Testimony of Tim Reynolds
President

Tribute, Inc.

On behalf of the National Small Business Association

House Committee on Small Business Hearing:

"The Biggest Tax Problems of Small Businesses"

April 9, 2014

Good afternoon. I would like to thank Chairman Graves, Ranking Member Velazquez and the members of the Small Business Committee for inviting me to testify today on the biggest tax problems facing America's small businesses.

I am Tim Reynolds, owner and President of Tribute Inc., a software company located in Hudson, Ohio. Our 38 employee company develops and markets software for industrial distributors. The company focuses primarily on distributors of hydraulic and pneumatic equipment, specialty and industrial hose and rubber, and gasket products. By way of example, many customers are Eaton or Parker Hannifin distributors. Tribute develops and markets two Enterprise Resource Planning (ERP) products: the Tribute Software System, a UNIX - based solution, and TrulinX, a Windows - based solution. Both provide a fully integrated business system supporting virtually all of the distributors' business system needs.

I am proud to be here representing not only my company, but also the National Small Business Association (NSBA)—the nation's first small-business advocacy organization. NSBA is a uniquely member-driven and staunchly nonpartisan organization—where I currently serve as First Vice Chair.

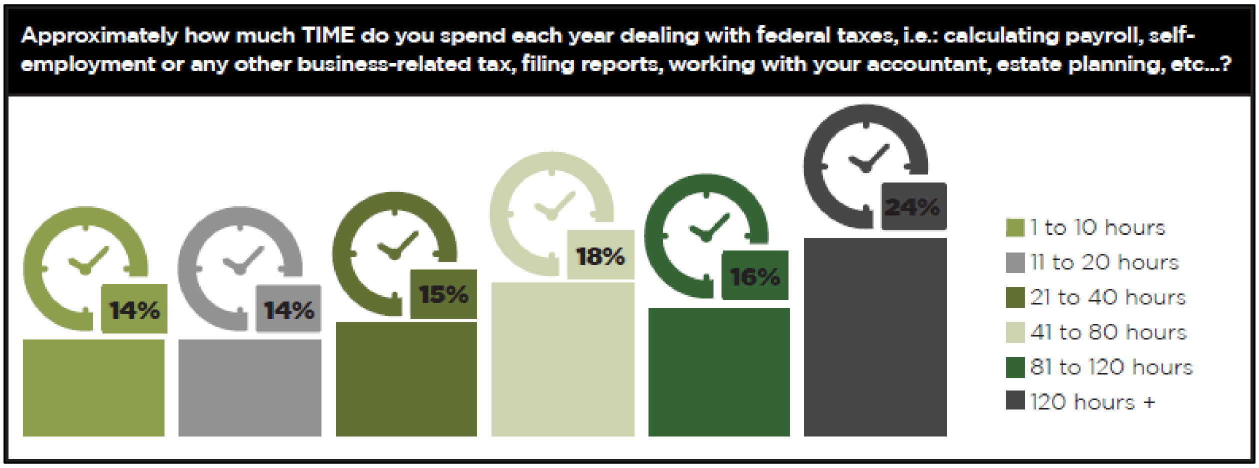
Recently, there have been ambitious policy efforts in Congress to replace the current U.S. Tax Code. I welcome the eagerness of many of your colleagues to fix America's broken tax system, but I also recognize there are significant challenges with enacting comprehensive tax reform legislation in the near future. Therefore, in the interim, simplification of the most complex provisions of the Code may help to significantly reduce the burden on individual taxpayers and small businesses.

While there are many obvious problems with the current tax system, there are two paramount issues that must be addressed. The first major problem with the system is the generally high marginal rates of taxation on income. The other, perhaps more significant dilemma is the almost impossible task of compliance with all the rules and regulations. It is time that Congress acts to reexamine the Tax Code and simplify or repeal some of its most complex provisions.

