



Ms. Michelle Greene
Designated Federal Officer
President's Economic Recovery Advisory Board
Office of the Under Secretary for Domestic Finance
Room 2326
Treasury Department
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Ms. Greene:

On behalf of the National Small Business Association, the nation's oldest nonpartisan small business advocacy group, I would like to request your careful review and consideration of any tax proposal, and how it stands to impact America's small-business community.

Reaching more than 150,000 small-business owners nationwide, NSBA serves as an umbrella group to myriad regional, state and local small-business associations and Chambers of Commerce. NSBA is charged with bringing together many diverse opinions and coalescing around one common goal: a strong small-business community. For the 111th Congress, our members have highlighted tax relief as a top priority.

While NSBA's members operate a wide variety of businesses, all agree that the current Internal Revenue Service (IRS) tax code is irreconcilably broken and the number one regulatory burden faced by business owners. Approximately 36 percent of NSBA members have fewer than five employees. With an already complex and burdensome tax code, business owners are forced to hire outside help to keep track of their paperwork.

Not only is the burden a heavy one, but it is disproportional as well. According to U.S. Small Business Administration (SBA) Office of Advocacy research, the cost of tax compliance for small firms is 67 percent higher than for their larger counterparts. For firms with less than 20 employees, the per-employee cost of complying with the tax code is \$1,304—and that doesn't include filing costs or actual taxes.

The current tax system is so complex and burdensome that small businesses are spending valuable time and financial resources on record-keeping and outside help to ensure compliance instead of using these resources to do what they do best: grow their business, create jobs, and stimulate the economy.

As Congress and the Administration grapples with a down-turned economy, banking failures and a skyrocketing deficit, it is only natural to look for ways to offset spending and raise revenues. Unfortunately, proposals to close the so-called tax gap have reappeared despite the concerns of many within the small-business community and beyond.

IRS data from the National Research Program (NRP) estimates the tax gap by measuring the rate of taxpayer compliance—the degree to which taxpayers fully and timely comply with their tax obligations. That rate is then used, along with numerous other assumptions, to estimate the dollar amount of taxes not timely or accurately paid. However, little attention is paid to the fact that the sheer complexity of the tax code is likely a huge factor in compliance rates. For tax year 2001, the IRS estimates nearly 17 percent of owed taxes were late or not paid at all, which translates into an estimated gross tax gap of \$345 billion. The IRS recovered about \$55 billion of this sum, leaving a net tax gap of \$290 billion.

In May, the administration's FY2010 budget proposed a number of steps to close the tax gap. Of the different proposals outlined, several of them would impose new regulatory, reporting and withholding burdens on small business—all in an effort to try to catch other businesses that might not be reporting all of their income. Given the extraordinary burden that compliance with the tax code already imposes on small businesses, it strikes our members as unfair at best to ask honest small businesses to do even more in order to catch a few potential cheats.

The most burdensome proposals would expand information reporting on payments to corporations, and require a certified taxpayer identification number from contractors. NSBA has thoroughly reviewed these recommendations and found they would not effectively increase compliance and minimize the tax gap. Instead, they add additional and unnecessary burdens on already over-burdened small-business owners.

Information Reporting Requirements on Payments to Corporations

Under current law, service recipients are only required to send 1099 forms to non-corporation service providers. For each non-corporation service provider, the service recipient is required to issue two 1099 forms—one to the IRS and one to the service provider. The FY2010 budget proposal recommends an expansion to the Form 1099 filing system by requiring a business to file an information return on payments to corporations aggregating to \$600 or more in a calendar year. The Department of Treasury argues that the exemption of corporations under the current system has created compliance issues and this new proposal will level the playing field. However, if this legislation goes into effect and corporations are no longer exempt from information reporting, the small business will have to issue two more 1099 forms for every service other provider that is classified as a corporation.

In practicality, this means that every time a small-business owner ships a package with Federal Express or uses some other service, and the expenses total more than \$600 by year-end, the small-business owner would need to keep the receipts, prepare a Form 1099

and file them not only with the IRS, but with Federal Express and any other companies exceeding the \$600 threshold. If enacted, every small-business owner will face increased paperwork and administrative burden for each additional 1099 Form prepared. Increased costs are incurred for mailing additional forms and for hiring outside assistance to ensure that businesses are correctly complying with the law. Furthermore, if a business previously has not been required to utilize the Form 1099 filing system, greater difficulty with compliance is likely to ensue. While the proposal seeks to capture non-compliant corporations, it clearly places the burden on the wrong taxpayer—the compliant small-business.

