July 31, 2013

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Baucus and Ranking Member Hatch:

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 American small-business community is a large and diverse group of entrepreneurs and create the majority of new jobs—small firms accounted for 64 percent or 9.8 million of the 15 million net new jobs created between 1993 and 2011. Small business innovation and growth is the foundation of a dynamic, prosperous and growing society.

According to NSBA's Economic Reports, reducing the tax burden is among small businesses top issues for Congress and the administration to address. Although the actual out-of-pocket cost is a huge issue, the sheer complexity of the tax code, along with the mountains of paperwork it necessitates, is actually a more significant problem for America's small businesses.

NSBA strongly believes that the present tax system is irretrievably broken and constitutes a major impediment to the economic health and international competitiveness of American businesses of all sizes. To promote economic growth, job creation, capital formation, and international competitiveness, fundamental tax reform is required.

We commend your efforts to reform the tax system in order to reduce its complexity and compliance costs and to promote economic growth and prosperity. I am writing to provide the small business community's perspective on tax reform.

An outline of our discussion is below and the body of the discussion follows.

Potential Gains from Tax Reform

The potential gains from undertaking tax reform are very large. Any tax reform that reduces marginal tax rates and administrative complexity without increasing the tax bias against savings and investment will promote economic growth. However, moving toward a simple broad-based consumption tax with a single low rate, such as the FairTax, would have a dramatically positive impact on the economy.

True tax reform will:

- Improve the incentives to work, save and invest and therefore increase economic growth, employment, productivity, real wages, incomes and consumption;
- Increase federal revenues because a higher level of economic activity increases the taxable base;
- Reduce federal spending because a higher level of economic activity, higher employment, higher real wages and higher incomes will reduce the burden on safety net programs;
- Reduce the compliance costs incurred by employers and free those resources for productivity enhancing investments or productive, welfare-enhancing employment;
- Improve the competitiveness of U.S. based businesses by reducing the tax and compliance burden on U.S. businesses and, if a destination principal system is adopted, place the same tax burden on foreign producers and U.S. producers rather than placing U.S. producers at a competitive disadvantage as the current tax system does.

Tax Reform is Pro-Growth and Will Increase Revenues and Reduce Spending

Moving towards a simple broad-based consumption tax with a single low rate, such as the FairTax, will have a pronounced positive impact on the economy. Estimates, of course, vary. But fundamental tax reform holds the prospect of increasing the overall economy over the baseline by something approaching 10 to 20 percent of GDP within 5 to 10 years.[1] More modest reform will have more modest positive effects.

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[1] David G. Tuerck, Jonathan Haughton, Keshab Bhattarai, Phuong Viet Ngo, Alfonso Sanchez-Penalver, "The Economic Effects of the FairTax: Results from the Beacon Hill Institute CGE Model, The Beacon Hill Institute at Suffolk University, February 2007; Kotlikoff, Laurence J. and Sabine Jokisch, "Simulating the Dynamic Macroeconomic and Microeconomic Effects of the FairTax," National Bureau of Economic Research, Working Paper No. 11858, December, 2005; Arduin, Laffer & Moore Econometics, "A Macroeconomic Analysis of the FairTax Proposal, Americans For Fair Taxation Research Monograph, December, 2005; Dale W. Jorgenson and P. J. Wilcoxen "The Long-Run Dynamics of Fundamental Tax Reform," American Economic Review , Vol. 87, No. 2, May 1997, pp. 126-132; Dale W. Jorgenson, "The Economic Impact of Taxing Consumption," in Committee on Ways and Means, United States House of Representatives, Replacing the Federal Income Tax , Vol. II, One Hundred Fourth Congress, Second Session, 1996, pp. 105-113; reprinted in Joint Economic Committee, Congress of the United States, Roundtable Discussion on Tax Reform and Economic Growth , One Hundred Fourth Congress, First Session, 1996, pp. 79-97; Jorgenson, Dale W., "The Economic Impact of the National Retail Sales Tax," November, 1996. Also see, Bachman, Paul, Jonathan Haughton, Laurence J. Kotlikoff, Alfonso Sanchez-Penalver, and David G. Tuerck.

The positive economic impact of marginal tax rate reductions is large. Conversely, the negative economic impact of marginal tax rate increases is large. This is because the economic loss (i.e. the excess burden or deadweight loss) associated with a tax rate increase with the *square* of the tax rate increase.[2] Thus, doubling the tax rate will result in a four-fold increase in the adverse economic effect of the tax system. However, this effect is equally true in reverse. Lowering marginal tax rates has a disproportionately positive impact on the economy.

