reform effort may affect them; and
4. a summary of several specific tax reform proposals that are intended to ensure that smaller businesses are not inappropriately disadvantaged by efforts at broader tax reform.

Tax policy is guided by three basic notions: efficiency, equity, and simplicity. An ideal tax system would advance all three goals to some extent, while recognizing that sometimes the goals conflict. Similarly, a tax reform effort would acknowledge that all three goals are important but would manage trade-offs among them.

An efficient tax system would distort economic choices as little as possible while raising the appropriate amount of revenue. Typical characteristics of an efficient tax system are relatively low tax rates, broad bases for taxation, a portfolio of different types of taxes to limit reliance on specific revenue sources, and an understanding of the incentives provided by the tax system so that policymakers minimize the enticements for taxpayers to reduce their tax bill though otherwise uneconomic actions.

Equity, as applied in tax policy, has two components: horizontal and vertical. Horizontal equity means that taxpayers in similar economic circumstance are treated similarly. In income taxation, this usually boils down to treating taxpayers with equal incomes equally. Strictly speaking, this would mean that the source of income would be disregarded in determining tax treatment and, ultimately, tax liability. Vertical equity means that tax liability should be distributed in accordance with the ability to pay taxes. That implies that those with larger incomes have a greater ability to pay taxes and therefore should shoulder a larger than proportionate share of the cost of public goods and services. This concept is associated with a progressive tax system, where the average tax rate paid (or average effective tax burden) goes up with a taxpayer's incomes. As a concept, vertical equity makes more sense when applied to the individual income tax or to the entire tax system than when applied to the corporate income tax. The US federal individual income tax is progressive throughout almost the entire income distribution. The overall US tax system is similarly progressive.¹

Simplicity is the third principle of desirable tax policy. One way to promote simplicity is to reduce the compliance burden that the tax system imposes. The Internal Revenue Service (IRS) regularly assesses the overall burden of the US tax system by the number of hours required to understand one's tax obligations, keep appropriate records, file the necessary tax forms, and interact with the IRS after filing. Individual taxpayers spend around 2 billion hours a year complying with the individual income tax, and the cost to businesses is estimated to run to over \$100 billion annually.

But beyond the hours and dollars, there is a sense among taxpayers and tax policy observers that the tax code is too complex for ordinary Americans to understand their tax obligations and comply with them. This sense of extreme complexity is evidenced by the robust tax preparation and tax software industries, as well as a sense among taxpayers that they are missing out on benefits being claimed by others. A lot of the existing complexity merely reflects the increasingly complex world in which we live. Individuals and businesses can enter into a nearly limitless number of possible economic transactions. These possibilities reflect economic and social complexity, globalization, and long-standing efforts at financial engineering. Congress, however, is complicit in this sense of growing complexity; the past three decades have been characterized by increasing amounts of social policy being run through the tax code. While this can be an efficient method of delivering benefits to particular taxpayers, every one of these provisions carries with it eligibility rules and benefit calculations that can overwhelm taxpayers. This proliferation of tax expenditures itself fosters complexity.

But tax incentives should not be avoided simply because they lead to complexity. In some instances, overriding public policy considerations argue for deviating from one or more of the

¹ See, for example, the Tax Policy Center's model estimate of average effective federal tax rates at <http://www.taxpolicycenter.org/model-estimates/baseline-average-effective-tax-rates-march-2017/t17-0042-average-effective-federal>.

three major tax policy principles. For example, our economic system by itself may lead to an insufficient amount of activities with important spillover benefits (such as basic research) or to over-consumption (or provision) of some activities with negative spillover benefits (like tobacco or alcohol consumption). In these cases, specific provisions in the tax code (such as the research and experimentation tax credit or excise taxes on alcohol or tobacco purchases) can address under- or over-supply.

It is important to be aware of the trade-offs among tax policy principles. An optimal system will seek to balance out the contributions of each dimension and carefully weigh deviations. When Congress enacted the 1986 Tax Reform Act, it devoted much time and energy and debate to considering the degree to pursue each of these desirable traits in the legislation. Given three decades of incrementally moving away from the 1986 agreement on each of these policy goals, it is time to refocus attention on designing a tax system that meets them to the maximum extent possible.

