

**Testimony of Todd McCracken
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Joint Hearing of the Subcommittees on Tax, Finance and Exports and Rural Enterprises,
Agriculture, and Technology of the Committee on Small Business

“Transforming the Tax Code: An Examination of the President’s Tax Reform Panel
Recommendations”

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Good morning Chairman Bradley, Chairman Graves and members of the committee. Thank you for the opportunity to testify and for holding a hearing on the vital topic of fundamental tax reform. My name is Todd McCracken and I am president of the National Small Business Association. We are the nation's oldest small business advocacy organization, representing 150,000 small-business owners across the country.

The members of our organization choose our top priorities every two years at the NSBA Small Business Congress. At the most recent Congress in February 2005, their number one priority was fundamental tax reform.

Only days before last year's event, President Bush had issued a historic executive order convening a non-partisan panel of experts to study the current Federal Tax Code and propose alternatives. NSBA's members, while long-time supporters of tax reform, took the opportunity to stand with the president and emphasize the importance of tax reform in the small business community.

When NSBA's members voted in 2005 to make fundamental tax reform the organization's top priority, they were hoping for a plan that would fulfill three goals. The first was a tax system that would bring efficiency to the federal government's tax collection. The President's Advisory Panel on Federal Tax Reform's final report did an excellent job detailing inefficiencies in the current code. They noted the cost of compliance was unacceptable in both time and money spent preparing returns. A replacement to the current code must be more efficient.

Second, a new system must also be more equitable for small businesses. Under the current code, there are many areas where small businesses are disadvantaged. In the area of health care, the health care premiums of self-employed individuals are exposed to the self-employment tax, looking at pensions we see that small business owners and their employees who use small business friendly SIMPLE 401(k) plans can set aside \$10,000 pre-tax while employees participating in traditional 401(k) plans can set aside \$15,000. The list of other inequities is long and we have testified before this and other committees on inequities for small businesses in the tax code. A replacement to the current code must be more equitable for small businesses.

Finally, any new system must ease compliance. It is well known by members of this committee that small business owners start their venture's not to become experts on the tax code, file returns and learn depreciation schedules; but to earn a living, and bring needed goods and services to their local community. The payroll tax is an example of a tax that is both difficult to comply with (it is often outsourced) and a serious barrier to entry (with tax liability long before profitability) for entrepreneurs. Business owners don't start businesses to cheat the tax code. Any replacement to the current code must be easy to comply with and not be a barrier of entry into the marketplace.

Ultimately, the members of the NSBA chose a national retail sales tax, specifically the proposed Fair Tax, as the best way to replace the current code. They believe that the Fair Tax, while not perfect, is the best way to achieve the goals of efficiency, equity and ease.

While we are disappointed that the panel chose to not recommend a national retail sales tax, there is definite merit and improvements to be found in both options drafted by the president's panel.

Each proposal was evaluated from a small business point of view and compared to the current system and a system based on the Fair Tax.

The Simplified Income Tax Plan

The Simplified Income Tax Plan, or Plan A, proposed by the panel fulfilled President Bush's requirement that one option for reform be based on the existing tax code. For the small business perspective, we've broken the proposal into three parts that specifically affect the small business community: income reporting, fringe benefit treatment and paperwork requirements.

Judging proposals on income reporting is important because most business owner's earnings are taxed at the individual level. Under the current system, owners use a variety of forms—including schedule C, E, SE or K—attached to their tax return to inform the IRS about profits or losses from their business. Profits, if there are any, are then passed through the marginal income tax rates. Plan A reduces the number of tax rates from six to four, simplifying the process. Plan A also wisely eliminates the Alternative Minimum Tax. However, even though there are fewer tax brackets to compute, there is still a requirement for small business owners to file a variety of small business specific forms to comply with tax law. This requirement would not exist for the vast majority of small business owners under the Fair Tax.

Another significance is that Plan A does not address the payroll tax burden faced by small business owners. Under the current code and Plan A, employers would still be required to withhold Social Security, Medicare and Unemployment Insurance contributions from employee wages. Employers would also still be required to withhold and report income tax on employee wages. The Fair Tax would end withholding of payroll taxes.

Current inequitable treatment for small business fringe benefits is greatly improved under Plan A. Pension inequity for small businesses is addressed through the Save at Work program. These plans would level the playing field between traditional 401(k) and SIMPLE 401(k) plans while retaining the latter plan's ease of maintenance. NSBA has been a longtime supporter of President Bush's previously proposed Employer Retirement Savings Accounts which closely resemble the Save at Work plans. In comparison to the Fair Tax however, where taxes are only applied to consumption and tax free saving is automatic, both the current system and Plan A are more cumbersome.