Tax Reform Will Reduce Wasteful Compliance Costs

Compliance costs are the costs incurred by taxpayers complying with the tax system. The compliance costs incurred by businesses are estimated to be about $95 billion annually but may be as much as 50 percent higher.[3] Individual and not-for-profit compliance costs are, of course, quite substantial as well. In the case of small businesses these costs include the time of small business owners and their accounting staff devoted to collecting necessary information and filling out Internal Revenue Service forms and the costs incurred hiring outside accountants and lawyers for advice about how to comply with the tax law. Small business compliance costs relative to income, revenues or per employee are disproportionately high. A recent Small Business Administration (SBA) study quantifies this disproportionate impact, showing that the impact on small firms in terms of per employee costs is three times that of larger firms (see following table).[4]

"Taxing Sales Under the Fair Tax: What Rate Works?" NBER Working Paper No. 12732. Cambridge, MA: National Bureau of Economic Research, 2006; Kotlikoff, Laurence J., and David Rapson. "Would the FairTax Raise or Lower Marginal and Average Taxes?" NBER Working Paper No. 11831. Cambridge, MA: National Bureau of Economic Research, 2005; Marco Fantini, "Macroeconomic Effects of a Shift from Direct to Indirect Taxation: A Simulation For 15 EU Member States, presented at the 72nd meeting of the OECD Working Party No. 2 on Tax Policy Analysis and Tax Statistics, Paris, 14-16 November 2006. See also, Joint Committee on Taxation, "Tax Modeling Project and 1997 Tax Symposium Papers," JCS-21-97, November 20, 1997. Symposium participants: Alan J. Auerbach, Charles L. Ballard, Michael J. Boskin, Roger E. Brinner, Eric Engen, William Gale, Jane G. Gravelle, Dale W. Jorgenson, Laurence J. Kotlikoff, Joel L. Prakken, David Reifschneider, Robert D. Reischauer, Aldona Robbins, Gary Robbins, Diane Lim Rogers, Harvey S. Rosen, Joel Slemrod, Kent Smetters, Jan Walliser, Peter J. Wilcoxen, John G. Wilkins.

[2] Alan Auerbach, "The Theory of Excess Burden and Optimal Taxation," in the Handbook of Public Economics, Alan Auerbach and Martin Feldstein, Editors, 1985; Harry Watson, "Excess Burden," Encyclopedia of Taxation and Tax Policy, Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, Editors, 2005; John Creedy, "The Excess Burden of Taxation and Why It (Approximately) Quadruples When the Tax Rate Doubles," New Zealand Treasury Working Paper 3/29, December 2003.

[3] Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, September, 2010, p. 29. See also, United States Government Accountability Office, "Summary of Estimates of the Costs of the Federal Tax System," August 2005, GAO-05-878 (business compliance costs are $40 to $85 billion annually); J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation Special Report No. 138, December 2005 (business compliance costs are $148 billion annually).

[4] Nicole V. Crain and W. Mark Crain, "The Impact of Regulatory Costs on Small Firms," U.S. Small Business Administration, Office of Advocacy, September, 2010, Table I, p. 7.

Tax Compliance Cost per Employee by Firm Size

	All Firms	Firms with <20 Employees	Firms with 20-499 Employees	Firms with 500+ Employees
Tax Compliance Cost per Employee	$800	$1,584	$760	$517

There will always be some compliance costs in any tax system. But today these costs are very high and if there is one thing the NSBA membership is almost universally agreed on, it is that the current compliance costs are too high and that the tax system needs to be simplified.

Results from the NSBA 2013 Taxation Survey indicate that the majority (55 percent) cited administrative burdens, while 45 percent highlighted financial burdens as the most significant challenges to their business posed by federal taxes. In 2013, 38 percent of small businesses reported they spend more than 80 hours per year dealing with federal taxes—that's two full work weeks—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, nearly half of small businesses spend $5,000 or more annually on the administration (i.e.: accountant fees) of federal taxes alone. This is before they even pay their actual taxes!

The time and money spent, coupled with the fact that 84 percent of small-business owners must pay an external tax practitioner or accountant to handle their taxes ought to be a clear signal that the tax code is far too complex.

We should aim to raise the revenue needed by the federal government in the least costly way. The costs of the current system represent a huge waste of resources that could be better spent growing businesses, creating new products, conducting research and development, or purchasing productivity enhancing equipment. Moreover, a simpler tax code is likely to increase voluntary compliance and reduce the tax gap.

These costs also represent a significant drag on the economic growth, on job creation and on the international competitiveness of U.S. businesses. Compliance costs must be recovered by businesses in the sales price of their goods or services. Otherwise, the businesses will fail. Reducing these costs is within our control and it should be a priority of Congress. Furthermore, there is strong reason to believe that U.S. costs are substantially higher than those of most other developed nations.