FACTS ON BUSINESSES

The taxation of business largely depends on the choice of organizational entity for the business. A business can be owned by one person and operated as a sole proprietorship, with all the net profits or losses passing through to the owner. A business can be established as a partnership of two or more people or entities. Partnership agreements can be flexible about the share of profits or loss and the source of those flows that goes to each partner. The tax consequences of the businesses activities of the partnership pass through to the partners in accordance with the partnership agreement.

Limited liability companies (LLCs) are a relatively recent phenomenon, where the members/owners of the company can elect to be treated as a partnership or as a traditional corporation for income tax purposes. But the members/owners can still benefit from the limited liability they receive from a traditional corporation without paying a separate corporate income tax. If members/owners elect to treat the LLC as a partnership, then the net profits and losses of the entity and their character, are passed through to the owners in accordance with the legal agreement establishing the LLC.

A traditional corporation, often called a C corporation (after the section of the tax code that governs it) pays an entity-level tax each year on its net profits. Distributions to the corporation owners in the form of dividends are taxed at the shareholder level. Thus, there is the potential for a second layer of taxation—one at the entity level and another at the shareholder level—on the income earned by a traditional corporation. A special category of corporation, called an S corporation (again, after the relevant section of the tax code) does not pay tax on net income at the entity level. Like partnerships, the net profits and losses are passed through to the owners. But, unlike a partnership, which may allocate profits according to any agreed-upon

formula, the pass-through amounts in an S corporation must be proportional to ownership shares. S corporations also have limits on the total number of shareholders, placing a limit of the use of this form of entity.

Owners of pass-through businesses are taxed more favorably than owners of traditional C corporations because they pay only the individual income tax on business earnings, while the profits of C corporations are taxed at the corporate level and then again at the individual level when paid out as dividends or realized as capital gains. For example, consider a business owner in the top individual income tax bracket receiving net taxable profits of \$1 million from ownership shares of an S corporation. This owner would report \$1 million of business income and pay a tax of \$396,000 at the top individual tax rate of 39.6 percent. There would be no additional income tax if the S corporation distributes some of its earnings to the owner. Now consider a similar owner of a traditional C corporation, also with \$1 million in net taxable profits. At the current corporate income tax rate of 35 percent, the corporation would pay \$350,000 in income tax. If the remaining \$650,000 is distributed to the owner as a dividend, it would be subject to individual income tax at a maximum rate of 23.8 percent, for an additional liability of \$154,700. This puts the total income tax payments related to the original \$1million in business income at \$504,700. This additional tax liability may provide a disincentive for the traditional C corporation form, affecting the choice of entity by individuals who are forming businesses.

Most business returns are sole proprietorships, followed by S corporations, partnerships (including most LLCs that elect to be treated as partnerships), and traditional corporations. While most businesses are pass-through entities, most economic activity (though a declining share) is associated with traditional C corporations, where it is subject to an entity-level tax (table 1).

TABLE 1

Distribution of Returns Filed And Business Receipts by Business Return Type, 2014



	C Corporations	Partnerships	S Corporations	Sole Proprietorships	Total
Number of returns (in millions)	1.6	3.6	4.4	24.6	34.2
Business receipts (in trillions of dollars)	20.1	5.3	7.2	1.4	34.0
Share of returns	4.7%	10.5%	12.9%	71.9%	100.0%
Share of business receipts	59.3%	15.6%	21.2%	4.1%	100.0%