NSBA is concerned with what the IRS will do with this amount of data. We believe that the IRS lacks the capacity to utilize these new reports as well as the necessary staff to handle the massive volume of paperwork resulting from this proposal. There is no data available to justify this additional burden. It is unclear whether business-to-business versus business-to-consumer transactions are the problem, or if underreporting is more prominent in payments over or under \$600. Furthermore, there is no breakdown of the underreporting of income by cash or credit card transactions, and no clear indication of whether some industries are more non-compliant than others.

Requiring a Business to Obtain a Certified Taxpayer Identification Number from Contractors

Another proposal included in the FY2010 budget recommends that a contractor be required to supply to the business the contractor's certified Taxpayer Identification Number (TIN). The business would be required to verify the contractor's TIN with the IRS, who would determine whether the certified TIN-name combination matches the IRS records. If the contractor fails to furnish an accurate TIN, the business would be required to withhold a flat-rate percentage of gross payments to that contractor.

NSBA supports an accurate and real-time verification system that is easily accessible via on-line or phone to businesses so they can properly verify these TINs. Otherwise, this will result in delays in performing and paying for contractors' services. A system with substantial requests for paperwork and long wait times to receive needed approvals would harm daily operations of the business and disrupt the contractor's cash flow.

Included in this proposal is the creation of a voluntary withholding system. Contractors receiving payments of \$600 or more in a calendar year from a business can require a business to withhold a flat-rate percentage of their gross payments, with the flat rate of 15, 25, 30 or 35 percent being selected by the contractor.

By allowing the contractor the option to require the business to withhold a flat-rate percentage from their gross payments places the business under an additional burden, especially if the business has no choice but to comply with the contractor's request. NSBA asserts this is especially burdensome and complex to small businesses if each contractor requests a different rate. Then business owners may have to withhold from some contractors and report information returns on others—resulting in increased

administrative nightmares for the small business. Allowing the contractors the option transfers the compliance burden from the contractor to the business owner creating further disincentives to utilize contractor services.

Administration Recommendation Conclusions

Beyond the invasiveness and red tape, NSBA is concerned about whether the current infrastructure and staffing levels of the IRS is adequate to handle the surge of paperwork that these proposals will create.

While the concept of significantly increasing taxpayer compliance may appear justifiable, the practical impact of implementing it could be devastating to the individual taxpayer. Additionally, for the entire burden they would impose on small business, these enforcement proposals—according to the budget report—would fill less than one tenth of one percent of the tax gap, collecting only \$10.7 billion over the next ten years.

While the overall goal of the administration and Congress to increase tax compliance and minimize the tax gap is understandable, it is not possible to completely close the tax gap. There will always be those who employ tax shelters, willfully non-comply, or inaccurately report their income. There will even be those circumstances where it is the unqualified tax preparers who are making the mistakes and should be held responsible for the filer's errors. NSBA strongly urges lawmakers to consider the unintended consequences on small business--and thus economic growth--in enacting proposals to close the tax gap regardless of how meager the returns might be.

Tax Reform

NSBA firmly believes that the complexity of our existing tax system is a significant reason for the tax gap. Perplexed, bothered and bewildered American taxpayers spent \$265 billion in 2007 alone just trying to comply with the tax laws and regulations. Yet, even with this vast expenditure of money, no one—including small-business owners—is sure they successfully complied with the law. In fact, the Treasury's own Inspector General for Tax Administration found an 84-percent error rate in spot audit visits to 26 different IRS Assistance Centers across the country in 2004.

Reforms can include consolidating the number of tax breaks in the code, rationalizing and harmonizing definitions, and in general reducing the number of forms taxpayers are required to fill out each year. These changes could easily reduce the non-compliance rate and potentially raise tax revenues without an increase in tax rates.

Tax code complexity is a significant challenge to improvements to voluntary compliance and reduction in the tax gap. Simplification of the tax code is long overdue and NSBA believes is critical to the continuing viability of our voluntary compliance system.

Congress should stop trying to impose more burdens on taxpayers and replace the current tax code altogether with something that makes more economic sense, such as the Fair Tax.

