

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-0515

To: Members, Committee on Small Business
Members, Subcommittee on Economic Growth, Tax, and Capital Access, Committee on
Small Business
From: Committee Staff
Date: April 11, 2016
Re: Committee and Subcommittee Hearings: “Keep It Simple: Small Business Tax
Simplification and Reform”

On Wednesday, April 13, 2016, at 11:00 a.m., in Room 2360 of the Rayburn House Office Building, the Subcommittee on Economic Growth, Tax and Capital Access of the Committee on Small Business will meet with a private sector panel to examine key tax provisions as they apply to small businesses. The full Committee on Small Business will meet at 2:30 p.m. the same day for a government panel on the same topic.

The United States Tax Code is incredibly complex. Nowhere is this fact felt more keenly than among the small business community. While their larger counterparts most certainly deal with a great deal of complexity in the Code, economies of scale result in an astronomically higher per-employee cost of compliance for small businesses. Corporations and partnerships with more than 50 employees face a tax compliance burden of approximately \$182 to \$191 per employee, but this number skyrockets to \$4,308 to \$4,736 per employee for the smallest employers with 1-5 employees.¹ The hearing will focus on some of the most egregious areas of both substantive and administrative complexity from the small business perspective and provide a discussion of potential solutions.

I. Introduction

On April 18, Americans will once again observe Tax Day, and small business owners across the country will be filing their tax returns. For small firm owners, tax costs can drive business decisions. Higher tax liabilities and compliance costs mean small firms have less capital to invest back into their companies or create jobs. Keeping up with tax obligations can be particularly problematic for small firms, not only because of the economic impact, but also the time needed to stay current with the law, the paperwork, and recordkeeping. Because small businesses are the economy’s job generators, the effect of tax policies can have critical importance to the economy.

¹ *Small Businesses, IRS Considers Compliance Burden in Tax Administration, but Needs a Plan to Evaluate Its Payment Card Information Pilot: Hearing Before the United States House of Representatives Committee on Small Business*, 114th Congress, First Session (July 22, 2015) (testimony of J. Christopher Mihm), available at <http://www.gao.gov/products/GAO-15-754T>.

II. Background

According to the Internal Revenue Service's (IRS) National Taxpayer Advocate, tax issues are a significant set of regulatory burdens for most small businesses.² One National Federation of Independent Business (NFIB) Research Foundation study of found that four of the top ten problems small businesses identified were tax related.³ Small businesses face unique challenges when dealing with the code. Entrepreneurs struggle to decipher the code, file paperwork and pay their taxes while keeping their businesses running. As new taxes are implemented, and tax rates increase, small business owners must stay current with the law, or hire a professional to do so, and ensure that their company complies.

A. Tax Complexity and Compliance

Small businesses are disproportionately affected by tax complexity. A study by the National Association of Manufacturers concluded that small firms pay more than twice as much per employee to comply with the tax code than large firms do, with tax complexity a contributing factor.⁴ The growing number of code provisions, along with the fact that small firms frequently do not have an in-house accountant or tax attorney, means that small business owners must hire outside experts or add those duties to another employee's workload.

Tax complexity is also important because it affects tax compliance. Individuals who do not understand the law have more difficulty complying with it, and the result is less revenue in the U.S. Treasury. Individuals who "feel distant" from the code have lower rates of voluntary tax compliance, although it is uncertain what makes one feel "connected" to it.⁵ The Taxpayer Advocate's 2011 Report to Congress states the code is so complex that even the IRS has difficulty administering it.⁶ The IRS has found it more challenging to answer the millions of phone calls and taxpayer correspondence it receives each year.⁷ The expectations are so low that IRS set its Fiscal Year 2010 telephone customer service goal at 71%. That means almost three out of ten callers to the IRS were not expected to get through.⁸

Over the past few years, the Report of the National Taxpayer Advocate identified the need for tax reform as one of the top priorities in tax administration.⁹ Taxpayers and preparers spend about

²*Tax Burdens Facing Small Businesses: Hearing Before the United States House of Representatives Committee on Small Business*, 109th Congress, Second Session (September 21, 2005) (testimony of Nina E. Olson), available at http://www.irs.gov/pub/irs-utl/nta_small_business_comm_testimony_v4_single.pdf.