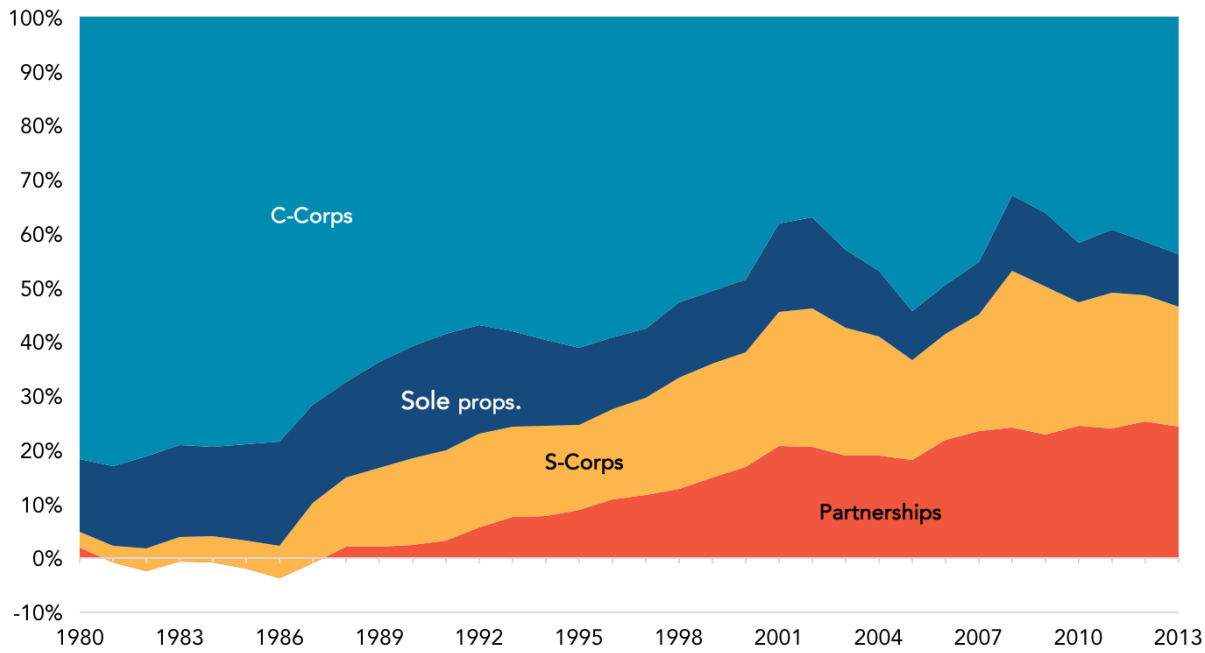
Source: Prinszano et al. (2016, Table 1).

This situation has changed somewhat over time: the composition of business income has changed over the past few decades, with the dominance of traditional C corporations declining since 1980 (figure 1). This shift reflects several factors: shifts in tax rates for individuals and corporations that affect the desirability of organizing as a traditional C corporation; tax law loosening the ownership limits of S corporations; state law changes accelerating the adoption of

LLCs; and greater acceptance by individual taxpayers of the complexities associated with investments in pass-through entities.

Figure 1

Share of Total Business Net Income (less deficit)
1980 - 2013



Source: Nelson (2016).

Note: Shares do not include regulated investment corporations (RICs) and real estate investment trusts (REITs). C- and S-corporation income includes officer compensation.

Each type of business entity—sole proprietorship, partnership, LLC, S corporation, and traditional C corporation—can be almost any size. But the distribution of businesses by type, like many other distributions in economics, has a large fraction of small entities carrying out relatively small amounts of activity, with the bulk of the economic activity carried out by a relatively small number of the very largest enterprises.

The largest number of entities are in the smallest size categories, but the bulk of total economic activity is accounted for by the relatively small number of the largest entities (table 2). While most businesses are small (including pass-through businesses), it is incorrect to equate small business with pass-through business. In fact, many large pass-through businesses are major players in such industries as accounting, law, financial management, natural resources, pipelines, and real estate.

