National Small Business Association®

The Honorable Mitch McConnell
Majority Leader
U.S. Senate
317 Russell Senate Office Building
Washington, DC 20510

The Honorable Paul Ryan
Speaker of the House
U.S. House of Representatives
1233 Longworth House Office Building
Washington, DC 20515

The Honorable Orrin Hatch
Chairman
U.S. Senate
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Kevin Brady
Chairman
U.S. House of Representatives
House Ways and Means Committee
1102 Longworth House Office Building
Washington, DC 20515

Re: NSBA Comments on the Unified Framework for Fixing Our Broken Tax Code

Dear Members of Congress:

Founded in 1937, the National Small Business Association (NSBA) is America's oldest, nonpartisan small-business advocacy organization with more than 65,000 members in every industry and every state across the country. The current U.S. Tax Code poses a significant disadvantage to America's small businesses, as it punishes work, investment, risk-taking and entrepreneurship. Comprehensive tax reform offers the prospect of sustained economic growth and could dramatically lower compliance costs. We commend your efforts to reform the tax system with the release of the Unified Framework for Fixing Our Broken Tax Code, in order to reduce its complexity and compliance costs and to promote economic growth and prosperity.

In general, we believe that the Framework contains the appropriate elements for a positive and constructive reform of our tax code—one that takes steps toward reducing the complexity of the tax system for businesses of all types while maintaining strong incentives for growth. However, we have some specific and significant comments that need to be addressed as you work toward filling in the critical details and move to a legislative package.

Key Issues for Small Business

Rate Parity: For NSBA, one of the main goals of fundamental tax reform is to make U.S. businesses—of all sizes—more competitive and to increase economic growth. This requires a reduction in tax rates on businesses and investment. Thus, most critical to small-business owners is lowering individual tax rates commensurate with corporate rate cuts. Congress should provide the same rate for all businesses whether organized as C corporations or pass-through entities, and Qualified Personal Service Corporation income should flow out at individual tax rates.

Permanent Expensing and Interest Deductibility: Furthermore, any legislation should allow businesses to immediately and permanently deduct the full cost of qualified capital investments, with interest deductibility for those with gross receipts under $10 million. As Congress debates what tax system should replace the current one, NSBA believes it is imperative that the U.S. moves towards a simpler, fairer tax system that does not attempt to only tweak one piece of the puzzle but instead is a permanent solution.

The Framework would reduce the likelihood that small firms will make inadvertent mistakes that can have a dramatic adverse impact on their business. However, we also believe that the various proposals released to date overlook some issues of importance to small firms, as further outlined below.

Fundamental Tax Reform

Federal taxes are routinely ranked among the top issues facing small businesses and pose a huge and unique financial and administrative burden for small-business owners. Results from the NSBA 2017 Taxation Survey indicate that the majority of respondents (58 percent) cited administrative burdens—while 38 percent highlighted financial burdens—as the most significant challenges to their business posed by the federal tax system. In 2017, 40 percent of small businesses reported they spend more than 80 hours per year dealing with federal taxes, and the majority spent more than 40 hours per year. Just imagine the collective business and job growth that could be done absent that burden. Furthermore, the majority of small businesses, 59 percent, say that federal taxes and credits or deductions have a significant to moderate impact on their business decisions while 67 percent say federal taxes have a significant to moderate impact on the day-to-day operation of their business.

As such, NSBA has developed nine principles as part of the NSBA Tax Reform Checklist to which any broad tax reform package ought to adhere. The nine principles are:

- Designed to tax only once
- Stable and predictable
- Visible to the taxpayer
- Simple in its administration and compliance
- Promote economic growth and fairness between large & small businesses
- Use commonly understood finance/accounting concepts

- Grounded in reality-based revenue estimates
- Fair in its treatment of all citizens
- Transparent

Individual Tax Rates and the Taxation of Pass-through Entities are Key for Small Businesses

Most small businesses are sole proprietorships, subchapter S corporations or limited liability companies. Most of the remainder are partnerships (either limited or general). There are also some business trusts. All of these businesses (83 percent, according to existing NSBA data) pay taxes on their business at the personal income level, or are so-called "pass-through" entities that are subject to individual tax rates not the corporate tax rates and face the same marginal tax rates as individuals.

Some small businesses are C corporations that are subject to the corporate income tax, but these are a relatively small percentage and a large portion of these companies' net income before compensating the owners' is usually consumed by paying the owners' salary. This salary is also subject to the individual tax rates as, of course, are any dividends paid by the corporation to its shareholders. Thus, even for small C corporations, individual tax rates are key. Therefore, addressing just one piece of the puzzle—such as corporate tax reform—will only lead to even greater complexity and a massive tipping of the scales in favor of the nation's largest companies at the expense of small businesses.

For the overwhelming majority of small businesses, individual marginal tax rates are much more important than corporate marginal tax rates. Pass-through businesses are subject to both the federal individual income tax, with a top rate of 43.4 percent, and state and local income taxes, with rates ranging up to 13.3 percent. Since small businesses disproportionately contribute to job creation, raising individual marginal tax rates can be expected to have a disproportionate negative impact on job creation.

The U.S. currently has the highest corporate tax rate (39.1 percent including state corporate taxes) among the 34 developed countries in the Organization for Economic Cooperation and Development (OECD). Reducing the corporate tax rate more towards the OECD norm of about 25 percent would be an economically constructive step, but pass-through entities cannot be left behind.

