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House Ways and Means Committee
Examining the Burdens Imposed by the Current Federal Tax System and
the Need for Reform

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Good morning, Chairman Camp, Ranking Member Levin, and members of the Committee. I am pleased to be here both as a small business owner and as a tax professional assisting small businesses.

My business, Hudak and Co, provides a full-range of tax services for small businesses, so I know first-hand the challenges that my clients and our company face in complying with the tax code. The complexities of the current tax code are especially onerous on small businesses. I appreciate that the Committee is interested in hearing from an active tax professional who has worked with numerous small business owners to get the help they needed to keep up with the changing federal tax laws.

In addition, I am a member of the National Federation of Independent Business (NFIB), the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. The results of the most recent NFIB Research Foundation's Small Business Problems and Priorities survey shows the challenges the tax code presents for small businesses. Four of the top ten issues identified in the survey are tax-related. Specifically, federal taxes ranked third and tax complexity ranked fifth.¹

The results of surveys like this, as well as the tax issues raised by small business clients like mine, demonstrate the need for tax reform. In addition, a less complicated tax code would reduce the cost of doing business and create a stronger business environment supporting the overall economy. Beginning the conversation early in this new Congress is a good first step.

Small businesses face particular challenges when complying with the tax code and they are unique to the structure and function of a smaller business. Small businesses are not miniature versions of larger corporations. While tax laws impact each small business differently, there are two general principles to keep in mind when considering taxes and small businesses. First, the business and the business owner cannot be separated and second, the tax code is too complicated.

The Business and the Business Owner Cannot be Separated

No matter what business entity the small business owner chooses, you cannot separate the business owner from the business. The majority of small businesses are organized as pass through entities, with nearly 75-percent choosing a pass through business structure.²

¹ William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.

² Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 4, Issue 7, 2004.

Pass through businesses play an important role in the economy and have been a growing source of entrepreneurship. From 1985 to 2005, the number of S Corps increased from 725,000 to 3.7 million and from 1993 to 2005 the number of LLCs taxed as partnerships grew from 17,000 to almost 1.5 million.³ Many of these are small businesses, which account for about 50 percent of GDP and 50 percent of employment in the overall economy.⁴

Business entities are chosen for different reasons. Entities such as sole proprietorships and S-Corps can ensure that a small business is not overburdened with extra layers of taxation. In other cases, entities like C-Corps, S-Corps, and LLCs can protect the business owner from personal liability. While the variety of business entities may lead to additional rules in the code, various models provide the business owner with more flexibility to organize their business in a way that best suits the needs of the business. The structures allow the business owner to make decisions based on the fundamentals of their business. If the business grows or changes, the different entities allow the business owner to adapt so that the business continues to operate effectively.⁵

The tax implications of choosing a pass through entity should play a major role in the tax reform debate. Discussions about tax reform are often coupled with a discussion about lowering the corporate tax rate. There is certainly an argument to be made that the corporate tax rate is too high, especially relative to the rest of the world, and the corporate provisions of the tax code are filled with complexity. But it is necessary to recognize the important role played by small businesses and the impact they have on the economy. The pass through rules helped to spur entrepreneurship, partially because of the tax treatment afforded to these business entities. That is why keeping in mind the importance of the individual tax rates that most small businesses pay should be part of any debate about tax reform.

Congress should also closely examine the rules governing pass through entities to determine if they need to be updated or simplified. The tax rules governing these business entities should not drive economic decisions. For example, some S Corp owners who either switched business entities or purchased another business are forced to hold onto certain assets known as built-in gain assets for up to 10 years.⁶ The idea of the holding period is to avoid certain abuses, but the current rules mean that a business may be sitting on a productive asset for a decade.

³ *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper*, U.S. Department of the Treasury, July 23, 2007.

⁴ *How Important is Small Business to the U.S. Economy*, Frequently Asked Questions, SBA Office of Advocacy. (<http://www.sba.gov/advocacy/7495/8420>).

⁵ Small businesses rarely change their business structure, with only about seven-percent of businesses making a change. The main two reasons why businesses changed entities were liability protection and taxes respectively. The change is usually made in response to a major change in the business itself. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 4, Issue 7; 2004.

⁶ 26 U.S.C. 1374.

While the pass through rules help many small business owners and entrepreneurs, one area of the pass through rules problematic to these owners is the tax treatment of health insurance. The value of health insurance is not excludable from income for the self employed as it is for employees or owners of C Corps. This creates an inequity for many small business owners and increases the complexity of the code. In the Small Business Jobs Act, Congress provided a one-year of equal tax treatment for the self employed, but only for 2010.⁷

The Tax Code is Too Complicated - Keep It Simple

Small businesses spend annually between 1.7 billion to 1.8 billion hours on tax compliance and \$18 billion to \$19 billion on compliance costs.⁸ The result is that 88 percent of small business owners now hire a paid tax preparer to complete their returns.⁹ Small business owners also spend on average \$74.24 per hour on the paperwork associated with tax compliance – the highest paperwork cost imposed on small business by the federal government.¹⁰

This is exactly what I see in my own business. My average client employs about 10 workers and their average tax return is more than 50 pages long.