TABLE 2

Distribution of Partnerships, S Corporations, and C Corporations Returns, Business Receipts, and Net Income by Asset Size (in percent), 2013



	\$100,000 or less	\$100,000 to \$1 million	\$1 million to \$10 million	\$10 million to \$50 million	\$50 million or more
Partnerships					
Returns	46.1%	28.9%	20.5%	3.3%	1.2%
Business receipts	6.6%	7.1%	13.0%	13.1%	60.1%
Net business income*	7.2%	5.7%	11.2%	9.3%	66.6%
S Corporations					
Returns	63.3%	28.5%	7.2%	0.8%	0.2%
Business receipts	9.3%	19.2%	27.2%	20.9%	23.4%
Net business income*	16.4%	21.5%	23.7%	15.7%	22.7%
C Corporations					
	\$1 million or less	\$1 million to \$10 million	\$10 million to \$50 million	\$50 million or more	
Returns	95.8%	3.1%	0.6%	0.5%	
Business receipts	10.9%	10.2%	8.3%	70.6%	
Net business income*	25.0%	-4.5%	-3.3%	82.8%	

Source: Internal Revenue Service, Statistics of Income, at <http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Data-by-Size-of-Total-Assets>;

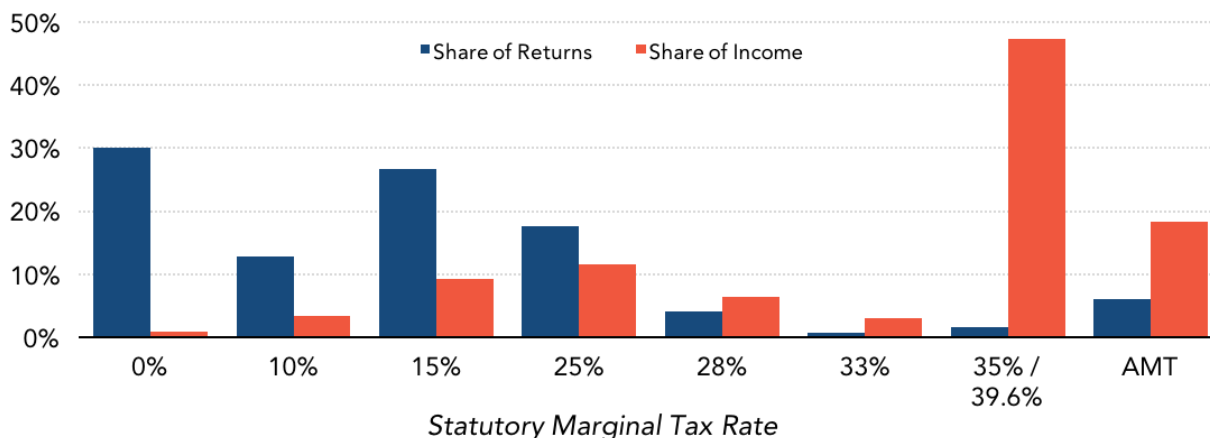
<http://www.irs.gov/uac/SOI-Tax-Stats-Nonfarm-Sole-Proprietorship-Statistics>; <http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book>;

Notes: *Equals net profits for firms with positive profits minus net losses for firms with losses.

Other important facts are who ultimately owns pass-through businesses and the marginal tax rates faced by these owners. In a technical report published last year, the Office of Tax Analysis in the Department of Treasury found that most tax returns with pass-through income are filed by individuals with a marginal tax rate of 15 percent or lower (figure 2). But the vast majority of income is reported by those in the highest income tax brackets (35 percent, or 39.6 percent subject to the alternative minimum tax). In fact, among firms with pass-through income, the 3 percent of individual income tax filers in the 35 percent or 39.6 percent tax brackets receive 51 percent of the total income from all pass-through entities. So, pass-through income is highly concentrated at the top of the income distribution. The degree of concentration is illustrated by the fact that over two-thirds of the total amount of S corporation and partnership income accrues to the 1 percent of taxpayers with the highest incomes.

FIGURE 2

Pass-Through Income by Statutory Marginal Tax Rate



Source: Prisinzano et al. (2016, Table 10).

Note: Includes income or loss from Sch. C, Sch. F, and Sch. E rental, partnership, and S-corp income.

HOW TAX REFORM CAN AFFECT SMALL BUSINESS

Traditional tax reform broadens the tax base, which expands taxable income and allows for lowering the statutory tax rates on that income without losing revenue. The 1986 Tax Reform Act, for example, broadened the income tax base enough to support a revenue-neutral reduction in the corporate income tax rate from 46 percent to 34 percent and a reduction in the top individual income tax rate from 50 percent to 28 percent. Even though more income (and more business income) was subject to tax, the related tax rates were dropped substantially.