Competing with imports has become very difficult since foreign firms have a lower tax burden, lower tax compliance costs and, often, fewer other regulatory burdens that do businesses in the US. As a result, US businesses both exports less and sell less in the US than would otherwise be the case due to higher prices US firms must charge to recover these costs.

Tax Reform should Place Foreign and Domestic Manufacturers on an Even Footing and Remove Impediments to Exporting

An origin principle tax system taxes goods and services based on where they were produced or originated rather than where they were purchased or consumed. In an origin principle tax system, the production of goods and services in the taxing country is taxed no matter where the goods and services are sold, used or consumed. In a destination principle consumption tax, goods consumed in the taxing country are taxed whether the goods or services were produced domestically or abroad. Exported goods are not taxed.

The individual and corporate income tax and payroll tax raise well over 90 percent of the revenue collected by the federal government. These taxes are origin principle taxes. Most consumption taxes (including sales taxes[5], European style credit-invoice type value added taxes, Canadian and Australian goods and services taxes[6] and proposed business transfer taxes[7]) are destination principle taxes. The Flat Tax[8] and various proposed consumed income taxes[9] are, however, origin principle systems.

It is a common fallacy that having a destination principle tax like a VAT or a GST helps domestic exporters and hurts foreigners importing goods into the taxing country. This is not the case because both domestic and foreign goods are subject to the same tax when consumed domestically. This is why VATs and GSTs are legal under World Trade Organization rules.

What will help U.S. producers and impose a greater effective tax burden on foreigners importing goods into the U.S. would be to replace the current origin principle taxes with a destination principle consumption tax. There are two reasons for this: first, exports will no longer bear a U.S. tax burden and imports, for the first time, will bear the same tax burden as U.S. goods. Second, as discussed below, a consumption tax reduces the U.S. user cost of capital and will increase the U.S. capital stock and hence the productivity of U.S. businesses.

The current tax system taxes U.S. producers whether they are selling in U.S. or foreign markets and imposes no appreciable tax on foreign producers selling goods into the U.S. market. It, therefore, places U.S. producers at a considerable disadvantage.[10] If the U.S. were to replace the

[5] Including U.S. state sales taxes and proposed national sales tax such as the FairTax.
[6] GST is essentially just another name for credit-invoice type VAT.
[7] These are subtraction method value added taxes.
[8] By "Flat Tax," I am referring to the plan proposed by the economists Robert Hall and Alvin Rabushka and later introduced by Rep. Armey and others.
[9] A consumed income tax is sometimes called an expenditure tax (Kaldor), cash flow tax (Aaron-Galper) or inflow-outflow tax (Ture) depending on the author or analyst. The only significant difference among the various proposals is the inclusion (or not) of the proceeds from debt in the tax base and the deduction from the tax base of principal payments.
[10] There is an argument sometimes made that exchange rates will adjust to compensate for this effect. It is beyond the scope of this letter to address that subject. Suffice it to say that the tax system alters costs, relative prices and rates of return and therefore alters behavior in this case just as in other better understood cases.

current tax system with a destination principle consumption tax (such as the FairTax) then, for the first time in nearly a century, the U.S. government through its tax system would no longer be according a major advantage to those who produce goods abroad over those that produce goods in the U.S.

What Tax Reform Is and Is Not

Principles of Tax Reform

Tax reform is not a tax increase and tax reform is not just repealing deductions credits and exclusions. Meaningful tax reform is a coherent set of reforms designed to promote economic growth, reduce complexity, 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.

While we firmly believe the Fair Tax is the best path forward, NSBA understands the political landscape and the need to move forward on broad reform, even if such reform retains the basic framework of the current tax system. 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:

1. Designed to tax only once
2. Stable and predictable
3. Visible to the taxpayer
4. Simple in its administration and compliance
5. Promote economic growth and fairness between large & small businesses
6. Use commonly understood finance/accounting concepts
7. Grounded in reality-based revenue estimates
8. Fair in its treatment of all citizens
9. Transparent

All "Base-Broadeners" Are Not Created Equal

The majority of small businesses say that federal taxes and credits/deductions have a significant to moderate impact on their business decisions. However, many NSBA members have commented that the complexity, continually changing and temporary nature of many credits and deductions are diminishing their importance.

Some tax deductions, credits or exclusions do little to promote economic growth. They may have other policy objectives and may or may not achieve those objectives, but they do not materially affect the incentives to work, to save or to invest. Examples would include the child credit, the employer-provided health insurance exclusion and the personal and dependent exemptions.