The complicated and, in many ways unpredictable tax code, places a heavy burden on small business owners. Unlike a larger business, small businesses generally do not have a finance department or a staff of accountants and lawyers to focus on the nuances and changes in the tax laws. Ultimately, this leads to additional costs and takes money away from the day-to-day business operations or investing in and expanding the business.

The confusing tax code leads to more errors. The vast majority of small business owners try to comply with their tax obligations, but a direct correlation exists between the ability to comply and small business owners actually meeting their tax obligations.

Key Challenges Facing Small Business

First, too many provisions in the tax code are temporary, adding to the confusion and complexity of the code. In fact, in the NFIB Problems and Priorities survey “frequent changes in the federal tax laws” was noted as one of the top tax problems. The Alternative Minimum Tax (AMT) is an example of this problem. For the past few years, Congress has provided taxpayers, many of whom are small businesses, with relief from the AMT. Unfortunately, this relief was not finalized until the end of the year. Delaying

⁷ Section 2402 of the Small Business Jobs Act of 2010; P.L. 111-240

⁸ Donald DeLuca, Scott Silmar, John Guyton, Wu-Lang Lee, and John O’Hare, “Aggregate Estimates of Small Business Taxpayer Compliance Burden,” Proceedings of the 2007 IRS Research Conference.

⁹ *Tax Complexity and the IRS – NFIB Small Business Poll*; NFIB Research Foundation; Washington, DC, Volume 6, Issue 6, 2006.

¹⁰ *Paperwork and Record Keeping – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 3, Issue 5; 2003.

such relief prevents taxpayers from knowing what their liability will be and, when passed late in the year, adds to the tax filing burden.

Section 179 expensing is another example of uncertainty in the tax code. Congress has continued to change the allowable amount of section 179 expensing and the current rules are set to expire in 2012. Expensing simplifies the tax code for small business. Instead of following complicated depreciation schedules and keeping the paperwork associated with the investment, the business owner can simply claim the deduction in the year the investment is made. Expensing simplifies the deduction for allowable business investments and puts money back into the business faster. If Congress fails to act, expensing will be reduced to \$25,000. Setting the expensing limit permanently at \$125,000 (adjusted for inflation) would provide businesses with the ability to plan when making investments.

Second, Congress should not make tax filing more complicated and add to the already high paperwork burden. The expanded 1099 reporting requirements included in the Patient Protection and Affordable Care Act (PPACA) demonstrates what not to do.¹¹ In an attempt to find additional revenue, PPACA created a major new reporting requirement on small businesses. This new requirement means that small businesses will have to report annually on all transactions that cumulatively exceed \$600. This is a massive new paperwork and reporting requirement making complying with the tax code more complicated and expensive. The new reporting requirement should be repealed.

Third, provisions of the code should not be so onerous that taxpayers avoid them. This is the case with the home office deduction. Home-based businesses are one of the fastest growing areas of small businesses, but the current deduction is especially complicated requiring the business owner to determine how much of the home is used for business and to keep detailed records to substantiate the deduction. The one-page form used to claim the deduction refers the taxpayer to the instructions 13 times.¹² Many small business owners avoid the deduction because of the complications and the fear of a potential audit.¹³

Finally, the complexity of the tax code too often drives business decisions. My clients do not think strategically about their business, but tactically because the tax code forces them in that direction. The tax code rewards consumption and debt financing, as opposed to capital formation and saving. Savings and investments are often double taxed and many tax incentives are too complicated or arbitrary. Any examination of the tax code must consider the kinds of incentives currently in the code and what kind of tax laws would best promote sound economic and business decisions.

¹¹ Section 9006 of the Patient Protection and Affordable Care Act.

¹² IRS Form 8829, Expenses for Business Use of Your Home.

¹³ Only 27% of businesses located in the home and 36% of businesses with a primary office in the home claimed the deduction. The top reasons for not claiming the deduction were that the it was too complicated or they were advised against it for fear of an audit. *Business Activity in the Home – NFIB Small Business Poll*, NFIB Research Foundation; Washington, DC; Volume 8, Issue 4; 2008.

Conclusion

Small businesses are a major source of economic activity and job creation in the economy. But small businesses have struggled to recover from the recession. The most recent NFIB Small Business Economic Trend Survey (SBET) shows that many small businesses are still struggling, although they are more confident that conditions will improve. Fundamental tax reform is one way that Congress can create an economic environment which helps small businesses to thrive. By improving our tax system, Congress can address a constant concern of small businesses, reduce the cost of doing business, and create a tax system that will support economic growth.