Compliance Costs

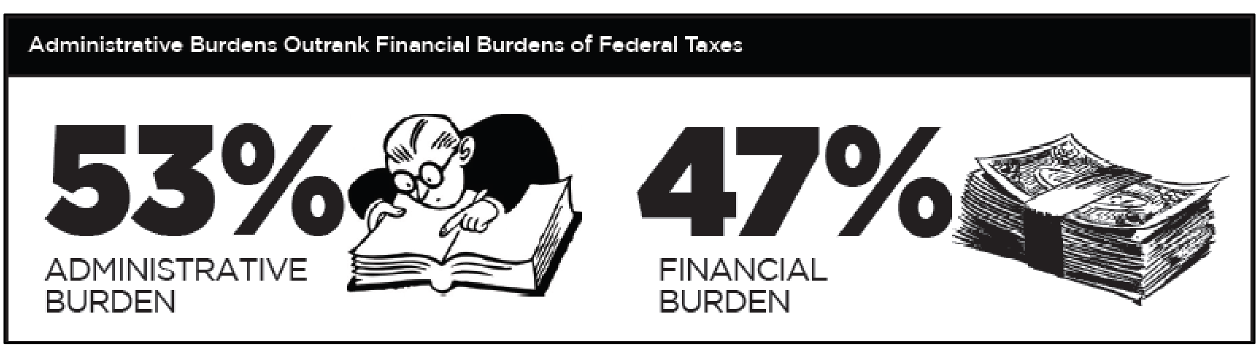
Although NSBA's members operate a wide variety of businesses, they all consistently rank reducing the tax burden among their top issues for Congress and the administration to address. The compliance burden on taxpayers, because of the complexity of our Code, is truly staggering. While the actual tax liabilities for small firms 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. We tend to be an easy target since, unlike big corporations which have large staffs of accountants, benefits coordinators, attorneys, personnel administrators, etc. at their disposal, small businesses often are at a loss to keep up with, implement, afford, or even understand the overwhelming regulatory and paperwork demands of the federal government and tax code.

According to the just released NSBA 2014 annual Taxation Survey, 40 percent of small businesses reported they spend more than 80 hours per year dealing with federal taxes—that's two full work weeks spent just on federal taxes. Nearly 60 percent of small firms spend more than 40 hours per year on federal taxes alone. Just imagine the collective business and job growth that could be done absent that burden.



Approximately 42 percent of NSBA members have fewer than five employees—few, if any of whom is a tax specialist—leaving business owners with no other choice but to hire outside help to keep track of all their additional reporting and filing requirements. In fact, according to the NSBA Small Business Taxation Survey, only 12 percent of small-business owners handle their taxes internally—meaning 86 percent are forced to pay an external accountant or practitioner—this data should send a strong message to the IRS and Congress that the tax code is far too complex.

Furthermore, when asked to rate the most significant challenge posed by the federal tax code to their business, the majority, 53 percent, picked administrative burdens while 47 percent highlighted financial burdens as the most significant challenges to their business posed by federal taxes. The time it takes is not the only administrative burden either, almost half report they spend more than $5,000 annually on the administration of federal taxes in the form of accountant fees, internal costs, legal fees and so on. This is before they even pay their actual taxes! In my company's case, the bill for preparing the company's taxes and my personal taxes as the owner of a Sub S corporation was $13,650.



According to a U.S. Small Business Administration (SBA), Office of Advocacy report entitled, "The Impact of Regulatory Costs on Small Firms," the compliance costs incurred by businesses are estimated to be about $95 billion annually but may be as much as 50 percent higher. 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 (IRS) 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 is disproportionately high. The SBA study quantifies this disproportionate impact, showing that the impact on small firms in terms of per employee costs are three times that of larger firms (see following table).

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.

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.

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.

Fair Tax

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 required.

To that end, NSBA was the first small-business organization in the country to support the Fair Tax (*H.R. 25*)—a national 23 percent tax on the end point-of-sale for all goods that would replace all current individual and corporate tax schemes. It would dramatically reduce the tax bias against work, savings and investment, and would substantially reduce complexity and compliance costs. Additionally, the Fair Tax would make the U.S. an extremely attractive location to manufacture goods and put U.S. produced products on even footing with foreign produced goods. The majority of small firms (53 percent) expressed support for the Fair Tax in NSBA's Small Business Taxation Survey.