Adequate capital cost recovery allowances, preferably expensing, are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace. It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If, of course, they fall far enough behind their domestic and foreign competitors, the firms will simply fail.

Tax Reform Does Not Mean Tax Increases

Tax changes that raise marginal tax rates or raise the cost of capital reduce the incentive to work, save and invest. They are the antithesis of tax reform. They will have an adverse rather than a positive economic impact and should be avoided. Marginal tax rate increases have well understood and well documented adverse economic effects. Tax increases that raise the cost of capital (including rate increases, reductions in section 179 allowances or capital cost recovery allowance or capital gains tax rate increases) will reduce investment, productivity, international competitiveness, growth and real wages.

The Strategic Risk to Small Business

The strategic risk to small businesses of tax reform as currently being discussed by some is that the business tax base will be broadened substantially and corporate tax rates reduced substantially while individual tax rates are reduced only slightly or not at all. This would result in a large tax increase on the majority of small businesses that are pass-through entities. This would be both bad economic policy and inequitable. Such a course needs to be avoided.

It can be avoided, as discussed below, by either reducing individual marginal tax rates across the board or by ensuring that pass-through entity income is not subject to higher marginal tax rates than C corporation income.

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.

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.[11] This salary is also subject to the individual tax rates as, of course, are any dividends paid by the corporation to its shareholders.[12] Thus, even for small C corporations, individual tax rates are key. Thus, 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. 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.

C Corporation Rate Reduction and Business Tax Base Broadening

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.

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, we have two primary concerns. First, 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. Second, as discussed above, we are deeply concerned that reducing corporate tax rates may be funded by economically counterproductive "base broadeners" that also apply to non-corporate businesses. It is highly unlikely that repeal of various provisions such as so-called "accelerated" capital cost recovery allowances, LIFO and other provisions would apply only to corporations. Therefore, "corporate" tax reform could easily end up substantially increasing the tax burden on unincorporated businesses and S corporations. It would increase the cost of capital to small firms. This would be both unfair and very counterproductive economically. It would be likely to eliminate the pro-growth and job creating aspects of C corporation tax reform.

On Oct. 27, 2011, the Joint Committee on Taxation (JCT) staff provided to Ways and Means Committee Ranking Member Sander Levin, a series of revenue estimates that are illustrative of this concern. Three fifths of the revenue from the proposed base broadeners comes from two

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[11] For data on the composition of small business entities, see, e.g., "Present Law and Background Relating to Selected Business Tax Issues," Joint Committee on Taxation, Part III, September 19, 2006, JCX-41-06.

[12] There are very few shareholders in small C corporations that are not either natural persons, pass-through entities or other C corporations that file a consolidated return.

provisions that are not tax expenditures properly understood and are not loopholes by any reasonable definition: (1) reasonable capital cost recovery allowances and (2) Last-In First-Out (LIFO) inventory accounting.[13] Returning to pre-1981 capital cost recovery allowances would dramatically increases the cost of capital, reduce investment and the capital stock, reduce productivity gains, reduce the international competitiveness of U.S. businesses and reduce real wages. Eliminating LIFO inventory accounting will mean that businesses have to pay tax on phantom inflation-induced gains.

It is not entirely clear how the committee intends to proceed. However, a corporate tax reform funded by returning to the dramatically inadequate capital cost recovery allowance of the 1970s and taxing phantom inflationary gains is likely to have an adverse rather than positive economic effect. Moreover, it would constitute an unacceptable shift of the tax burden from large businesses to small businesses. We caution the committee against proceeding down that road.

Having adequate capital in the U.S. is important to U.S. businesses. Small businesses, in particular, have difficulty obtaining adequate capital for their businesses. Eliminating barriers to the repatriation of capital to the U.S. will help small businesses in two ways. First, by increasing the amount of capital on deposit with U.S. financial institutions, it will improve the likelihood of U.S. small businesses obtaining capital and reduce the cost of obtaining capital.[14] Second, money invested in the U.S. instead of abroad will have positive effects because employment and investment would occur here. That, in turn, will increase small businesses opportunities.

There is reportedly at least $1.5 trillion “trapped” or “locked-in” off shore because repatriating those funds would trigger a large tax whereas keeping those funds invested abroad will not. It is time to bring these funds home.

The primary way to eliminate this “lock-in” effect is to eliminate deferral of tax on foreign source income allowed by the law relating to Controlled Foreign Corporations (CFCs).[15] This may be accomplished by a territorial system combined with a zero percent or very low tax on repatriated income. This is the approach employed in the Ways and Means discussion draft. A second approach, tried in 2004, is to apply a substantially lower tax rate on repatriations made during a specified window of time. A significant disadvantage of this approach is that it is a temporary solution.[16] A third approach is to eliminate deferral and in general tax foreign source income earned by U.S. businesses currently. Any of these approaches would eliminate the lock-in effect and increase repatriations. It is probable that the latter approach would harm U.S. businesses in other ways. For example, it is thought that U.S. owned subsidiaries are

[13] Most of the remaining revenue would come from repeal of the research and experimentation credit and the domestic production activities deduction.