³ William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC, series. See also TAXES, TAX REFORM AND SMALL BUSINESS, NFIB, available at <http://www.nfib.com/advocacy/taxes>.

⁴ See Nicole V. Crain and W. Mark Crain, *The Cost of Federal Regulation to the U.S. Economy, Manufacturing and Small Business 2* (2014), available at <http://www.nam.org/Data-and-Reports/Cost-of-Federal-Regulations/Federal-Regulation-Full-Study.pdf>.

⁵ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, REPORT TO CONGRESS 337 (2011) [hereinafter "Advocate's Report"], available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

⁶ *Id.* at 4.

⁷ *Id.* at 9.

⁸ Elizabeth Glagowski, *The IRS' Customer Service Goal: Don't Answer 30 Percent of Calls* (January 7, 2010), available at http://www.1to1media.com/weblog/2010/01/the_irs_customer_service_goal.html.

⁹ Advocate's Report, *supra* note 5 at Summary.

6.1 billion hours annually to comply with the complex requirements of the law.¹⁰ It has also been estimated that U.S. taxpayers spend over \$160 billion annually just to comply with income tax requirements.¹¹ Because of complexity, more than 60% of taxpayers pay a preparer to complete their returns, and about 22% purchase tax software to assist them in preparing their own return.¹² This means that individuals and businesses are spending resources on tax preparation that could otherwise be invested back into their own business and job creation.

The hearings will focus on a select few issues that increase the complexity of small business returns. These include aggressive state treasury tactics to impose withholding requirements on out-of-state companies, requirements to claim the § 199 domestic manufacturing deduction and the research and experimentation (R&E) credit, and the complex compliance challenges of trying to expand outside the United States. Other issues, including administrative complexity, are also likely to be raised. For small businesses, compliance is tedious and expensive.

B. Cost of Tax Compliance for Small Firms

According to the SBA, small businesses spend more than 5.5 billion hours fulfilling their income tax obligations.¹³ Of course, this does not include other tax obligations, such as state and local taxes. In 2012, the National Taxpayer Advocate reported estimated that it took a total of 6.1 billion hours for taxpayers to handle all their taxes. This was down from 7.6 billion hours in 2008, probably due to the efficiencies of tax software.¹⁴

The SBA report found that in general, the annual tax compliance burden of small businesses increases as the size of the business and its receipts increases.¹⁵ In 2004, the average number of hours spent on tax compliance by sole proprietors was 32 hours, by partnerships 55 hours and S corporations 314 hours.¹⁶ Small business owners have said that the cost of tax compliance is wasted money and effort, and that making it easier to comply would lower costs for both the public and private sectors.¹⁷

Even a simple mistake may have consequences. The number of federal income tax returns that the IRS examined increased over the past few years, with one out of every 90 taxpayers examined in Fiscal Year 2010.¹⁸ That represents an increase of 23% from Fiscal Year 2006, when about one

¹⁰ *Id.*

¹¹ *Id.*

¹² Nina E. Olson, *We Still Need a Simpler Tax Code*, WALL ST. J., April 10, 2009.

¹³ OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, MEASURING AND MODELING THE FEDERAL INCOME TAX COMPLIANCE BURDEN OF SMALL BUSINESSES (Sept. 2011) [hereinafter "SBA report"], available at <http://www.sba.gov/sites/default/files/files/rs382tot.pdf>.

¹⁴ OFFICE OF THE NATIONAL TAXPAYER ADVOCATE, UNITED STATES INTERNAL REVENUE SERVICE, REPORT TO CONGRESS (2011), available at: <http://www.taxpayeradvocate.irs.gov/Media-Resources/FY-2011-Annual-Report-To-Congress-Full-Report>.