The economy will grow most rapidly and society's scarce resources be used most effectively if the tax code's many provisions rewarding or punishing particular types of investment or other economic behavior are eliminated. Business decisions should be made for sound business reasons, not because of the tax treatment or tax subsidy accorded certain activities.

When it comes to corporate tax reform, however, NSBA has some concerns. NSBA's top priorities for any tax reform are rate parity for all types and sizes of businesses, increased simplicity, and long-term stability. While the Unified Framework moves us closer to rate parity, the current proposal leaves a disparity by offering pass-through entities a 25 percent tax on business income while dropping the corporate rate to 20 percent. NSBA is urging the tax writers to find ways to close that gap.

Although traditional C corporations pay a higher overall tax rate on their income, there are specific advantages to the C corporation—the ease of raising money, less restrictive shareholder rules (compared to an S corporation), and deferral of domestic taxation.

Thus, it would be unfair to reduce corporate tax rates without also reducing the individual tax rates that apply to small firms. Moreover, a large disparity in the corporate tax rate and individual tax rates is likely to lead to various forms of tax gimmickry. If the business tax base is broadened, i.e.: eliminating certain business credits and deductions, and corporate tax rates substantially lowered while individual tax rates are reduced only slightly or not at all, the result will be a larger tax increase on those pass-through small businesses – many of which rely on possibly eliminated business credits and deductions.

Reducing the marginal tax rates applicable to small business income—with parity among organizations—is among the most important constructive steps that the tax-writers can take. NSBA members overwhelming believe that any serious tax reform proposal must also include lowering the individual tax rate to support pass-through businesses. Allowing U.S. pass-through entities to compete with larger U.S. corporations is as important as allowing U.S. multinational corporations to compete on an equal basis with foreign multinationals.

To address concerns that a special pass-through rate will lead to gaming, the Framework also says that the tax writing committees will be tasked with drafting rules to prevent recharacterization of wage income as partnership income.

NSBA's concerns remain that the framework does not, however, provide guidelines for what those anti-abuse rules should look like, and NSBA does not support lower rates for professional services income. Currently, Qualified Personal Service Corporation (QPSC) — such as law and accounting firms and medical practices — pay income tax at a flat 35 percent rate. In most cases, the QPSC does not pay income taxes since the owners generally arrange that all of the income be paid out as salary, bonuses, and fringe benefits, which, of course, is deductible by the QPSC, but it does remove the advantages of income splitting between the corporation and the employee-owners that would otherwise be possible with a C corporation. To prevent this, NSBA urges lawmakers to consider making QPSC income flow out at individual tax rates.

Expensing

The framework would allow businesses to immediately write off 100 percent of the cost of new capital investments – other than structures – for "at least five years," effective for investments after Sept. 27, 2017.

Expensing is one of the most important provisions in the tax code to small businesses. It simplifies tax accounting, aids cash flow and reduces the cost of capital for small firms. In particular, Section 179 expensing is of vital importance for smaller firms, particularly those in more capital intensive industries. More than one in three NSBA members take advantage of this break as it encourages small businesses to invest in new equipment by letting them expense much of the cost up front, instead of depreciating it over time.

Currently, expensing eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. NSBA supports the current law expensing provisions that permanently allow for full and immediate write off or expensing the cost of investments. NSBA is concerned that under the Framework, lawmakers are reverting backwards, making them temporary—for only five years—which makes them tax extenders with the risk of a phase-out.

At the same time, it is important that smaller businesses continue to be able to deduct their interest expenses against any interest income, a significant and necessary business expense for many. The loss of interest deductibility to non-capital intensive businesses would be devastating. While NSBA supports the proposal to allow businesses to immediately deduct the full cost of qualified capital investments, we recommend that it includes interest deductibility for those with gross receipts under $10 million.

Furthermore, the expensing rule is the only proposal in the Framework with an explicit effective date, meaning that businesses would not benefit from accelerated expensing for any property acquired prior to the effective date. That is, any depreciable property acquired prior to Sept. 27, 2017, would not have its remaining depreciation deductions accelerated into immediate expensing. A consequence of this effective date, however, is that if a tax reform bill is not signed into law until 2018, any qualifying purchases made after Sept. 27, 2017, but prior to Jan. 1, 2018, would seemingly be eligible for immediate expensing at the current corporate income tax rate of 35 percent.

The Estate and Gift Tax

NSBA supports a complete repeal of the Alternative Minimum Tax as well as a total repeal of the Estate Tax. Both provision, if enacted, would help small business owners pass their companies down to the next generation without the same tax burdens they face today. NSBA is pleased that the joint tax reform Framework includes both of these full repeals. We also applaud you for retaining the R&E tax credit.

Conclusion

Clearly, the current tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes, with widespread competitive disadvantages to small firms. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is necessary.

For NSBA members, meaningful tax reform is a coherent set of reforms designed to promote economic growth, reduce complexity, and reduce administrative costs, increase transparency and voluntary compliance in an equitable manner. In order to promote economic growth, tax reform must reduce marginal tax rates without raising the cost of capital.

Too often, critical pieces of legislation are pushed through without the proper consideration. Your leadership throughout the process will lead to a better legislative product with more understanding of how the tax code impacts all stakeholders. We look forward to working with you and the committees of jurisdiction to achieve these laudable goals.

Sincerely,

Todd McCracken
President & CEO

Cc: Secretary Steven Mnuchin, Director Gary Cohn