[14] Financial intermediation will direct this capital far beyond just banks.

[15] Subchapter N, Part III, Subpart F of the Internal Revenue Code. In principle, the Passive Foreign Investment Company rules would need amended as well. These are much less important than the CFC rules.

[16] A permanently reduced rate on repatriations would reduce the lock-in effect to the extent the rate was reduced but would not accelerate the tax revenue gain as much as a short-term reduction to the extent firms believed the change was permanent.

disproportionately likely to buy from the U.S. Thus, by making U.S. owned foreign manufacturing subsidiaries less attractive, it may be that U.S. exports are harmed. The latter approach would also make it very unattractive to headquarter a business in the U.S. and make U.S. firms the likely targets of foreign takeovers. This third approach would also raise taxes on multinational business.

The key point is that the repatriation of foreign profits to the U.S. should not be subject to a major tax burden. However, if a territorial system is adopted, robust intercompany pricing, interest allocation and intangible income rules are vital if corporate taxes are not to become entirely optional for multinational corporations.

An entirely different means of solving the problem is to move to a destination principle consumption tax such as the FairTax. Under the FairTax, repatriation of foreign source income would not be a taxable event. Neither foreign source nor U.S. source income would be taxed. Instead, domestic consumption would be taxed.

Fundamental Tax Reform: The FairTax

There are many ways to improve the tax system. NSBA regards the FairTax (*S. 122* with 8 sponsors, *H.R. 25* with 71 sponsors) as the best fundamental tax reform proposal. It would have a dramatic positive impact on economic growth, job creation, real wages, investment and international competitiveness. Small businesses would thrive and here are the reasons why:

1. The FairTax would be simple and dramatically reduce compliance costs have a disproportionate negative impact on small firms. The resources currently used to comply with the present tax system can be better used growing businesses, creating new products, conducting research and development, purchasing productivity enhancing equipment or reducing prices to customers.
2. The FairTax would be neutral toward savings and investment and reduce the user cost of capital substantially. The capital stock would therefore grow. Productivity, innovation and real wages would increase.
3. The FairTax has much lower marginal tax rates than the current tax system and has virtually the lowest possible marginal tax rate consistent with a neutral tax treatment of savings and investment.[17] It would dramatically reduce the tax disincentive to work, save and invest. The double taxation of corporate income (i.e. dividends and individual capital gains that are a function of retained corporate earnings) would be eliminated.
4. Entrepreneurial risk-taking and innovation would increase because more investment capital would be available and the tax on capital gains would be zero.
5. The U.S. would attract capital from around the world. Investment in the U.S. whether by Americans or foreigners would not be taxed. The U.S. would, in effect, become the

[17] The only reason it does not have the lowest possible rate theoretically possible is the rebate that prevents the poor from paying any federal income or payroll tax and reduces middle class effective tax rates substantially.

largest tax haven in the world. Having adequate capital is important for all businesses but particularly important for small and start-up businesses.

6. For the first time, the tax system would impose the same tax burden on foreign produced goods and U.S. produced goods. The FairTax would eliminate the current origin principle system that places U.S. based firms at such a large disadvantage. This is because the FairTax is a destination principle tax (i.e. it is, in effect, border adjusted).

Discussion of Specific Tax Provisions

We understand that in the current political context, the committee is unlikely to pursue fundamental tax reform like the FairTax. Substantial reform of the current tax system, however, could have a very important positive impact on the economy and on small businesses. The remainder of this letter addresses reform of the current system.

Reducing Marginal Tax Rates on Business Income

Reducing the marginal tax rates applicable to small business income is among the most important constructive steps that the committee could take. This could be accomplished by reducing individual tax rates across the board or by taxing pass-through entity income at lower rates. Taxing pass-through entities at lower marginal tax rates would entail taxing income reported on Form 1040 Schedules C, E and F at lower marginal rates (relating to sole proprietorships, S corporations and partnerships, and farming income, respectively).

Section 179 Expensing

Section 179 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. 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, section 179 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. For 2013, up to $500,000 of investment purchases may be deducted.[18] However, in 2014, the figure falls to an unacceptably low $25,000. This latter limitation dramatically limits the number of firms that can appreciably benefit and dramatically reduces the economic effect of the provision. We would urge you to retain the threshold at its present $500,000 level.