¹⁵ OFFICE OF ADVOCACY, UNITED STATES SMALL BUSINESS ADMINISTRATION, MEASURING AND MODELING THE FEDERAL INCOME TAX COMPLIANCE BURDEN OF SMALL BUSINESSES, (Sept. 2011), available at <http://www.sba.gov/sites/default/files/files/rs382tot.pdf>.

¹⁶ *Id.*

¹⁷ Email from Tim Reynolds, President, Tribute, Inc. to Committee Staff, March 26, 2014 (on file with the recipient).

¹⁸ TREASURY INSPECTOR GENERAL FOR TAX COMPLIANCE, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2010 9, July 18, 2011, available at <http://www.treasury.gov/tigta/auditreports/2011reports/201130071fr.pdf>.

of every 108 individual tax returns was examined.¹⁹ The IRS has also strengthened its use of enforcement tools, such as liens, levies and seizures.²⁰

In recent years, the IRS has attempted to reduce the tax gap – the difference between what the IRS collects on time and what it believes taxpayers owe. As a result, the IRS increased its audits of businesses.²¹ Simplifying the code could help reduce audits of small business owners who are non-compliant simply because they cannot decipher the code.

II. Mobile Workforce Issues

The United States is an interconnected, mobile economy. The modern workforce isn't stationary—many people travel all over the country to do their jobs. These employees and their employers are forced to comply with a patchwork of confusing, outdated, and sometimes predatory nonresident state income tax laws.²²

States currently have inconsistent, varying standards and requirements for employees to file personal income tax returns when traveling to a nonresident state for temporary work periods, and for employers to withhold income tax for those employees. Employees who travel outside of their states of residence for business purposes are subject to onerous administrative burdens because they may be legally required to file an income tax return in every other state into which they traveled, even if they were there for only one day.²³ Employers are similarly required to incur extraordinary expenses in their efforts to comply with the states' widely divergent withholding requirements for employee business travel to nonresident states. In some cases, requirements for employees and employers do not match up. Just keeping track of these requirements is incredibly complex, and on top of that is the cost of actually complying.²⁴

More than half of the states that have a personal income tax require employers to withhold tax from a nonresident employee's wages beginning with the *first day* the nonresident employee travels to the state for business purposes (maroon states on the map below). Other personal income tax states provide for a threshold before requiring tax withholding for nonresident employees (teal states). See map below.²⁵