Principles of Tax Reform

While we firmly believe the Fair Tax is the best path forward, NSBA understands the political landscape and need to move forward on broad reform, even if in a different iteration. 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

This kind of broad reform is what small firms want: according to NSBA's Small Business Taxation Survey, 67 percent expressed support broad reform of the tax system that reduces both corporate and individual tax rates, coupled with reducing both business and individual deductions.

All Tax Credits are Not Created Equal

According to NSBA's tax survey, 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 73 percent say federal taxes have a significant to moderate impact on the day-to-day operation of their business. However, many NSBA members have commented that the complexity, continually changing and temporary nature of many credits and deductions are diminishing their importance.

The discussion of tax policy must not occur in a vacuum. NSB A is firmly committed to seeing the deficit reduced, and as such, we believe it is important to promote those tax credits that stand to offer the most benefit to the most people, both directly and indirectly.

While there are a number of tax deductions, credits and exclusions that are very beneficial to small-business growth and overall economic stimulation, some 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. One in particular that, while good-intentioned, does not offer broad relief is the hiring tax credit whereby a firm would receive a credit for hiring a previously unemployed individual. Small firms are unlikely to hire a new person simply for that tax credit – those that are in a place to hire will likely do so regardless of a temporary, one-time credit, and they will look for the person best suited with the appropriate skills. Unfortunately, if that person isn't among the long-term unemployed, that will not likely be a factor in the employer's decision making process.

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.

Not only do these kind of investment-spurring tax credits and deductions help the qualifying firm, it helps promote economic growth by encouraging firms to make investments and purchase equipment from other firms. These tax provisions are the epitome of stimulatory.

Please indicate your level of support for each of the following tax reform proposals

	SUPPORT	DON'T SUPPORT	NOT SURE
Reduce both corporate and individual tax rates, and reduce both business and individual deductions	67%	19%	14%
A broad reform of the tax system in-line with the Fair Tax (elimination of all income and corporate tax rates as well as all deductions, and instead implement a 23 percent tax on the end point-of-sale for all goods)	53%	25%	22%
Reduce the corporate tax rate and eliminate some business deductions	47%	23%	29%
Moving the current U.S. tax system from a "worldwide" tax system, in which all income is taxed regardless of its origin, to a "territorial" system, in which all foreign-source income is exempted from tax	18%	50%	32%
A European type value added tax	11%	50%	39%

Taxation of Pass-through Entities

Most small businesses are sole proprietorships, subchapter S corporations—such as Tribute Inc.—or limited liability companies. Most of the remainder are partnerships (either limited or general). There also are some business trusts. All of these businesses (83 percent, according to 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 corporate tax rates. It is no surprise then, that income taxes were ranked the most burdensome administratively, while payroll taxes were ranked the most burdensome financially, by small firms.

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.

Broad reform of the entire tax code is necessary, not just for corporate entities. Allowing the smallest businesses to pay a much higher tax on their business income than a multinational, multi-billion corporations undercuts any semblance of fairness. Many proposals have called for reducing the corporate tax rate while eliminating various business deductions and credits, which—if not examined more closely—sounds like a fine plan. However, many pass-through entities, small businesses, utilize these tax benefits that would be on the chopping block. So now I would be facing the same, high tax rate on my business income, but I could no longer take advantage of some important tax credits and/or deductions. The result is a tax increase on my firm while large corporations would be given a tax cut.

I firmly believe that 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.

Imposing higher tax rates on small firms will stymie any growth from what is widely recognized as the source of much of the economic growth and dynamism in the U.S. economy: small business. 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. It is this kind of shortsightedness that has made the IRS a major foe of small firms and why so many of us support broad tax reform.

If Congress overhauls the tax system by dramatically broadening the base — cutting the breaks that litter the tax code—and lowering rates, we would see real economic growth and raise revenues.