Fair Tax

In response to overwhelming sentiment calling for a simpler, more fair and efficient, and less intrusive system of taxation, NSBA became the first small-business group to endorse the Fair Tax. Legislation has been introduced in both the House and Senate, the *Fair Tax Act of 2009 (H.R. 25/S. 296)* which NSBA proudly supports.

H.R. 25/S.296 will repeal all corporate and individual income taxes, payroll taxes, self-employment taxes, capital gains taxes, estate taxes and gift taxes—and replace it with a revenue-neutral personal consumption tax. A 23 percent, single rate, national retail sales tax, the Fair Tax will be applied to the sale of all consumer goods and services at the final point of consumption. This way, every taxpayer will be subject to the same tax rate with no exceptions and no exclusions. Those who are least able to share in the cost of government will bear no burden at all. Business-to-business purchases for the production of goods and services will not be taxed. Small-business owners see the Fair Tax as a reasonable, efficient, and intelligent solution to the frustration and inequity they face with our current tax system.

The Fair Tax allows Americans to keep 100 percent of their paycheck, pension, and Social Security payments, thus enabling them to save more, invest in their businesses, and boost our economy through job creation and innovation.

Self-Employment Tax on Health Care

One such simplification that can readily be accomplished will immediately reduce the cost of health insurance for self-employed individuals. Currently, all workers at a large C corporation, from the mail room to the board room, can exclude employer provided health insurance from their taxable income.

However, small-business owners are excluded from those tax savings granted to the CEOs of Fortune 500 companies. This is the reality of our current tax code, which excludes self-employed individuals from deducting the cost of their health insurance for self-employment tax purposes. This inequity in the tax code means that the self-employed pay a 15.3 percent additional tax on their health insurance premiums that no one else has to pay.

As the law stands now, self-employed individuals still pay for their health insurance with money that has been subject to the self-employment tax. All employed individuals pay the FICA tax on their income, of which 6.2 percent is allotted for Social Security and 1.45 percent goes to Medicare. Employers are

required to match employee contributions with a 7.65 percent contribution of their own.

Self-employed individuals are required to pay both sides of this tax resulting in a total 15.3 percent tax on income, commonly referred to as the “self-employment tax.” Contrary to rules for C Corporations, a provision of the Internal Revenue Code requires self-employed individuals to pay the additional 15.3 percent self-employment tax on the cost of their health insurance premiums. No other worker is required to pay FICA taxes on any portion of their employer-sponsored health benefits. With health insurance costs already sky-high, our members find it unbelievable that the federal government would slap an extra tax on those who have the hardest time securing coverage in the first place.

The issue of full deductibility for the self-employed goes far beyond the simple inequity of the matter, there is a very real economic impact as well. A report released by the SBA’s Office of Advocacy titled, *Health Insurance Deductibility and Entrepreneurial Survival*, shows that, “the health insurance deduction for the self-employed has decreased the likelihood of entrepreneurial exit by 10.8 percent for single filers and 64.9 percent for married filers.” While these numbers are staggering at first glance; if you think about the issue from a personal point of view, the impact of deductibility in entrepreneurial growth seems like common sense. When a family’s principle earner makes the decision to leave the predictable and structured world of a large employer and strike out on their own, availability of health insurance is a major issue. It stands to reason that the positive results from income tax deductibility for health insurance discovered by the SBA Office of Advocacy report would grow if Congress allowed the self-employed full deductibility.

Fortunately, many Members of Congress agree that it is unfair and unwise to penalize the self-employed. Representatives Ron Kind, Wally Herger, Suzanne Kosmas and Dave Reichert stepped up to the plate and offered legislation to fix this inequity. *Equity for Our Nation's Self-Employed Act (H.R. 1470/S.725)*, would allow our nation’s roughly 21.3 million self-employed business owners to fully deduct the cost of their health insurance. Companion legislation has been introduced in the Senate by Sens. Jeff Bingaman and Orrin Hatch.

NSBA wholeheartedly believes allowing self-employed business owners to fully deduct the cost of health insurance is an important part of the health care debate that will bring immediate relief and equity.

Tax Bracket Restructuring

Another burdensome proposal included in the administration’s FY 2010 budget is the call to restructure the upper income tax brackets. The income of most small businesses is taxed at the individual level. The administration’s proposal would raise the top two tax rates from 33 percent and 35 percent to 36 percent and 39.6 percent, while at the same

time raising the threshold for entry into the new 36 percent bracket. Entry into the 36 percent bracket would start at \$231,300—up from \$208,850 for couples, and at \$190,650—up from \$171,550 for individuals.