¹⁹ *Id.*

²⁰ *Id.*

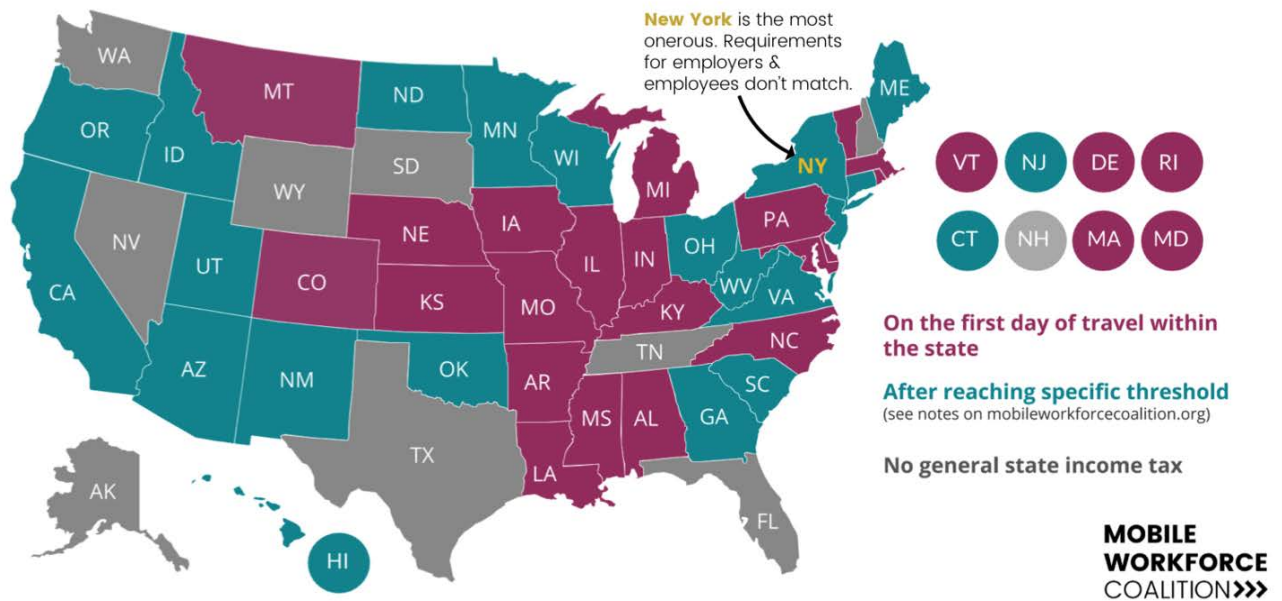
²¹ *Id.*

²² Mobile Workforce Coalition website, www.mobileworkforcecoalition.org.

²³ *Id.*, see map on following page.

²⁴ *Id.*

²⁵ *Id.*



On May 14, 2015, Representatives Mike Bishop (R-8th MI) and Hank Johnson (D-4th GA) sought to address this problem by introducing H.R. 2315, the Mobile Workforce State Income Tax Simplification Act of 2015. The bill provides for a uniform, fair, and easily administered law and helps to ensure that the correct amount of tax is withheld and paid to the states without the undue burden that the current system places on employees and employers.²⁶ It does so by establishing a uniform 30-day threshold before income tax liability attaches and withholding is required.²⁷

Consistent with current law, the bill provides that an employee's earnings are subject to full tax in his or her state of residence. Further, an employee's earnings would be subject to income tax in the state(s) in which the employee is present and performing duties for more than 30 days during the calendar year. Nonresident employees who visit a state and perform employment duties for more than 30 days during a calendar year are subject to tax—and employers are required to withhold taxes—in the nonresident state from the date of commencement of duties performed by the employee in the nonresident state. As under current law, nonresident employees who visit a state for longer than 30 days (and are therefore subject to that state's nonresident filing and withholding rules) will still be able to take a credit against their resident state personal income tax liability for amounts paid to other states. The legislation does not cover professional entertainers, professional athletes, and certain public figures.²⁸

H.R. 2315 has 134 cosponsors, including Chairman Chabot.²⁹ H.R. 2315 was passed by the Committee on the Judiciary on a 23-4 vote on June 17, 2015, and was ordered to be reported. A companion bill, S. 386, was introduced on February 5, 2015, by Senators John Thune (R-SD) and

²⁶ *Id.*

²⁷ H.R. 2315, 114th Cong. (2015).

²⁸ *Id.*

²⁹ Chairman Huelskamp has recently agreed to cosponsor the bill, but as of this writing is not yet officially listed as a cosponsor with the House of Representatives.

Sherrod Brown (D-OH) and currently has 18 cosponsors. A similar bill was passed by the full House of Representatives on the suspension calendar during the 112th Congress and was reported to the Senate.³⁰

III. Section 199 Domestic Manufacturing Deduction and the Research and Experimentation Credit

CPAs and attorneys who serve the small business community have observed that there is a significant amount of self-censorship in the areas of the domestic manufacturing deduction³¹ and the research and experimentation (R&D) tax credit.³² Small businesses that are eligible for these provisions simply don't claim them. In some cases, it results from companies not being aware that these provisions exist, and in others it stems from the perception that they are just too complicated to be worth the effort.

