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ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

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Statement for the Record of Warren S. Hudak
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United States House of Representatives
Committee on Small Business

Paying Their Fair Share: How Tax Hikes Crush the Competitiveness of Small Businesses

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National Federation of Independent Business
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Good afternoon, Chairman Williams, Ranking Member Velazquez, and Members of the House Small Business Committee. My name is Warren Hudak; I am the President of Hudak and Company, an accounting and payroll firm in Camp Hill, Pennsylvania. Thank you for inviting me to testify on Tax Day at this important hearing.

Our firm, Hudak and Company, is a small business that serves small businesses. We have 11 employees and 90% of our customers are small businesses. Hudak and Company's focus is small business accounting. We provide the full resources small businesses would expect from a large accounting firm – accounting, business planning, tax return preparation, payroll, or small business consulting – while maintaining a personal touch.

It is our job to work with small business clients to translate the complicated federal tax code and frequently changing tax provisions. This challenge comes on top of other economic problems that small businesses are facing, which include stubbornly high inflation and workforce shortage issues. Our business similarly faces these challenges as our labor costs are up 40% and software costs have tripled since the pandemic began. Tax professionals, who face demographic challenges due to an ageing workforce, have been stretched thin over the pandemic as we worked long hours helping our clients navigate pandemic assistance programs.

Small businesses are facing a very uncertain future that makes business planning extremely difficult. Beginning this year, certain business provisions of the Tax Cuts and Jobs Act (TCJA) of 2017 expire or wind down. In fewer than 3 years, the vast majority of the provisions that benefit individuals and small businesses will also expire. If Congress fails to act, there will be a detrimental and substantial tax increase on more than three quarters of small employers.[1] Further, proposals to increase taxes on businesses cloud optimism and further complicate business planning. Finally, the small business paperwork burden is increasing, which complicates tax compliance and shortens the tax season, while the IRS disproportionately expands enforcement efforts over compliance assistance and customer service improvements.

[1] *Table 2, Legal Form of Organization (2019), Frequently Asked Questions About Small Business*, U.S. Small Business Office of Advocacy, March 2023, https://advocacy.sba.gov/wp-content/uploads/2023/03/Frequently-Asked-Questions-About-Small-Business-March-2023-508c.pdf. *The Small Employer column shows 77.9% are organized as pass-throughs (Sole Proprietors, Partnerships, and S-Corporations) and 22.3% are organized as C-Corporations and Other.*

Benefits of Tax Cuts and Jobs Act of 2017

Small businesses received substantial tax savings upon enactment of the Tax Cuts and Jobs Act of 2017. For the more than three-quarters of businesses organized as pass-throughs (S-Corporations, LLCs, Sole Proprietorships, and Partnerships), the 20% Small Business Deduction (also known as Section 199A), combined with the lower individual tax rates and broader income brackets, provided tax relief that was invested in the businesses and employees. All of these provisions expire on December 31, 2025.

The TCJA also contained provisions that encouraged business investment by allowing for the immediate deduction of equipment and research and development. These provisions include permanently extending Section 179 expensing and temporarily extending bonus depreciation and Research and Development (R&D) expensing (Section 174).[2,3] The latter two provisions expire or wind down last year and this year. R&D expensing is a big deal when cashflow is tight, which it is occurring right now with pervasive inflation and rising interest rates. The sooner that the beneficial small business and expensing provisions are extended, the better small businesses will be able to plan for the future. Extension of these provisions is paramount to recovering from the Covid malaise.

President's Fiscal Year 2024 Budget Request

Further clouding business planning are proposed tax increases on small businesses. President Biden's Fiscal Year 2024 Budget Request would increase taxes on small businesses organized as corporations and pass-throughs. For the nearly one-quarter of small employers organized as corporations, the budget proposes increasing the corporate tax rate from 21% to 28%.[4] For the more than three-quarters of small employers that are pass-throughs, the budget proposes increasing the top marginal income tax rate, lowering the threshold that the top rate begins, creating a new 5% tax on business income above $400,000,[5] increasing capital gains tax rates above $1 million, and further limiting the ability to smooth

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[2] *"Congress made a number of significant changes in the [bonus depreciation allowance] BDA in P.L. 115-97. Specifically, the act set the rate for the BDA at 100% for qualified property acquired and placed in service between September 28, 2017, and December 31, 2022. The rate then is scheduled to decrease to 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, 20% for property placed in service in 2026, and 0% starting in 2027 and thereafter."* Gary Guenther, *The Section 179 and Bonus Depreciation Expensing Allowances: Current Law and Economic Effects*, Congressional Research Service, May 1, 2018, https://www.everycrsreport.com/reports/RL31852.html.