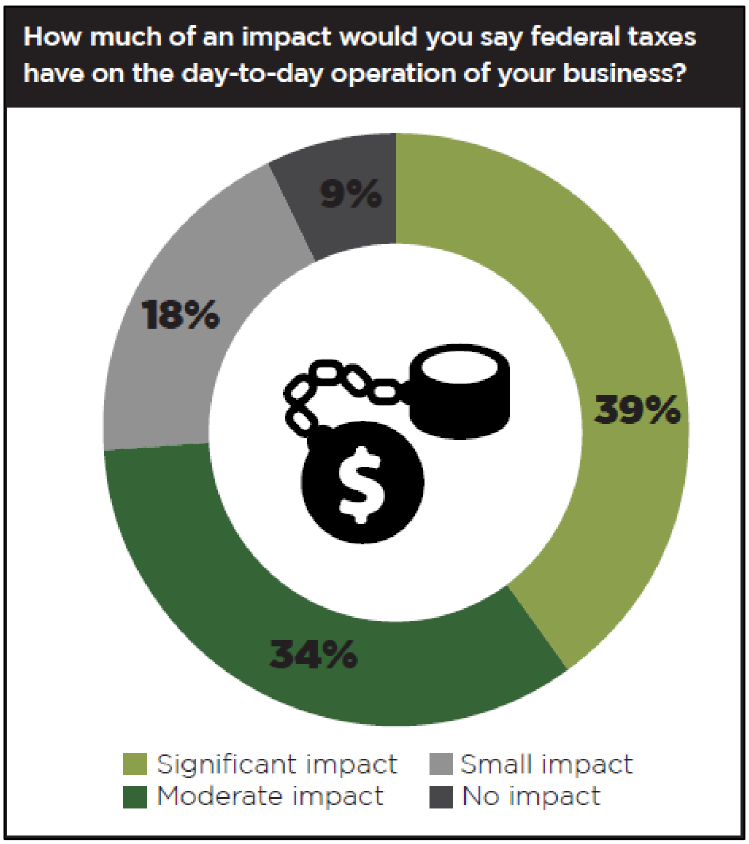
Which of the following deductions or credits do you take advantage of? (Check all that apply)

Sec. 179 expensing	34%
Home mortgage interest deduction	31%
Home office deduction	22%
Bonus depreciation	20%
15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and qualified retail improvements	13%
R&E (Also called R&D) credit	8%
Energy efficiency credits	5%
Start-up costs deduction	5%
Work Opportunity Tax Credit	3%
None of the Above*	27%
Other	4%

*The ongoing debate over the so-called "tax extenders" holds significant importance for small businesses as the majority, 73 percent, report utilizing some kind of tax benefit covered under the extenders umbrella.

Tax Extenders

As a software development company, Tribute spends a significant amount of time, money and resources each year on research and development. As such, we are entitled to take advantage of the Research and Experimentation (R&E) tax credit, which can produce significant tax savings to innovative companies such as mine. As most small innovators, we are always trying to improve what we do, be more competitive, reduce costs and increase market shares. However, because we are a sub chapter S corporation and the income of the business passes thru to my personal income taxes, I am always subject to the Alternative Minimum Tax (AMT). This prevents my company from taking the R&E credit, or we are limited to such a small amount each year that our accounting firm now no longer even calculates what the credit might be. The costs of calculating the credit usually would exceed the allowable credit. The R&E tax credit is meant to encourage additional research and development, yet I am penalized for the way I structured my business. Small businesses are often America's greatest innovators, and yet the complicated tax code steps on its own foot in this area.



Now, even if I wanted to take the R&E tax credit I can't because on Dec. 31, 2013 it expired, along with more than 55 other tax provisions commonly referred to as "tax extenders." The loss of some of these vital credits will negatively impact job creation, investment, research and international competitiveness. It's no wonder so many small firms say federal taxes have a significant impact on the day-to-day operation of their business—and no wonder why so many small firms are beyond frustrated with the Tax Code.

While most of these tax incentives have been extended several times in recent years and even expanded to help small businesses manage throughout the economic downturn, it often has been done retroactively and in a rushed manner, leaving many small firms scratching their heads on how to plan for the upcoming year. Now, however, these provisions have been expired for several months and by Congress continuing to further delay there extensions, it punishes our work, investment, risk-taking and entrepreneurship.

Due to budgetary and political restraints, too many of these provisions were enacted on a temporary basis, requiring repeated extensions. The uncertainty resulting from such temporary tax policy makes it difficult for small businesses to plan effectively for the future, creating significant uncertainty and making it difficult to remain competitive in an increasingly global marketplace.