A. Section 199 Domestic Manufacturing Deduction

The domestic production activities deduction was enacted as part of the American Jobs Creation Act of 2004.³³ Basically, a business engaged in "qualified production activities" can deduct up to 9% of their net income derived from those activities. Qualified production activities include:

- Manufacturing based in the United States;
- Selling, leasing, or licensing items that have been manufactured in the United States;
- Selling, leasing, licensing motion pictures that have been produced in the United States;
- Construction services in the United States, including building and renovation of residential and commercial properties;
- Engineering and architectural services relating to a domestic-based construction project; and
- Software development in the United States, including the development of video games.³⁴

Section 199 entails a very complex set of rules, and claiming the deduction can be either very simple or enormously complex, depending on the nature of the business.³⁵ Additionally, the dollar amount of the deduction is subject to several limitations. The deduction is taken at the individual level and is limited to adjusted gross income in the case of pass-throughs.³⁶ For corporations, the deduction is limited to taxable income.³⁷ Also, it cannot exceed 50% of W-2 wages.³⁸

³⁰ House Report 112-386, MOBILE WORKFORCE STATE INCOME TAX SIMPLIFICATION ACT OF 2011, February 3, 2012.

³¹ 26 U.S.C. § 199.

³² 26 U.S.C. § 41.

³³ Pub. L. No. 108-357, 118 Stat. 1424 (2004), codified at §199 of the Internal Revenue Code.

³⁴ William Perez, *Domestic Production Activities Deduction* (undated), available at <http://taxes.about.com/od/deductionscredits/a/domesticproduct.htm>.

³⁵ *Id.*

³⁶ I.R.C. §199(d).

³⁷ I.R.C. §199(a).

³⁸ I.R.C. §199(b).

B. The Research and Experimentation Tax Credit (the R&D credit)

The R&D credit is a general business tax credit codified under section 41 of the Internal Revenue Code. It was originally introduced in the Economic Recovery Tax Act of 1981, sponsored by Representative Jack Kemp and Senator William Roth,³⁹ and was intended to incentivize technological advances and hiring in the United States.⁴⁰

Often, entrepreneurs overlook the R&D credit based on misperceptions of who is eligible. Some also fear that claiming the credit will trigger an IRS audit. According to IRS data from 2006, \$388 million in R&D credit was claimed on individual tax returns, including pass-through income.⁴¹ Given that the total “cost” of the credit would have been between \$5 and \$8 billion that year,⁴² a very small percentage is going to small businesses.

Frequently, small companies don’t know how to capture and quantify qualified research expenses. R&D expenses are frequently highest early in the business cycle, when a small company is developing its products.⁴³ Many countries provide additional incentives for small and medium-sized enterprises.⁴⁴ By contrast, the United States not only doesn’t provide any additional R&D tax credit benefit, it has historically erected barriers to smaller companies claiming the credit.⁴⁵

In recent years, several improvements have been made to eliminate these barriers and increase the effectiveness of the credit for small businesses. Two of these are discussed below.

The biggest barrier against small businesses claiming the R&D tax credit is that it could not be used if the business owner was subject to the alternative minimum tax (AMT).⁴⁶ This made the credit effectively useless for many pass-throughs. A survey conducted by alliantgroup of thousands of tax returns determined that 8 out of 10 businesses that would otherwise benefit from taking the R&D credit would receive little or no benefit because it could not be used to reduce AMT.⁴⁷ Given that the vast majority of small and medium-sized businesses are organized as pass-throughs, the provision disproportionately affected these businesses. This provision was changed in the Omnibus Spending Bill enacted in December of 2015 to allow the credit to be used against AMT liability.⁴⁸

³⁹ JOSEPH J. CORDES ET AL., ENCYCLOPEDIA OF TAXATION AND TAX POLICY 330-332 (2005).

⁴⁰ Karen E. Klein, *The R&D Tax Credit Explained for Small Business*, BLOOMBERG BUSINESS (August 16, 2011), available at <http://www.bloomberg.com/small-business/the-rampd-tax-credit-explained-for-small-business-08162011.html>.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Making the R&D Tax Credit Work for Small and Medium Businesses: Hearing before the United States Senate, Committee on Finance*, 112th Congress, First Session (September 20, 2011) (testimony of alliantgroup submitted for the written record) [hereinafter alliantgroup testimony].

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Pub. L. No. 114-113 (2015).

