Small Business Tax Reform Priorities

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A report prepared by the Democrats of the House Committee on Small Business
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Executive Summary

Retirement

- **Rothification and other modifications to pre-tax contributions will severely impact small business sponsorship of retirement plans and savings rates of workers.**

- **Tax reform should consider methods to expand tax incentives, increase plan flexibility, and reduce administrative burdens for small businesses.**

Tax Rates

- **An estimated 86 percent of small firms structured as pass through entities currently pay at or below a marginal tax rate of 25%, thereby receiving no benefit from the proposed pass through tax rate.**

- **Besides gaining nothing from a corporate or pass through rate cut, many small firms will be harmed by losing critical tax expenditures, such as the Section 199 domestic manufacturing deduction.**

- **Tax reform should focus on expanding and modifying sections of the Internal Revenue Code that drive economic growth and benefit small employers no matter their tax structure.**

Simplicity and Uniformity

- **The single greatest complaint from the small business community is the ever growing complexity of the tax code, resulting in confusion and additional costs.**

- **Tax reform should provide clarity and simplification through greater uniformity among code sections.**

Modernization

- **Technology and business practices have changed dramatically since the last rewrite of the tax code in 1986 as evidenced by the innovative sharing economy.**

- **Tax reform should reflect these innovations by updating expenditure dollar amounts and thresholds, indexing for inflation, and guarding against fraud and abuse through updated administrative policies.**

Background

Given that the last major overhaul of our tax code took place in 1986, it is clear changes are long overdue. What is also abundantly clear is that we cannot move forward without input from small business owners and entrepreneurs. With that in mind, it is important we continue our progress towards comprehensive tax reform to spur innovation and stimulate job creation.

Several months after releasing broad bullet points for tax reform, the Administration and Republican leadership in the House and Senate delivered their tax framework. As expected, the framework is slightly more detailed but foregoes the detail required to understand the small business impact. It proposes three tax brackets, with a potential fourth for wealthy taxpayers; however, the income levels are unknown. The framework lowers the corporate rate from 35 percent to 20 percent and creates a new maximum tax rate on pass through business income of 25 percent. To do so requires the elimination of credits and deductions, but only the section 199 manufacturing deduction was specifically named. The absence of such specificity is leaving the small business community confused and concerned that they will be unduly harmed by efforts to expedite a tax package through Congress without the requisite examination.

The Small Business Committee has heard repeatedly from owners about how complexity breeds uncertainty, increases compliance costs, and hinders business planning. For small firms, the existing tax code is an obstacle to success rather than a means of encouraging growth and job creation. For this reason, small entities have called for a more predictable and simpler tax system. In that vein, tax reform efforts should devote attention to supporting our nation’s job creators by allowing them to continue hiring and expanding without worrying about expiring provisions or constantly changing dollar limitations. Modernizing the tax code to reflect new business realities will assist in providing simplicity, fairness, and permanency to businesses of all sizes.

Retirement

Perhaps no other issue is more important to the nation's future than whether people will be adequately prepared for retirement. Baby boomers and millennials alike are struggling to save for the future. While millennials are more hopeful, their savings rates are dismal – they are not alone. Over thirty percent of entrepreneurs lack a retirement savings plan. Employer sponsorship rates are also lower among businesses with fewer employees. The costs and complexity associated with starting and maintaining a plan are daunting to business owners. Tax incentives to start a savings plan are the key to expanding coverage and plan adoption among smaller firms.

Unfortunately, various tax reform proposals are attacking the way people save for the future. In order to help pay for cutting tax rates, the Administration and Republicans intend to reduce the types of plans, limit contributions, and modify other tax incentives. One option is to create an offset by cutting retirement contribution limits, as was done in 1986, in addition to rothification. Rothification entails converting defined contribution plans, like 401(k)s to Roth-like plans, which many experts believe will lead to fewer small employers establishing a 401(k) plan.

Small business owners who rely on the up-front savings and pre-tax funding may stop sponsoring a plan if there are fewer advantages. Small employers generally choose pre-tax contributions over Roth plans. In fact, one survey found that 89 percent of over 8,000 surveyed small business owners did not make a Roth election. And, when Roth contributions were chosen, those balances were one-third of the average pre-tax contribution balance, indicating much less is being saved over time. Many experts agree that Rothification could significantly reduce both the savings rate and dollar amounts among small employer-sponsored plans.

Furthermore, the budgetary gimmick of raising short-term revenue at the expense of retirement savings is irresponsible, not just for small employers and their employees but for all Americans. Traditional savings plans result in higher net revenues to the federal government than when Roth plans are chosen. Instead, Congress should consider what the Small Business Committee Democrats have heard from actual business owners – they need more plan flexibility, auto-enrollment, increased tax benefits for starting a plan, and additional incentives for maintaining them.

Tax Rates

In discussions with the small business community, they have explained their understanding of the balance between lowering tax rates and eliminating or reducing some tax incentives. However, it is important to remember that small businesses must not bear the expense of rate cuts if they see no benefits.