[18] The section 179 deduction is not available to firms investing $2.5 million or more.

Capital Cost Recovery

Adequate capital cost recovery allowances are critical to maintaining a reasonable cost of capital and to firms of all sizes being able to afford the capital investment necessary to compete in the international marketplace.[19] It is hard to overstate this point. Capital formation is critical to maintaining long-term competitiveness and preserving relatively high U.S. wage rates. Unless U.S. firms invest in productivity-enhancing or innovative cutting-edge equipment that provides new capabilities, U.S. firms will only be able to compete by accepting lower returns and by paying workers less. If returns to investing in the U.S. fall substantially, firms will relocate their operations overseas. If, of course, they fall far enough behind, the firms will simply fail.

Current capital cost recovery allowances are not tax expenditure, properly understood. Expenditures on machinery and equipment are businesses expenses that should be deductible when made and must be recovered in full if a profit is to be made.

Health Insurance Tax

Starting in 2014, the *Patient Protection and Affordable Care Act* (PPACA) imposes an excise tax on health insurance premiums. The tax is an unusual tax in that it is not imposed at a specified rate but instead the rate is set annually to raise a specified amount of revenue. The tax is imposed on insurance companies and is not tax deductible. Insurance companies, in turn, will be required to raise premiums to recover the cost of the tax.

Health Insurance Tax Revenues

Yeas	Annual Amount Raised
2014	$8.0 billion
2015	$11.3 billion
2016	$11.3 billion
2017	$13.9 billion
2018	$14.3 billion
2019 and thereafter	Increases with premium growth

[19] Expensing is always the correct answer in a consumption tax where either (i) interest is neither taxable nor deductible or (ii) debt proceeds are includible in the taxable base and principle and interest are deductible. In a hybrid system, such as the current U.S. system, some limits on debt financed investment in expensed property may be appropriate. As a practical matter, this will only be important in the case of large enterprises with large borrowing capacity.

This tax is expected to raise health insurance premiums by two to three percent.[20] Since large corporations generally self-insure, this tax is aimed almost exclusively at small businesses and individual consumers.

Increasing the cost of health insurance plans for small-business owners and the self-employed makes offering affordable coverage, or any coverage at all, to employees more difficult. The JCT estimates that "eliminating [the HIT] fee could decrease the average family premium in 2016 by $350 to $400." The JCT also has noted multiple times in their analyses that the tax would be passed on to the purchaser of insurance in the form of higher premiums, further validating what the Congressional Budget Office (CBO), small-business owners and others have stated since passage of PPACA.

The *Jobs and Premium Protection Act* (*S. 603*) which has 25 sponsors would repeal the annual fee on health insurance providers enacted by PPACA. The House version is also titled the *Jobs and Premium Protection Act* (*H.R. 763*) and has 226 sponsors, a majority of the House.

Health Insurance Exclusion

The employer provided health insurance exclusion afforded by section 106 of the Internal Revenue Code is the source of many of the ills of our health care system. It encourages employer coverage of even minor health care costs and encourages coverage such that employees have no incentive to economize in their health care expenditures. Moreover, it removes consumers from the health care purchasing decision.

Because employers have every incentive to provide tax-free compensation in the form of health insurance coverage, they tend to provide policies that provide more health benefits than they would if the tax code was neutral between forms of compensation. Therefore, most health insurance policies are not only insurance (in the sense they insurance against large losses) but also, in effect, tax-free pre-paid health expenditure plans. This results in a system where consumers do not have any meaningful incentive to shop on the basis of price and therefore health care providers have no incentive to compete on the basis of price. This is one of the central reasons why our health care delivery system costs nearly twice as much as the OECD average.

The tax code should not encourage third-party payment of routine medical care or elective procedures and it should encourage health insurance that ensures that consumers incur marginal costs and therefore have a continuing incentive to care about the cost of the health care they consume. The current system with its flat co-pays, first dollar deductibles and little or no marginal co-pays encourages consumers and providers to care little about cost.

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[20] See, e.g., "Annual Tax on Insurers Allocated by State," Chris Carlson, Oliver Wyman, November, 2012. Former Congressional Budget Office (CBO) Director Douglas Holtz-Eakin estimates the average impact is as much as a three percent, equivalent to a roughly $5,000 increase in premiums for a family of four over ten years.

Making such changes to the employer-provided health care exclusion would not only reduce health care spending but also raise revenue that could be used to reduce tax rates.

LIFO Accounting

Eliminating LIFO inventory accounting will mean that businesses have to pay tax on phantom inflation-induced gains. Given the very large increase in the monetary base over the past few years, higher rates of inflation over the coming years is quite likely. Thus, repealing LIFO is likely to present a very substantial burden on small businesses that maintain significant inventories, most notably retailers and wholesaler-distributors.