[3] *Beginning in tax year 2022, small businesses are now required to capitalize R&D costs and amortize them over a minimum of 5 years for domestic research and development.*

[4] *The Build Back Better Act that was considered by the Ways and Means Committee would have created a graduated corporate rate structure, as did the Senate amendment offered by Senators Sanders (I-VT) and Whitehouse (D-RI). The President's FY2024 Budget Proposal does not.*

[5] *The threshold for joint filers is $450,000. These thresholds are not indexed for inflation so it will absorb an increasing number of small businesses and a greater percentage of small business income every year*.

out business losses. For all structures of businesses, the proposed budget limits like-kind exchanges and changes tax treatment of stepped-up basis for family businesses and farms. While small businesses may not be impacted by these proposed tax changes every year, they will be impacted when they have profitable years, when they sell their businesses to fund their retirement, or when they pass along their businesses to the next generation.

The President's Budget Request describes certain tax increases misleadingly as "closing loopholes." One example of this mischaracterization was a deliberate policy choice.[6] This proposal would expand the 3.8% "Net Investment Income Tax" (NIIT) to active business income and increase the tax rate to 5%. This tax was originally created as part of the Affordable Care Act reconciliation bill as a tax on investment, or passive, income above $200,000.[7,8,9] It was a deliberate policy choice to not apply it to active business income, which is not investment income. As former Chairman of President Obama's Council of Economic Advisors Jason Furman described, it was not applied to active business income, "because it could be demonized as a tax on small businesses and doctors."[10]

A deliberate policy choice is not a "loophole." The proposed expansion of the tax would more than double the revenue collected, further demonstrating that the tax increase proposal is not "closing a loophole."[11,12] If it is ultimately enacted, this substantial tax increase would reduce the ability of pass-through business owners to invest in their businesses and employees, leaving them at a further disadvantage relative to corporations.

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[6] *"The Budget closes the loophole that allows certain business owners to avoid paying Medicare taxes on these profits, and dedicates revenue raised by the Net Investment Income Tax (NIIT) to the Medicare HI Trust Fund, as originally intended. In addition, the Budget raises the Medicare tax rate on earned and unearned income and the NIIT rate from 3.8 percent to 5 percent for the wealthiest Americans." Budget of the U.S. Government, Fiscal Year 2024*, Office of Management and Budget, page 45, March 9, 2023, https://www.whitehouse.gov/wp-content/uploads/2023/03/budget_fy2024.pdf.

[7] *The NIIT was neither included in the House or Senate ACA proposals; it was added during reconciliation after the Cadillac tax (which has since been repealed) was delayed and Cadillac tax thresholds were increased*.

[8] *The threshold for joint filers is $250,000. These thresholds are also not indexed for inflation.*

[9] "*In summary, the NIIT arose as a last-minute revenue replacement to offset the revenue loss from Congress's delayed implementation of the 40% excise tax on high-cost, or Cadillac, health insurance plans. As a direct substitute for the Cadillac tax's general fund revenues, the receipts from the NIIT needed to flow into the Treasury's general fund instead of being dedicated to either of Medicare's trust funds. In other words, while helpful to supporting federal expenditures, including Medicare, the ACA did not directly link the NIIT to Medicare.*" Ausher M.B. Kofsky and Bryan P. Schmutz, *What a Long Strange Trip It's Been for the 3.8% Net Investment Income Tax*, May 15, 2019, https://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1057&context=endnotes.

[10] Jason Furman, Tweet, October 28, 2021, https://twitter.com/jasonfurman/status/1453756933689823241.

[11] *According to IRS Statistics of Income, the NIIT collected $32.1 billion in taxes in 2020*, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-with-small-business-income-and-losses.

[12] *According to the FY2024 Treasury Greenbook, the proposed tax increase would collect an average of $65 billion per year over ten years – expansion of 3.8% NIIT to active business income (average $30.6 billion per year over ten years) and increase NIIT rate to 5% (average $34.4 billion per year over ten years)*, https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.

IRS Enforcement Expansion

The Inflation Reduction Act of 2022 provided nearly $80 billion in new funding for the Internal Revenue Service (IRS), primarily focused on enforcement. Unfortunately, only 4% of that funding was designated for customer service, which needs significant improvement at the IRS. Small business owners are concerned about the implementation of increased enforcement efforts, the continued backlog of tax returns, and the combination of increased paperwork and data privacy.