The overwhelming majority of small firms structure their businesses as pass through entities and while the Administration's framework considers this, it completely ignores how low the rate must be to truly benefit average small firms. False promises are being offered in the form of a pass through rate of 25% as it offers nothing for 86 percent of small firms structured as pass through entities. According to the Center for Budget and Policy Priorities, 69 percent of pass through taxpayers currently paid at or below a marginal tax rate of 15%, while 17 percent paid at or below the marginal tax rate of 25% in 2017. Therefore, it is reasonable to anticipate the $1.4 trillion cost of tax reform to be on the backs of the nation's job creators.

Besides losing the advantages of both a corporate and pass through tax rate cut, many small business filers will be harmed by lost tax deductions and credits. In order to pay for reform, the Administration and GOP Congressional leaders have clearly stated their intention to eliminate tax breaks. Unfortunately, besides the Section 199 domestic manufacturing deduction, not much information is available as to which provisions will be struck from the Internal Revenue Code. Based on previous iterations of tax reform plans, it is likely that many tax breaks and common provisions will be removed or modified, such as cash accounting, like kind exchanges under Section 1031, the last in, first out (LIFO) accounting method, and depreciation and capitalization reform.

While many small firms would like to see lower rates, the majority of business owners simply do not want to agree to any specific changes prior to seeing a final proposal. As they have stated, they do not want to offer a vital tax incentive for the possibility of a lower rate that may or may not benefit them. It is the belief of the Small Business Committee Democrats that targeted tax relief should drive reform plans. Expanding the start-up deduction, increasing retirement savings, and enhancing tax breaks, like the R&D credit, for small firms is critical to economic growth, especially if they fail to see rate cuts.

Simplicity and Uniformity

One of the biggest complaints small businesses have is the ever growing complexity of the U.S. tax system and its adverse impact on their ability to operate. Ideally, tax law should be simple so that small businesses can understand the rules and comply with them correctly and in a cost-efficient manner. As the tax system generally relies on voluntary tax compliance, policymakers have an incentive to ensure that tax reform creates a clear and concise tax system. Most small businesses want to accurately report their income and pay taxes that are due, but unfortunately, it can be costly and difficult to determine. A goal of tax reform is to create simplicity and uniformity in the tax code to generate greater compliance and ease for taxpayers.

Typically, the term small business brings to mind risk-taking entrepreneurs who are involved in the hands-on management of their small firms like the corner grocery store owner or the local auto mechanic. Yet, when policymakers refer to small businesses, it is unclear who they are referring to because no definition of a small business exists within tax policy. In fact, the tax code contains at least 53 different definitions of a small business. Currently, a consensus does not exist regarding the specific attributes that distinguish small businesses from other firms. Rather than using multiple definitions that skew the underlying policies, a uniform designation can both improve tax reform discussions and ease future tax writing and compliance.

Furthermore, many tax code provisions reference various dollar limitations, creating uncertainty and confusion. Business practices have evolved since the last tax overhaul in 1986 and the code should reflect those changes. Unifying thresholds and filing deadlines, such as quarterly reporting deadline and 1099-K and 1099-MISC thresholds, not only streamlines reporting for the taxpayer, it can lead to more revenue by increasing compliance. Finally, aligning code provisions, such as the self-employment net earnings exclusion with the Social Security quarter of coverage requirement, are commonsense and practical reforms.

Congress should look to targeted provisions that will truly impact every small business owner and entrepreneur. Simple changes, while modest, address feedback the Small Business Committee has heard time and again.

Modernization

Technology and business operations have changed dramatically since the last overhaul of the tax code in 1986, impacting their usefulness to small business owners. Due to these advancements, the tax code creates more burden in the form of costly compliance. For instance, the 1099-MISC used to report payments to independent contractors has not been adjusted since 1954. Other provisions lack clear data showing they are operating as Congress intended, like Section 1202.

America's small businesses have outgrown the tax code thanks to ever changing technology and business types, such as that of the sharing economy and solopreneurs. It is time Congress recognizes and adapts to this evolution if we want to encourage job creation and revenue to lower the nation's deficit. Ways in which Congress can modernize the code is through inflation adjustments, increasing credit and deduction amounts, and reflecting the tax code to offer flexibility to evolving types of work arrangements and business structures.

Finally, a comprehensive review of the tax code should also account for policy modifications in tax administration. Today's technological environment forces Americans to be diligent in their efforts to stay secure and protect their private information. Tax filing and administrative policies should follow suit by protecting against fraud and abuse with advanced security in the form of electronic signatures and pre-notification testing. It is important that as this technological revolution advances, government practices keep pace.

While it is complex to design a tax structure which provides simplicity, fairness, and pro-growth policies to all business taxpayers, it is essential that the needs of small businesses come first. No matter the approach taken, the small business community wants to ensure their voice is heard in shaping policy. We cannot move forward without their input and we must fully recognize tax reform's impact on them, in both drafting legislation and during any transitional period.

An opportunity exists for this Congress to implement long-lasting reforms to ensure the nation's long-term economic growth. However, we must do it with the proper respect for America's small businesses by allowing them to take part in the discussion.