With business tax reform, many base-broadening proposals would increase the size of the tax base across the board: for small and large businesses and for traditional C corporations and pass-through entities. This might disadvantage smaller C corporations unless the tax rates applied to lower-income corporations (already below the statutory maximum) also were reduced. Such a reform also would certainly broaden the tax base for pass-through businesses. These entities could see an increase in tax liability for their owners, unless individual income tax rates were also correspondingly reduced.

Policymakers would need to grapple with the issue to reach an accommodation, because this illustrates the trade-offs in designing tax policy. If the steps taken to broaden the tax base under reform more accurately measure income, then these changes should be encouraged as increasing horizontal equity between those who earn income from business activities and those who earn salary or wage income. Similarly, if the net effect of the base-broadening and lowering corporate tax rates is to decrease the tax advantage that pass-through entities have over traditional C corporations, then that also could be a positive step for economic efficiency. But if

these changes dissuade business formation by entrepreneurs or discourage innovative activities that have positive spillover effects, then there could be an offsetting effect.

It is important to focus on the innovation and business formation activities rather than on the size of the businesses involved. Small businesses have many attractive attributes for society, but the public policy focus on designing tax policy should be on aspects of the business activity that spill over to the larger community and are not perfectly captured by the business owners themselves. For instance, economic research has shown that innovation is often associated with new firms, which can drive industry-wide or economy-wide change, opening up new markets or unlocking efficiencies. Thus, there is a reasonable economic argument for encouraging new firms and start-up firms and individuals exploiting their entrepreneurial ideas. The current tax code does some of this, providing significant benefits to successful start-up entrepreneurs.²

APPROACHES TO SMALL BUSINESS TAXATION

In evaluating reforms, it is useful to consider the benefits that small businesses might obtain from specific proposals and then consider whether these benefits advance the tax policy goals of efficiency, equity, and simplicity. If the important public benefits of tax policy changes are associated with new forms that can drive innovation, then a few specific policies stand out as being supportive in this area.

Increased limits for start-up and organizational expenses can help businesses form and commence operations. These types of expenses generally are limited to new firms that are establishing themselves as operating entities. Under current law, an entity can immediately expense (deduct) up to \$5,000 in start-up expenses and another \$5,000 in organizational expenses. These amounts could be combined and the aggregate amount increased to provide a larger tax benefit for starting up a new business. This change could also provide some simplification by permitting an immediate deduction instead of amortization (cost recovery) over a period of years.

Under Section 179 of the tax code, a business may immediately expense up to \$500,000 of qualifying property and equipment each year. This immediately deductible amount is phased out if the amount of qualifying property placed in service exceeds \$2 million. So, this provision is targeted at smaller firms by design and encourages these firms to make capital investments that can embody the newest technology. Congress set the amount at \$500,000 (adjusted for inflation) in 2015, but a reexamination of this provision may be warranted, since it clearly simplifies the tax calculations for affected entities and could also help spur innovation. Calculating depreciation expenses and maintaining adjusted basis for assets owned are a source of significant complexity for small businesses.

² See, for example, Eric Toder, "Taxing Entrepreneurial Income" (Washington, DC: Tax Policy Center, 2017) at <http://www.taxpolicycenter.org/publications/taxing-entrepreneurial-income>.

Smaller businesses often have a larger per-unit cost of complying with the tax code than larger businesses. One major area of complexity is accrual accounting, which often requires sophisticated financial skills. Under current law, businesses must undertake a series of calculations involving gross receipts, type of business activity, entity type, and sometimes ownership interests to determine whether they must use accrual accounting or if they are eligible for the simpler cash accounting method. These restrictions are meant to ensure some measure of horizontal equity for different types of taxpayers, but Congress may wish to review the various constraints to see if they still function as desired. One possible approach would be to set a dollar threshold where firms with smaller amounts of gross receipts could use a simplified method of cash accounting (similar to maintaining a checking account). This approach could simplify tax compliance for many smaller businesses at the cost of a loss of horizontal equity.