Cash Method of Accounting

The ability to use the cash method of accounting is very important to small businesses, as it provides flexibility and simplicity. Cash accounting—widely seen as a more simple, straightforward method of accounting—is utilized by 42 percent of small businesses, according to the NSBA 2013 Taxation Survey and 51 percent report using cash accounting for purposes of filing their taxes. The Ways and Means Committee discussion draft would retain that option for all firms with less than $10 million in gross receipts. It would expand the availability of the cash method for C corporations under $10 million in gross receipts and limit the special rules in current law for larger farming and personal service corporations. This proposal deserves support because it establishes simpler and more uniform rules and preserves the cash method of accounting for small firms.

The Estate and Gift Tax

Ideally, the estate and gift tax should be fully repealed. Alternatively, Congress should enact legislation that contains an effective exemption, fully indexed for inflation, of $3.5 million per decedent, the lowest possible estate and gift tax rate, and a stepped-up basis. In addition, the annual per donee gift tax exclusion should be increased substantially from its current $14,000.

Self-employed Health Insurance Deductibility

Self-employed individuals (including partners and LLC members), unlike large corporations, cannot fully deduct the cost of their health insurance as a business expense. At issue is the 15.3 percent tax that self-employed individuals must pay on their employer-provided health insurance costs to which nobody else is subjected. The self-employment tax rate on net earnings is the sum of 12.4 percent for Social Security (old age, survivors, and disability insurance), and 2.9 percent for Medicare (hospital insurance).

While the important 2003 change enabled small-business owners to deduct the cost of health care from their income, that income already has been exposed to the payroll tax. Thus, the self-employed effectively pay the self-employment tax on income used to purchase health care.

The self-employed pay an average of $12,680 per year for health insurance. Because they cannot deduct this as an ordinary business expense, the 15.3 percent payroll tax they alone pay on their premiums amounts to $1,940 in extra taxes that only the self-employed pay. This is money that could be used to reinvest and grow the business, hire part-time help or cover the ever-increasing costs of health insurance. This additional 15.3 percent tax makes already disturbingly high-priced health care cost even more by adding thousands of dollars to the cost of an individual's health care. Any tax reform proposal should address this problem.

Guaranteed Payments

The repeal of the rules relating to guaranteed payments, as proposed in the Ways and Means Committee discussion draft, is a material simplification in the law that would make it less likely that business owners will inadvertently run afoul of rules that are, in our judgment, of virtually no utility and very unclear. This provision deserves to be enacted.

S corporation simplification

The Ways and Means Committee discussion draft would extend the time for filing an S election to the due date (with extensions) for filing the corporation's tax return. This proposal is of tremendous importance to small start-ups that do not have teams of tax attorneys or CPAs at their disposal and are not well advised. These firms often do not consider taxes until they retain an accountant at year-end, only to find that the time for establishing an S election has lapsed. NSBA supports this proposal.

A few discrete, simple and understandable changes would eliminate many of the complexity and problems associated with S Corporations. In addition changing the inordinately short S corporation election period that can snare start-ups that wait too long to seek professional advice, eliminating three of the restrictions found in Internal Revenue Code §1361(b) would achieve flexibility nearly as broad as partnerships and eliminate most of the ways that firms inadvertently lose their S corporation status.

Eliminating the more than 100 shareholder limit (or raising it) will become increasingly important as alternative means of raising small amounts of capital from large numbers of people become common. For example, Title III of the JOBS Act required the Security and Exchange Commission (SEC) to issue regulations permitting crowdfunding by the end of 2012. While the SEC has not yet done so, they will presumably do so eventually. Improving small firms' access to capital is a major goal of the small-business community and NSBA strongly supported the JOBS Act. We are actively involved in promoting a reasonable and timely implementation by the SEC. Yet, the current S corporation restrictions relating to shareholder number will make it very difficult for S corporations to crowdfund, precluding a new and innovative way for them to raise needed capital.

Similarly, the non-resident alien shareholder restriction contained in Internal Revenue Code §1361(b)(1)(C) should be repealed. Instead, the partnership withholding rules (Internal Revenue

Code §1446) should be amended to apply to S corporations with non-resident alien shareholders. Were non-resident alien shareholders permitted, the withholding rules would need to be amended to mirror the partnership rules to ensure that income effectively connected to a U.S. trade or business bears appropriate tax. The restriction on non-resident alien shareholders can also trigger inadvertent loss of S corporation status when a resident alien shareholder leaves the U.S. and becomes a non-resident alien.

