National Small Business Association®

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

The Honorable Ron Wyden
Ranking Member
U.S. Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Hatch and Ranking Member Wyden:

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

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

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

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.

To that end, NSBA was the first small-business organization in the country to support the Fair Tax (H.R. 25/S. 1025). 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.

While we 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

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

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

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

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

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

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

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

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

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

Currently, Qualified Personal Service Corporation (QPSC) — such as law and accounting firms and medical practices — pay income tax at a flat 35 percent rate. In most cases, the QPSC does not pay income taxes since the owners generally arrange that all of the income be paid out as salary, bonuses, and fringe benefits, which, of course, is deductible by the QPSC, but it does remove the advantages of income splitting between the corporation and the employee-owners that would otherwise be possible with a C corporation. To prevent this, QPSC income should flow out at individual tax rates.

Expensing

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

Currently, expensing eliminates the tax bias against savings and investment for firms that can take advantage of it. It reduces the user cost of capital considerably for small firms. NSBA appreciates that the provisions in the House Republican Blueprint will provide businesses with the benefit of fully and immediately writing off or expensing the cost of investments. However, we are concerned that under the Blueprint, while job creators will be allowed to deduct interest expense against any interest income, no current deduction will be allowed for net interest expense. While NSBA supports the proposal to allow businesses to immediately deduct the full cost of qualified capital investments, we recommend that it includes interest deductibility for those with gross receipts under $10 million.

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

An origin grounded 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, European style credit-invoice type value added taxes [VAT], Canadian and Australian goods and services taxes [GST] and proposed business transfer taxes) are destination based taxes. The Flat Tax and various proposed consumed income taxes are, however, origin principle systems.

It is a common misconception 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 (WTO) 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 taxes with a destination 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, 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. Hence, as a starting point for discussions, NSBA is supportive of the proposal by House Republicans that includes a destination-based cash flow tax that provides for "border adjustments" that would eliminate U.S. tax on products, services, and intangibles exported abroad and impose a 20 percent U.S. tax on products, services, and intangibles imported into the U.S.

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. If the U.S. were to replace the current tax system with a destination principle consumption tax 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.

The Estate and Gift Tax

NSBA supports a complete repeal of the Alternative Minimum Tax as well as a total repeal of the Estate Tax. Both provision, if enacted, would help small business owners pass their companies down to the next generation without the same tax burdens they face today.

Health Insurance Tax

NSBA supports repeal of the Health Insurance Tax (HIT) included in the Patient Protection and Affordable Care Act (ACA). Since virtually all large corporations self-insure, this tax, by taxing small group premiums, is aimed squarely at small businesses and will further raise the health insurance costs at a time they are expected to increase dramatically for other reasons.

Maintain full deductibility for health insurance purchased by the self-employed and other business owners

Large corporations can deduct the cost of maintaining health insurance for their employees. The law should not discriminate against the self-employed by denying them a deduction for health insurance costs. They are the only business entity that does not receive the tax option of deducting the full costs of their health insurance. The law should permanently provide for the deductibility of health insurance costs by the self-employed.

Accounting and Inventory

Providing flexibility and simplicity to small businesses in which method of accounting they use for tax purposes is important. Cash accounting—widely seen as a simpler, more straightforward method of accounting—is utilized by 46 percent of small businesses, according to NSBA survey results. NSBA supports retaining that option for all firms with less than $10 million in gross receipts, as it preserves the cash method of accounting for small firms. It is also important that small-business owners have flexibility when it comes to inventory cost methods: the majority of NSBA members report that if the Last-in, First-out (LIFO) method was no longer an option, it would have a significant to moderate impact on their firms, especially to those that maintain significant inventories, most notably retailers and wholesaler-distributors.

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.

One of the main goals of fundamental tax reform is to make U.S. businesses more competitive and to increase economic growth. This requires a reduction in taxes on businesses and investment. Ultimately, NSBA supports a broad overhaul of the tax system by dramatically broadening the base—cutting the breaks that litter the tax code—and lowering rates. As Congress debates what tax system should replace the current one, NSBA believes it is imperative that the U.S. moves towards a simpler, fairer tax system that does not attempt to only tweak one piece of the puzzle but instead is a permanent solution.

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

Sincerely,

Todd McCracken
President & CEO