PREPARED STATEMENT OF LAWRENCE B. GIBBS

Thank you for inviting me to provide the Committee with comments about the impact of several tax legislative proposals to ameliorate the effect of certain increasing costs of small businesses, including a possible increase in the minimum wage. My comments assume the Committee has made or will make the policy decision to consider tax reduction proposals to reduce the impact on small businesses of these costs.

Recently, we have read and heard a great deal about the importance of after-tax earnings per share to the executives and shareholders of corporations whose stock is traded on Wall Street. To the owners of small businesses on Main Street, however, after-tax cash flow is much more important. After-tax cash flow is important because it provides: cash to pay back the mortgage and other borrowings. Cash to carry larger inventories. Cash to buy new machinery and equipment. Cash to expand and to hire and train new employees.

Recently, we have read and heard a great deal about some Wall Street companies that take advantage of the complexity of our federal tax laws to reduce their taxes. For the small businesses on Main Street, tax complexity often is a cost burden rather than a savings opportunity.

Recently, we have read and heard a great deal about some Wall Street companies that seek a competitive advantage through tax reduction transactions, some of which represent appropriate tax planning techniques and others of which are abusive tax shelters. Main Street small businesses that usually cannot afford expensive tax consultants are more concerned about ensuring a level tax playing field, so that their competitors cannot use tax techniques to gain a competitive advantage, and about clear rules, so they do not have to worry about possible disagreements with the IRS about how the rules apply to their businesses.

Therefore, as the Committee begins to consider tax proposals to assist small businesses, I would urge that you consider relatively straight forward, easy to understand proposals that will increase after-tax cash and minimize competitive disadvantage. As you know and we will learn again, these three goals – tax proposals that are simple, efficient and fair – are easy to state and hard to obtain, particularly when they compete with one another.

1. Increasing section 179 deductions. The usual tax rule is that the cost of new property used in a trade or business must be capitalized and depreciated over time. Currently, section 179 provides a limited exception to the normal rule by permitting business taxpayers to elect to deduct (rather than capitalize and depreciate) a portion of the cost of certain new business property. The deduction is allowed in the year the new property is placed in service, up to $24,000, except that the $24,000 is reduced proportionately by the cost of such new property placed in service that is in excess of $200,000. Last year the Committee considered a proposal that would (a) increase the amount of the deduction from $24,000 to $35,000 and (b) increase the point at which the deduction is reduced from $200,000 to $325,000.

The proposal is relatively straightforward and easy to understand. Most small businesses are aware of and used to claiming deductions under section 179. Small businesses would benefit from this proposal because it would permit them to deduct more of the cost of property that they purchase to use in their businesses, thereby reducing their taxes and increasing their after-tax cash flow. Although the deduction is an exception to the normal rule requiring capitalization and depreciation, the policy decision to permit this exception has been in Code for over 20 years and, therefore, is well established. By increasing the point at which the deduction begins to be reduced, under this proposal, more types of property would qualify for the maximum deduction, thereby reducing competitive disadvantages among taxpayers, albeit at a cost to the fisc. Finally, the IRS has been administering this provision for over 20 years, and the proposed changes do not appear to involve any unusual administrative difficulties.

2. Increasing depreciation deductions. There are several proposals to increase depreciation deductions available to small businesses. Some would shorten the period of time over which the cost of leasehold improvements could be recovered by a business, thereby increasing the amount of the annual depreciation deduction and increasing the amount of after-tax cash flow to small businesses that lease and improve property they use in their business. Other proposals would permit the cost of office furniture to be recovered over 5 years or permit the cost of certain retail restaurant property to be recovered over 15 years.

Although I am not an economist, to the extent that these provisions would more closely match the depreciation period to the economic useful life of the affected business properties, they would seem to be supported by sound economic principles. For many of the reasons similar to those previously indicated above in discussion about increasing section 179 deductions, these depreciation deduction proposals would appear to benefit small businesses without unduly adding complexity to the Code, causing major competitive disadvantages, or creating major administrative burdens for the IRS.

3. Proposals to reform the requirements applicable to S corporations. There are several proposals to change the requirements applicable to S corporations, which are entities created under state incorporation statutes that generally protect the owners from personal liability with respect to the business activities at the corporate level. Unlike regular corporations that pay taxes on net business profits at the corporate level and again at the shareholder level when the after-tax profits are distributed to the shareholders, the business net profits of an S corporation generally are not taxed at the entity level but are taxed to the corporation's owners. Previously, S corporations were popular among small businesses owners who wished to pay only one tax on their business net profits and who also wanted the limited liability protection afforded by the use of a corporation.

Because of the complexity of the numerous tax rules applicable to S corporations and the severity of the tax cost if the rules were violated, small business owners faced the dilemma of whether (a) to incur the ongoing costs of a tax consultant in order to avoid violating the complex rules or (b) to risk incurring substantial, unanticipated taxes if the rules were violated in the absence of a tax consultant's day-to-day advice.