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.

For Tribute, it has its largest impact on our sales. We sell ERP software to industrial distributors. The software we sell is typically my customer's second largest investment in their business, behind only their investment in inventory, and is eligible for the benefits allowed under Section 179. This deduction often is the difference between affordable and not, and our customers often plan several years in advance for this very significant purchase and implementation. The annual termination, change in limits and delayed extension of this and other tax extenders disrupts this planning, interferes with business efficiency improvements and harms the economy both for buyers and sellers of capital goods.

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 was deductible. However, in 2014, the figure fell to an unacceptably low $25,000. This lower threshold dramatically limits the number of firms that can appreciably benefit and significantly reduces the economic effect of the provision.

Which of the following deductions or credits do you think are most important to stimulating small-business growth? (check all that apply)

Allow full deduction for health insurance costs for self-employed	**62%**
Sec. 179 expensing	**36%**
Start-up costs deduction	**32%**
Bonus depreciation	**31%**
Home mortgage interest deduction	**25%**
Work Opportunity Tax Credit	**25%**
Home office deduction	**22%**
15-year straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and qualified retail improvements	**22%**
R&E tax credit	**17%**
Energy efficiency credits	**17%**
Other	**17%**

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 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.

Furthermore, according to the NSBA tax survey, small firms rated the full deductibility of health insurance costs the number one most important deduction or credit when it comes to stimulating small-business growth.

Deficit Reduction

Reducing the deficit is another top priority for America's small businesses, inextricable from the tax reform debate. The U.S. has always been a leader in entrepreneurship, however, if we do not address our record-high national debt and annual budget deficits, our global competitiveness will be stymied.

The nation's long-term economic health cannot be assured unless the government gets control of its most costly entitlement programs. In light of many contributing factors: health care costs growing faster than the economy; the aging and increased life-expectancy of a Baby Boom generation reaching retirement eligibility; negative personal savings rates; and the fact that 55 percent of the elderly currently rely on Social Security for the majority of their income, Social Security and Medicare will be unsustainable in the long-run absent significant reforms.

Even with an economic recovery and the ensuing increase in tax revenues and decrease in spending on stimulative and safety net programs—without major changes—federal spending will continue to outpace revenues. If we continue to run high deficits, increased interest rates and constricted credit will negatively impact small businesses' ability to garner financing, the life-blood of every small firm. And this inability has real-world implications for all of us: based on NSBA data from as far back as 1993, there is a direct correlation between small firms' ability to get financing and their job growth. When small firms can't access financing, they don't hire.

To address the deficit, the two proposals supported by the majority of small businesses are: an across-the-board cut for federal agencies; and eliminating all tax credits and deductions in conjunction with dramatically lower income tax rates.

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 either renewal of the tax extenders or 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 debate on fundamental tax reform will continue well into the next Congress. However, unless and until Congress agrees upon a replacement, we must fix tax problems with the current Tax Code by developing simplification measures that are fair and fiscally responsible.

Weighing in at more than 70,000 pages, the tax code punishes work, investment, risk-taking and entrepreneurship. The Tax Code is unfair to small businesses, biased against savings and investment, and impossibly complex. A tax system dedicated to investment, savings and small-business growth must be put in its place.

I would like to mention specifically House Ways and Means Chairman Dave Camp (R-Mich.) and applaud his efforts over the last few years to garner stakeholder input, go through the very difficult and time-consuming work to craft reform language, and push forth on the need for lawmakers to work together to achieve some tax relief. Additionally, on the other side of the Capitol and other side of the aisle, Senate Finance Committee Chairman Ron Wyden (D-Ore.) has been a leading proponent on broad tax reform, dating back to the Wyden-Coats reform bill from several years ago.

Standing on the sideline and lobbing stones is easy—digging in and doing the work is hard, and something small-business owners do every day. I'd like to encourage every member of this committee to reach out to Chairman Camp and offer your support and input. More than that, I encourage you to reach across the aisle and work with your cohorts to solve this problem.

Again, I would like to thank Chairman Graves and the members of the Small Business Committee for the opportunity to speak today. I would be happy to answer any questions you may have.