The alternative simplified credit (ASC) was included as part of the R&D credit in 2006 to expand the number of companies that would be able to claim the R&D credit.⁴⁹ The implementing regulations then limited its availability by providing that only the traditional credit could be claimed on an amended return and the ASC could not.⁵⁰ This regulation was amended in May of 2014 to remove this limitation.⁵¹

These and other recent changes are a good start toward simplifying the use of the credit for small businesses and increasing its availability to the population it was intended to benefit. The hearing will examine whether these changes go far enough and whether more can or should be done in this area.

IV. International Expansion

Finally, one of the most complex areas that is fraught with pitfalls for small businesses is cross-border expansion. With some exceptions, small businesses are generally interested in growing and becoming bigger businesses. As the world becomes smaller, this frequently entails engaging in cross border activities involving customers, suppliers, and, possibly, locations in other countries. This necessarily implicates more than one country's taxing jurisdiction. Obviously, every country's system is different, and learning about and complying with another country's rules is a high hurdle in and of itself. However, there are some traps for the unwary in United States law as well.

For example, the Financial Crimes Enforcement Network (FinCEN) imposes special requirements if the business opens a bank account in a foreign jurisdiction. These are the Report of Foreign Bank and Financial Accounts (FBAR) filing requirements.⁵² FBAR reporting is required for basically any type of foreign financial accounts with an aggregate value exceeding \$10,000. The report must be filed electronically each year by June 30, and no extensions are available.⁵³ Failure to file triggers strict penalties, both criminal and civil.

For willful violations, the maximum civil penalty is the greater of \$100,000 or 50% of the balance of the account at the time of the violation.⁵⁴ This penalty is imposed for each year for which the filing requirement was not met. For violations deemed to not be willful, then the penalty is limited to \$10,000 per violation. However, the IRS deems there to be a separate violation for each account not reported. Again, this penalty is imposed annually. If failure to file is due to "reasonable cause," the penalty may be waived, but the IRS is unlikely to find in the taxpayer's favor on this point.⁵⁵

⁴⁹ Alliantgroup testimony, *supra* note 44.

⁵⁰ Treas. Reg. §1.41-9(b)(2) (2011).

⁵¹ Treas. Reg. §1.41-9, §1.41-9T (2014).

⁵² See IRS Form 8938, *Statement of Specified Foreign Financial Assets* (2015) and FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (Oct. 2013).

⁵³ FRAZIER & DEETER CPAS AND ADVISORS, INSIGHTS – FOREIGN BANK ACCOUNT REPORTING (May 29, 2014), available at <http://www.frazierdeeter.com/en/Insights/Articles/Individual-Tax/FBAR-Explained.aspx>.

⁵⁴ 31 U.S.C. 5321(a)(5).

⁵⁵ BRAGER TAX GROUP, WHAT ARE THE PENALTIES FOR FAILING TO FILE A FOREIGN BANK ACCOUNT REPORT 90-22.1 (FBAR)? (undated), available at <https://www.bragerlaw.com/what-are-the-penalties-for-failing-to-file-a-foreign-bank-accoun.html>.

Smaller companies looking to expand are frequently not as sophisticated as their larger counterparts, and mistakes like this can too easily occur. These penalties are set dollar amounts, with no real sliding scale for smaller businesses.

While there is little this Committee can do to ameliorate the complexity of applying tax laws required by other countries, this hearing will examine how the United States might be able to reduce the complexity of our own compliance burdens and encourage our small businesses as they grow beyond our borders.

I. Conclusion

As Congress and the Committee pursue the goal of overall tax reform, simplification of the Tax Code remains key. Small businesses are our nation's job creators. However, if they are continually mired in increasingly complex rules just to stay compliant with our tax laws, it takes valuable resources – in the form of time and money – away from their businesses, increases the likelihood of error, and lowers voluntary compliance. The Subcommittee will hear from a panel of private sector witnesses who will discuss the complex compliance burdens borne by small businesses and potential solutions. The Committee will later hear from IRS Commissioner John Koskinen, who will also address these types of issues from the agency perspective.