This is bad news for small-business owners who report more than \$190,000 in income as individuals or more than \$230,000 as joint filers. NSBA members also argue that this income tax increase comes with a host of other burdens. Under the administration's plan, those affected by the higher rates would not receive the full value of their itemized deductions, will see their capital gains and dividends taxed at a 20 percent rate instead of 15 percent, and may be forced to pay the alternative minimum tax.

While NSBA analysis based on the 2008 Survey of Small and Mid Sized Business shows that likely less than 13 percent of small businesses would be impacted, it is important to remember that those small businesses above that threshold are likely those creating the largest share of new jobs. According to well-known small-business researcher David Birch, the fastest growing companies—so-called “gazelles”—represent no more than 3 percent of U.S. companies, yet created 5 million jobs between 1990 and 1994. Gazelles have at least 20 percent sales growth every year for four years, starting with base revenue of at least \$100,000. Many of these gazelles would likely be over the profit threshold in Obama's proposal, and could face higher taxes which would certainly impact their ability to create jobs and grow the U.S. economy.

Additionally, higher tax rates on the country's most successful small-business owners will discourage them from building cash reserves and reinvesting in their companies. A large number of business owners who have reported income that is very high typically reinvest a large chunk of it. This proposal takes away their incentive to take risks and grow their company—harming the very people who create jobs in this country.

This proposal also represents yet another complicated tax law change that small businesses would be forced to keep track of, adding to the growing complexity of the tax code. Instead, Congress should be examining ways to reform our tax system, making it more efficient and equitable.

Improved Services

Although the IRS has made strides in improving customer service, there needs to be a concerted effort to improve compliance assistance rather than enforcement. Additional improvements to customer service should facilitate tax paying while ensuring that unintentional errors are minimized and not penalized. Addressing the tax gap must entail balancing the desire to collect taxes that are owed with the importance of minimizing intrusive and complicated reporting requirements and additional audits of small businesses.

Accurate tax reporting and compliance is extremely important to small business. Those who make a good faith effort, yet are inaccurately complying should be assisted through education and tax simplification efforts. Vague rules and poorly defined regulations

understandably result in mistakes. In order for taxpayers to comply more easily with the tax laws, taxpayer services should include providing timely guidance on issues, promoting electronic filing of tax returns, explaining IRS notices and correspondence, and helping taxpayers with problems.

NSBA does not condone tax cheats—those willfully disregarding their tax liability should be held accountable. However, the more assistance offered to taxpayers and the simpler it is to understand and comply with tax laws, the more taxpayers will accurately meet their tax obligations. Increased enforcement at the expense of taxpayer education will not accomplish sustained, improved compliance. With the high level of tax complexity facing many taxpayers, NSBA believes a key priority should be the development and implementation of initiatives to improve IRS guidance.

NSBA believes that the IRS should conduct more research to better identify noncompliant taxpayers, enhance taxpayer services to inform taxpayers of correct tax obligations and adjust its enforcement tools to target those who intentionally evade paying taxes. Adding new burdens and requirements on small businesses already struggling to do the right thing is simply the wrong answer.

Conclusion

NSBA supports proposals that are fair and reasonable to address issues such as the tax gap and to increase tax compliance, and endorses the development of a comprehensive tax reform strategy that does not target the same source of non-compliance through multiple legislative or regulatory efforts. This will minimize expense on taxpayers or compliant businesses while maximizing the return to the government.

The vast majority of small-business taxpayers want to comply with existing tax laws, thus tax simplification and taxpayer education and outreach is the most effective and equitable way to improve compliance. Congress needs to support proposals that are fair and reasonable, without hindering the survival, growth and innovation of our nation's entrepreneurs.

NSBA is a uniquely member-driven organization and we are fortunate to have a membership with wide variances in expertise. We serve not only as an advocate for our small-business members, but as a resource for you and welcome any opportunity to connect you with our members.

Small-business owners face many challenges that require strong advocates on Capitol Hill. NSBA is hopeful that you will take our recommendations into consideration as a way to ensure that entrepreneurs are afforded the appropriate environment and assistance to start, run and grow a small business.

Sincerely,

Todd McCracken
President