Another fringe benefit inequity fixed under Plan A is differential treatment for health care costs between self-employed individuals and most other employees. Divorcing employment from the provision of health care and allowing all individuals, regardless of their form of employment, to pay for health insurance premiums with pre-tax funds in the same fashion eliminates an important disincentive to becoming self-employed. It would also be an important step in reforming our health care system.

Paperwork and record keeping are greatly improved in Plan A. Fifty-two percent of NSBA's members earn less than one million dollars in revenue and more than 85 percent earn less than five million dollars in revenue according to the most recent NSBA survey. We agree that most small business owners would benefit from the use of cash reporting in Plan A. Those that fell into the medium size business tier would also benefit from simplified depreciation categories and the cumulative method for calculating the depreciation benefit. While it is clear that small business depreciation is improved under Plan A, it is also true that it pales in comparison to the Fair Tax which requires no need to depreciate assets or report inventories. It should also be noted that the panel's report is vague on the topic of unifying rules for different pass through entities.

The Growth and Investment Tax Plan

The Growth and Investment Tax Plan, or Plan B, was the panel's proposal for fundamental reform. Plan B is a hybrid system that retains an income tax for individuals but imposes a subtraction method value added tax on businesses. The small business community would be split between the two systems with sole-proprietorships taxed at the individual rate and all other forms of business entity taxed at the flat 30 percent business tax rate.

Most of the improvements, and shortcomings, compared to the Fair Tax, for entrepreneurs found in Plan A are continued in Plan B. The number of income tax rates is further consolidated from six to three and improvements in fringe benefit treatment for small business owners in health care and pension plans are also carried over. The AMT is also repealed.

Administering a business under Plan B would also be an improvement over the current system. Tax liability would fall squarely on a business's cash flow, defined as receipts less the cost of materials, labor services, and purchases of business assets. Many small business owners already know the benefits of immediate expensing in the current code thanks to Section 179 expensing. Extending this common sense policy to all businesses would encourage investment and productivity and eliminate the incentive for businesses to keep old or inefficient equipment past its maximum potential to recover the depreciation. Business owners would still be required to report the cash flow calculation to the IRS and keep receipts and records for all applicable deductions—an improvement over the current system but inferior to the reporting burden under the Fair Tax.

The distinction in Plan B between sole proprietorships and all other forms of business entity also presents interesting questions. Under current law, business owners that operate pass-through entities (S-corporations, LLC, partnerships) are taxed on profits or losses at the individual income tax rates. Plan B would continue this practice for sole-proprietors, currently 20 percent of NSBA's members, but tax all others at a level equal to the top marginal income tax rate of 30 percent, regardless of income. This split treatment of business owners could create difficult decisions for those just starting their business who wanted the benefits of limited liability or partnership options found in some current pass-through entities but did not want to immediately jump into the top tax bracket.

Plan B is a step in the right direction towards a consumption tax, and an improvement over the current code, but its retention of individual income tax reporting, payroll and income tax withholding and taxation of capital gains and dividends make it less desirable than the Fair Tax.

Conclusion

In summation, the President's Panel on Tax Reform did an excellent job making the case for why our current system is broken and harmful to economic growth. The National Small Business Association fully agrees that the system needs to be replaced with one that is efficient, equitable and eases compliance.

Both Plan A and Plan B are improvements over the current tax code. Both would cut paperwork burden, reduce non-economically sound business decisions and encourage entrepreneurship. However, from a small business point of view neither is as good as the Fair Tax.

Our members choose the Fair Tax because it is the most efficient and least intrusive form of taxation. It would relieve small business owners from their current role as proxy federal tax collector for income taxes and payroll taxes. Those retail locations that did collect and remit sales taxes to the government would see their overall net tax paperwork burden vastly reduced.

The Fair Tax would treat all forms of small business entity the same by eliminating the need for business owners to make the complex and costly choice of business entity for tax purposes.

By eliminating the need for specialized tax advantaged savings vehicles for pensions, health care and other fringe benefits; small business owners would see equal access to these goods in their own lives and be better able to compete in a tight labor market with their larger competitors.

We appreciate the efforts of the tax reform panel and their hard work on proposing reforms. We disagree with their dismissal of a national retail sales tax and will continue to advocate for it as the best possible alternative for small businesses.

I sincerely appreciate the opportunity to testify before the panel today and look forward to any questions you may have.