The one class of stock restriction is a function of concerns about allocation of basis and other tax attributes. It is, however, a very substantial restriction on the capital structure of small S corporations and impedes their ability to creatively raise capital like a C corporation or partnership (including LLCs). It is also an important way that small firms inadvertently lose their S corporation status, and should be repealed. Partnerships have dealt with these issues without material difficulty for a very long time. Typically, the partnership agreement governs the allocation of tax attributes but there are default rules that govern tax allocations in the absence of written partnership agreement provisions. Similarly, a revised S corporation statute, without the one class of stock restriction, could provide that an agreement between all stockholders would govern the allocation of tax attributes but that, in the absence of such an agreement, default rules promulgated by the IRS would govern.

Retirement Savings Plan Simplification

When a small business owner is considering his or her retirement needs and those of his employees he must consider simplified employee pensions (SEPs), salary reduction simplified employee pensions, SIMPLE IRA plans, SIMPLE 401(k) plans, regular 401(k)s, profit-sharing plans, money purchase pension plan, Keogh plans, defined benefit plans, defined contribution plans, and employee stock ownership plans. Most of those plans are qualified plans subject to the minimum coverage requirements, minimum vesting standards, the actual deferral percentage test, the non-discrimination requirements, and the top heavy plan requirements.

If your eyes have glazed over, you would not be alone. The problem is that if a small business owner fails to figure this entirely out and gets it wrong, then the entire plan may become subject to immediate taxation and penalty. Is it any wonder that many small businesses owners decide not to get involved in this morass?

The bottom line is that it should not be this difficult for a small business owner to provide for his or her retirement and that of the business' employees. This can be accomplished under current law by radically changing and simplifying the defined contribution plan rules. Most Americans should be permitted to place as much in a retirement plan (such as a 401(k) plan) as they can and should not be subject to arbitrary limits or caps.

Congress should prioritize dramatic simplification of the law in the area of retirement savings. Congress may want to consider merging simplified employee pensions (SEPs), salary reduction simplified employee pensions, SIMPLE IRA plans, SIMPLE 401(k) plans and Keogh plans into a unified small business defined contribution pension plan. Some ideas for how this might be done include a reasonably large deduction (for example, up to 25 percent of salary) and uniform simple, comprehensible non-discrimination rules. Moreover, employers should be permitted to elect to automatically enroll their employees (as under current law).

Congress needs to act to improve the retirement savings climate in the U.S. U.S. retirement savings are inadequate. The median IRA balance is $20,444.[21] The median 401(k) plan balance is $17,794.[22] Median household financial assets owned declined from $31,300 to $29,600 from 2007 to 2009.[23] The median equity in primary residences declined nearly 33 percent to $64,000.[24] These figures have undoubtedly improved somewhat due to the recent increase in housing and equity prices, but they are still woefully inadequate. These levels of savings are only enough to generate a few hundred dollars a month of annuity income. In other words, most Americans have entirely inadequate retirement savings.

Tax Return Due Date Simplification

In our judgment, all pass-through entities should be required to file by April 15 with a uniform automatic extension (preferably six months). This would be a simpler rule and allow taxpayers sufficient time to file their tax return. We would also support the same rule with respect to C corporations.

Conclusion

Complexity and inconsistency within the tax code pose a significant and increasing problem for small businesses. The ever-growing patchwork of credits, deductions, tax hikes and sunset dates is a roller coaster ride without the slightest indication of what's around the next corner. Without comprehensive tax reform, the investment and hiring decisions of businesses must be made in an uncertain and confusing business environment. This is unsustainable and unacceptable.

The U.S. Tax Code poses a significant disadvantage to America's small businesses, and it punishes work, investment, risk-taking and entrepreneurship. Tax reform offers the prospect of sustained economic growth and dramatically lower compliance costs. Tax reform needs to be done. 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 the committee to achieve these laudable goals.

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[21] Craig Copeland, "IRA Balances and Contributions: An Overview of the EBRI IRA Database," Employee Benefit Research Institute Issue Brief, September 2010, No. 346, p. 9.

[22] Jack VanDerhei , Sarah Holden and Luis Alonso, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009," Employee Benefit Research Institute Issue Brief, November 2010, No. 350, p. 10.

[23] Jesse Bricker, Brian Bucks, Arthur Kennickell, Traci Mach and Kevin Moore, "Surveying the Aftermath of the Storm: Changes in Family Finances from 2007 to 2009," Board of Governors of the Federal Reserve System, March 2011, p.27.

[24] Ibid., p. 27. Figures derived from primary residence assets and liabilities data.

Sincerely,

Todd McCracken
President

cc: Members of the Senate Finance Committee