More recently, under rules issued by the Treasury and the IRS, many small business owners have been able to use limited liability companies ("LLCs") to obtain the benefit of protection from liability for the business activities at the entity level and also enjoy the economic benefit of paying only one level of tax, by electing to treat the LLC as a partnership for tax purposes. However, some small businesses are prevented from using LLCs to conduct their business. Other small businesses that previously have chosen to use a corporate form cannot switch to a partnership form without incurring potentially substantial taxes or risking the possibility of having to pay such taxes.

Because my law firm has been retained by private clients to request that certain, specific changes be made in the requirements applicable to S corporations, I do not wish to discuss the specific changes that are being proposed to the S corporation requirements. However, I do wish to make a general observation. The policy decision has been made to permit new small business owners to use an LLC to conduct its business and thereby avoid payment or risk of payment of two levels of tax – one at the entity level and one at the ownership level – and also to avoid the tax complexities and risks of an S corporation. In light of that policy decision, I would urge the Committee to take a hard look at proposed changes in the S corporation rules that would permit the appropriate reduction or elimination of the existing S corporation complexities in order to permit existing S corporations to more closely match the greater tax simplicity of the LLCs, to achieve the tax efficiencies of the LLCs, and to avoid the after-tax disadvantages now faced in competing with the LLCs.

4. Self-employment tax changes for unincorporated small businesses. The Taxation Section of the American Bar Association and the Tax Division of the American Society of Certified Public Accountants previously have proposed amendments to section 1402(a)(13) of the Code, and I believe the Committee should consider these proposals in connection with its consideration of proposals to assist small businesses. The problem addressed by these proposals arises, in part, out of statutory amendments to section 1402(a)(13) enacted in 1977 after some taxpayers were becoming limited partners to attempt to qualify for Social Security benefits through the payment of self-employment tax, Social Security, and Medicare ("SECA taxes"). A number of changes have occurred over the last 25 years, including changes in the state laws applicable to limited partnerships, the increasing importance of LLCs, the treatment of LLCs as partnerships for tax purposes under certain circumstances pursuant to the so-called "check-the-box" entity classification regulations (effective for 1997), and the issuance of two sets of Treasury regulations (in 1994 and 1997) applying SECA taxes based on the 1977 provisions. The uncertainties and perceived inequities arising out of the confluence of these changes and a 1997 one-year statutory moratorium (that expired on July 1, 1998) prohibiting any further changes by regulation have caused small business owners and their tax advisors to request that changes be made in the statutory rules applicable in determining the amount of SECA taxes to be paid by owners of unincorporated small business entities.

Although the ABA Tax Section and AICPA Tax Division proposals have minor differences, they both seek to address the confusion that many small business owners now face when they conduct their businesses in the form of LLCs, partnerships (general or limited), or proprietorships. In such event, the confusion is over the extent to which amounts paid or distributed by the business to each of its owners constitute "net earnings from self-employment" for purposes of the SECA taxes. Both proposals would amend the provisions of section 1402(a)(13) to permit SECA taxes to be computed without the inclusion in "net earnings from self-employment" of distributions that represent a return of capital to an owner of a LLC, partnership or proprietorship, and both would provide for safe harbors that owners can elect to use in order to avoid the difficulties of having to deal with a test based on all of the facts and circumstances to determine the portions of distributions attributable to compensation for an owner's services and to a return of owner's invested capital. Both proposals provide for the Treasury to be given discretion to issue regulations to deal with anticipated (and unanticipated) issues and situations that will arise under the proposed new statutory rules.

The SECA taxes problems to which the proposals are directed are real for affected small business owners, particularly as Social Security and Medicare taxes continue to increase. The proposals appear to represent a reasonable attempt to balance taxpayer and Treasury needs. Therefore, I urge the Committee to consider making a statutory change in this area to address the confusion, inefficiencies, and costs that now exist for the IRS and small business owners alike.

5. Healthcare proposals. Several proposals have been made to increase the healthcare insurance deductions for self-employed individuals, so that they will be able to deduct all of their allowable healthcare costs.

Some might argue that the cost of a person's healthcare is a personal cost that should not be subsidized by the tax law. However, the policy decision long ago was made to encourage individual and family health insurance to be provided through business employment relationships. Thus, the federal tax law has long permitted corporations, as employers, to deduct the cost of the premiums of healthcare insurance and also has permitted the employees to avoid including the economic benefit of such employer-provided insurance in their taxable incomes.

As the cost of health and medical expenses has continued to rise, this policy has assumed increasing importance. In light of these growing costs, the failure of the existing employment system to provide health insurance coverage to over 45 million working Americans and their families has become a cause for national concern.

I would urge the Committee to reconsider the present failure to permit self-employed to be able to immediately deduct the cost of their health insurance premiums in light of these developments, rather than wait for the phase-in of the full deduction in the future. If necessary, I would suggest that such acceleration of the full deduction be made subject to whatever dollar limitations may be deemed appropriate to make the change feasible. However, I also would urge the Committee to carefully consider any other changes that would place self-employed small business owners in the same position as small businesses owners who are employed by their own corporations.

UNITED STATES SENATE
COMMITTEE ON FINANCE

PREPARED STATEMENT

OF

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WASHINGTON, DC

Hearing on

"Small Business and Rural Economic Development"

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