

Testimony of Thomas Pitrone,

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**On Behalf of
The National Small Business Association**

House Small Business Committee Hearing
“Assisting Small Businesses Through the Tax Code – Recent Gains and What Remains to
be Done”

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Introduction

I would like to thank Chairman Manzullo, Ranking Member Velazquez and the other members of the Small Business Committee for the opportunity to testify before you today. My name is Thomas C. Pitrone and I am a principal of the Integrity Group, a financial planning practice I started with my father, Frank P. Pitrone. Since we started our business in 1983, we have worked to guide individuals through the complexities of the tax code while finding the most intelligent ways for our clients to plan for their future. Overall, I have been active in estate, succession and investment planning for small businesses for over twenty years.

I also come before the committee today as a representative of the National Small Business Association (NSBA). The National Small Business Association, formerly National Small Business United, is the nation's oldest bipartisan advocate for small business. NSBA represents over 65,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations across the country. The goal of our association is to protect and promote our members and all of our nation's small businesses before Congress and the Administration. We, at the NSBA, work toward this goal by working with Congress, the media, our direct members, affiliates and a national audience as a small-business advocacy organization.

Background

I have been a member of the National Small Business Association for 15 years and now chair our Tax Committee. For many years, NSBA cataloged small business owner's criticisms of the tax code. An overarching feature of the varied complaints was that the tax code frequently discriminated against small businesses. Without fully knowing what we would discover, NSBA commissioned the Prosperity Institute to conduct an exhaustive review of the U.S. tax code and document which provisions directly put small firms, and their owners, at a disadvantage.

As we released the report, titled *The Internal Revenue Code: Unequal Treatment Between Large and Small Firms*, during Small Business Week in 2002 even we were amazed by the wide-ranging disincentives for our nation's small business owners built into the tax code. While most of the offending regulations appear to unintentionally harm small business owners, some are blatantly discriminatory. All should be fixed.

Since the report was so wide-ranging, NSBA's members voted on three top priorities to focus on in the 108th Congress. We are encouraged by the progress we have made thus far on the issues that I will now summarize.

Pension Reform

Small-business success requires owners reinvest compensation derived from their trade back into the business. This is especially of concern when entrepreneurs begin to survey retirement plans for their families and their employees. In the past 20 years, Congress has amended and revised the tax laws governing pension plans about every ten months, adding new layers of complexity with every change. Starting with the Employee Retirement Income Security Act (ERISA), created in 1974, these changes have contributed significantly to a steep decline in small-business pension plans. The 2003 Employee Benefit Research Institute's *Small Employer Retirement Survey* highlighted small employers' failure to participate in pension plans stating that, "(J)ust 34% of full-time workers in small private establishments (99 or fewer workers) were covered by a retirement plan." Two provisions embedded in the tax code are important factors in this disturbing trend.

First, nondiscrimination rules, key-employee clauses and plan administration costs drive many small business owners away from popular defined contribution pension plans. Owners that do begin traditional 401(k) or other plans for their employees must deal with administrative burdens and fees designed with large corporations in mind. The cost of administering even a simple profit-sharing plan is around \$1,500. A larger company easily absorbs this cost. However, it is often an overwhelming burden for a small

business. Strict nondiscrimination rules also disproportionately affect the smallest firms who lack the diverse employee pool characteristic of large firms.

Congress, in effect, has acknowledged that the regulatory environment surrounding popular pension plans is too onerous for small businesses by creating Savings Incentive Match Plans (SIMPLE). Created in the 104th Congress, SIMPLE plans allow small business owners and their employees access to tax benefits awarded to traditional qualified pension plans but with greatly reduced regulatory burden and cost. Unfortunately, this acknowledgement comes with a serious cost to participants. Current rules allow a traditional 401(k) participant to put away \$12,000 in tax-advantaged dollars for retirement while a SIMPLE 401(k) participant may only save \$8,000. It is stunning that Congress would penalize the small-business community's ability to save for retirement in the same legislation that acknowledges it is hard for them to do so.

It is important to note that President Bush has offered a genuine fix for the problems identified above in the Employer Retirement Savings Accounts (ERSA) proposed in January of this year. ERSAs would follow existing rules for 401(k) plans but with greatly simplified administrative burden, reduced testing requirements and no top-heavy rules. The President's actions show that the administration is clearly interested in helping to bring retirement security to those in our nation now most likely not to have it.

Section 125 "Cafeteria Plans"

Current law prohibits most entrepreneurs from taking advantage of benefits widely available to employees in the form of "Cafeteria Plans" or education assistance programs. Small business owners who are self-employed, partners in a partnership, Limited Liability Corporation members and more than two percent shareholders in an S Corporation are specifically banned from participation in these plans because they are not employees as required by Internal Revenue Code section 125(d). Cafeteria plans and their like can be used by participants to save in tax-advantaged accounts for health care, childcare, eldercare and education costs. Non-discrimination rules also bedevil those

small business owners who could participate if organized as a C Corporation but who are too small to satisfy non-discrimination testing.

NSBA believes that excluding small business owners from “Cafeteria Plan” benefits is both unfair to entrepreneurs and detrimental to plan adoption. An individual should not be deprived of widely available savings on health care and education costs because they took a risk and started their own business. This inequity is a clear example of a tax provision that penalizes entrepreneurship.

Self-employment Tax on Healthcare

As many members of this committee are very aware, we have recently crossed the finish line in a small-business victory that was a long time coming. Just this year, small business owners will be able to deduct the cost of their health care against their income taxes. A genuine thank you to all who helped fix this glaring error.

Many of you are also aware that our job is not finished. As the law stands now, self-employed individuals still pay for their health care 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% is allotted for Social Security and 1.45% goes to Medicare. Employers are required to match employee contributions with a 7.65% contribution of their own. Self-employed individuals are required to pay both sides of this tax resulting in a total 15.3% 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% self-employment tax on the cost of their health care premiums. No other worker is required to pay FICA taxes on any portion of their employer-sponsored health benefits. With health care 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.

Chairman Manzullo and Ranking Member Velazquez are to be commended for recognizing this inequity and introducing H.R. 1873, the Self-employed Health Care

Affordability Act. Their bill, supported by many members of this committee, can immediately reduce the cost of health care for our nations self-employed by a substantial amount.

Conclusion

The three issues outlined above illustrate clear examples where individuals who decide to enter into business for themselves are penalized. As most any business owner will tell you, it takes a lot of courage to strike out on your own. Being unfairly discriminated against in the tax code does not have the effect of encouraging the American Dream.

I have to assume that Congress is not intentionally trying to disadvantage entrepreneurs' nest eggs, make it harder for them to pay for their loved ones elder care or pay for their own family's health care. I assume this because I always hear in speeches that small-business is the backbone of the economy. We hear that small businesses will pull us from recession, create new jobs and drive innovation. If all of this is true, then I hope we can continue to work together to fix the problems identified today.

We are making good progress thus far with the help of members on this committee through H.R. 1873 and the White House's desire to simplify and expand pension plan adoption. On behalf of NSBA, we look forward to continuing working with you to achieve equity in our nation's tax code.