On April 6, 2023, the IRS released the long-awaited Strategic Operating Plan seven weeks after the original deadline directed by Treasury Secretary Janet Yellen.[13,14] The Strategic Operating Plan is vague and dominated by increased enforcement efforts. For example, the plan would increase enforcement on "large corporations, large partnerships, and high-income individuals" without defining a "large corporation," "large partnership," or "high-income individual." Additionally, the plan states five times that small businesses and individuals earning less than $400,000 will not see increased audits relative to historical levels, but never quantifies "historical level."[15]

The IRS processing backlog was historically large, and while there have been improvements, it remains considerable.[16] Paperwork burdens are expanding. Currently, business owners are inundated with paperwork and current Form 1099 information reports. This paperwork makes tax preparation more difficult for preparers and business owners. I previously mentioned that tax professionals are already stretched thin. The forthcoming expansion of Form 1099-K reporting could further complicate tax preparation and require more reconciliation of paperwork. It

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[13] *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan, FY2023–2031*, Internal Revenue Service, April 6, 2023, https://www.irs.gov/pub/irs-pdf/p3744.pdf.

[14] *"Before it was stricken during the Byrd process, the Inflation Reduction Act would have required the IRS to produce a six-month operational plan detailing how these resources will be deployed over the course of the next decade. This kind of planning is crucial, so I am directing that such a plan should be delivered to me six months from today."* Janet L. Yellen, Secretary of Treasury, *IRS Operational Plan*, Memorandum for Commissioner Rettig, August 17, 2022, https://www.taxcontroversy360.com/wp-content/uploads/2022/08/2022-27034_TNT_Docs_treasury.pdf.

[15] *See, for example, the description of pass-through audit rates, which lists multiple historical levels of audits, "For example, while total tax return filings increased by 13% from 2011 to 2021, filings by pass-through entities, including partnerships and S corporations, increased by 26% over the same period. However, monitoring the compliance of pass-through entities—particularly large and more complex ones—requires more IRS resources. As a result of funding limitations, the audit coverage rate has fallen. While the IRS audited 4.4% of passthrough entities in 2010, that number fell to 0.1% in 2017 (the most recent tax year with nearly all audits closed), and audits have continued to decrease." Internal Revenue Service Inflation Reduction Act Strategic Operating Plan, FY2023–2031*, Internal Revenue Service, page 141, April 6, 2023, https://www.irs.gov/pub/irs-pdf/p3744.pdf.

[16] See, for example, *"As of April 1, 2023, we [IRS] had 2.26 million unprocessed individual returns… Status of Processing Form 941, Employer's Quarterly Federal Tax Return: As of April 6, 2023, we had 140,000 unprocessed Forms 941… As of April 5, 2023, our total inventory of unprocessed Forms 941-X was approximately 929,000, some of which cannot be processed until the related 941s are processed."* IRS Operations: Status of Mission-Critical Functions, accessed on April 16, 2023, Internal Revenue Service, https://www.irs.gov/newsroom/irs-operations-status-of-mission-critical-functions.

has already been delayed once administratively as a result. Small business owners must also file beneficial ownership reporting paperwork with Treasury beginning next year. The outreach and education efforts on both of these new reporting requirements has been lacking.

I also remain concerned about the ability of the IRS to protect personal information, and I worry pre-populating tax returns could exacerbate privacy risks. Late last year, the IRS admitted to "inadvertently" exposing confidential data of more than 112,000 taxpayers. This data remained publicly available on the IRS' website for more than a month.[17]

If there is massive tax evasion, I hope the IRS finds it. But I worry if that is not the case. If there is not sufficient revenue generated from increased audits and enforcement of large corporations and high-income taxpayers, then what happens? Is the priority for enforcement to crack down on tax evasion at the top or is it to collect nearly $200 billion to fund the Inflation Reduction Act spending and tax credits? I encourage continued oversight of the IRS expansion and the potential impacts on small businesses.

Small businesses continue to face economic headwinds. Congress can help mitigate economic challenges by extending beneficial small business tax provisions and rejecting tax increases on small businesses. Tax certainty will help businesses plan for the near- and medium-term and increase small business confidence. I appreciate your time and attention to these concerns. Thank you for the opportunity to testify today on behalf of small businesses.

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[17] Chris Cioffi, *IRS Accidentally Releases 112,000 Taxpayers' Private Data Again*, Bloomberg Tax, December 15, 2022, https://news.bloombergtax.com/daily-tax-report/irs-accidentally-releases-112-000-taxpayers-private-data-again.