A final area for Congress to consider that relates to ease of tax compliance is the establishment of basic income reporting rules for payments between businesses. Congress has established thresholds for reporting miscellaneous income to individual recipients using Form 1099 and has established thresholds for debit and credit card reporting. Pushing a little further on information reporting could provide taxpayers (particularly entrepreneurs and smaller firms) with the information necessary to fulfill their tax compliance obligations at relatively low social cost (especially where electronic information already exists). And it would help improve horizontal equity by treating taxpayers with similar amounts of income similarly.

In the ongoing discussion of business tax reform, several proposals have been made to establish a special preferential tax rate for income from pass-through businesses. These proposals are often characterized as providing support for small businesses. However, as the basic facts on US businesses show, most small business owners pay income tax at a modest rate and so would not benefit from a reduction in the maximum tax rate applied to pass-through income. But most pass-through income accrues to individuals who are subject to the top individual income tax rates. That means providing a preferential pass-through business income tax rate would be expensive in terms of forgone revenue. And a preferential tax rate for this type of business income would create a huge tax wedge between income earned as salaries and wages and income classified as pass-through business income. By itself, this would exacerbate concerns about horizontal equity as people with similar overall incomes could be treated quite differently. But a large wedge between ordinary income tax rates and the new preferential tax rate on pass-through income would create a huge incentive for inappropriately characterizing ordinary income as lower-taxed pass-through income. This could add substantial amounts to the potential revenue cost.³

³ For a recent illustrative analysis, see Jeffrey Rohaly, Joseph Rosenberg, and Eric Toder, "Options to Reduce the Taxation of Pass-Through Income," (Washington, DC: Tax Policy Center, 2017), <http://www.taxpolicycenter.org/publications/options-reduce-taxation-pass-through-income>.

SUMMARY

In determining how to move ahead on tax reform, policymakers should be aware that reform can have disparate effects on different participants in the economy. The three guiding principles of tax policy—efficiency, equity, and simplicity—provide a framework for evaluating policy choices. And some facts about US businesses can help guide the ongoing tax reform discussions:

- most businesses are small (traditional corporations and pass-through businesses);
- most economic activity takes place in larger enterprises (traditional corporations and pass-through businesses);
- pass-through businesses overlap with, but are not identical to, small businesses; and
- most income from pass-through businesses accrues to individuals at the top of the income distribution.

These facts, combined with the tax policy principles articulated, can help inform the policy debate and evaluate policy alternatives.

APPENDIX: RESPONSE TO QUESTION FOR THE RECORD

Question for Mr. Mark J. Mazur¹

Question from: Chairman Risch

On Section 179 Expensing for Small Businesses

Section 179 expensing allows a small business to immediately deduct the cost of investing in their business – up to \$500,000 of qualifying property and equipment each year. This deduction puts money back into the small business for investment rather than spreading the deductions out over a long depreciation schedule. Expensing also reduces tax complexity by eliminating the paperwork and record-keeping burden associated with longer depreciation periods.

QUESTION 1

In your testimony, you discussed Section 179 expensing and how small businesses use this deduction. You also mention a reexamination of this provision may be warranted to increase simplification and spur innovation: can you expand on this statement and discuss any concrete suggestions you have for this provision were it reevaluated?

RESPONSE

Section 179 expensing is an important incentive for capital investment made by smaller firms. It is also a source of simplification, because firms taking advantage of it do not need to keep track of accumulated depreciation and maintain records indicating the adjusted basis of their productive physical assets. Increasing the current law \$500,000 limitation to \$1 million (and indexing the amount for future inflation) would help ensure that smaller businesses can make significant capital investments in a tax-advantaged way and would expand the simplification benefits provided by Section 179 to these firms. In addition to increasing the limitation, increasing the dollar threshold on investment where the benefit begins to phase out from the current law \$2 million (indexed for inflation, so the value is \$2,030,000 in 2017) to a larger figure (such as \$3 million, also indexed for inflation) would ensure that more smaller firms can benefit.

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