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April 14, 2015

Senator John Thune
Senator Benjamin L. Cardin
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Senator Thune and Senator Cardin:

It is heartening that the Senate Finance Committee has undertaken the hard but necessary work of reforming our tax code. Reforming the business portion of the code is of critical importance to restore strong economic growth and rising real wages.

Later this month, the Heritage Foundation will release a paper examining the adverse economic impact of the current business tax system and making broad recommendations for major reform.

In addition, I would like to provide 12 recommendations for reform that were included in testimony I delivered to the House Small Business Committee on March 4, 2015 ["Building an Opportunity Economy: The State of Small Business and Entrepreneurship," Testimony before the Committee on Small Business, United States House of Representatives, March 4, 2015 http://smallbusiness.house.gov/uploadedfiles/3-4-2015_final_burton_tesimony_final.pdf].

The recommendations are:

1. **Expensing of Investment in Machinery and Equipment.** Amend Internal Revenue Code §179 to permanently allow annual capital expenses of up to $1 million to be deducted when incurred. Expensing would simplify small firms' tax returns, reduce compliance costs, reduce small firms' cost of capital and aid cash flow.[1]

2. **Retirement Account Simplification.** Very few small employers offer retirement accounts because of the complexity, high compliance costs and regulatory risk of doing so.[2] This makes it more difficult for them to attract employees and more difficult for both the small business owners and their employees to save for retirement. This is one of the

[1] David Burton, "Constructive Small Business Expensing Bill Introduced," *The Daily Signal*, April 11, 2014 http://dailysignal.com/2014/04/11/constructive-small-business-expensing-bill-introduced/; Curtis Dubay, "Ways and Means Committee Following Right Approach on Tax Extenders," *The Daily Signal*, May 27, 2014 http://dailysignal.com/2014/05/27/ways-means-committee-following-right-approach-tax-extenders/.

[2] Kathryn Kobe, "Small Business Retirement Plan Availability and Worker Participation," Small Business Administration, Office of Advocacy, March 2010, Table 2 (only 28 percent of firms with under 100 employees offered some kind of retirement plan in 2006) https://www.sba.gov/sites/default/files/rs361tot.pdf.

most complex areas of the tax law and desperately in need of simplification.[3]

One possible solution would be to amend the Internal Revenue Code to create a Small Business Uniform Retirement Account as a voluntary alternative for employers with 500 or fewer employees to replace: (1) simplified employee pensions (SEPs), (2) salary reduction simplified employee pensions, (3) SIMPLE IRA plans, (4) SIMPLE 401(k) plans, (5) Keogh plans, (6) regular 401(k)s (with respect to employers with 500 or fewer employees), (7) profit-sharing plans (with respect to employers with 500 or fewer employees), (8) money purchase pension plan (with respect to employers with 500 or fewer employees), and (9) employee stock ownership plans (with respect to employers with 500 or fewer employees). The Small Business Uniform Retirement Account would (1) have check the box eligibility, (2) uniform employee eligibility, (3) automatic enrollment of employees with an option to opt-out, (4) no non-discrimination, coverage or key employee rules, (5) allow contribution levels to be chosen by the employee, (6) be maintained through a financial institution and (7) be available to employees and self-employed persons (including partners and LLC members).

3. **Reduce the Top Long-Term Capital Gains Tax Rate to 20 percent.** Evidence shows that a capital gains rate much above 20 percent actually reduces federal revenues. In addition, a high capital gains tax rate reduces the willingness of investors to invest in relatively risky start-up and growth companies and impedes capital formation. The top long-term capital gains tax rate should not exceed 20 percent (including the Obamacare investment income tax).[4]

4. **Permit Cash Method Accounting for Firms with up to $10 million in Gross Receipts.** Cash method accounting is simpler and aids cash flow.[5]

5. **S Corporation Liberalization.** Permit S corporations to have more than one class of stock, non-resident alien shareholders (subject to 30 percent withholding on dividends) and more than 100 shareholders. The latter is particularly important if S corporations are going to have practical access to the crowdfunding or Regulation A+ provisions in the

[3] See generally, David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs and Account Simplification," Testimony before The Committee on Ways and Means, United States House of Representatives, April 17, 2012 http://www.heritage.org/research/testimony/2012/04/pursuing-universal-retirement-security-through-automatic-iras-and-account-simplification.

[4] J.D. Foster, "Obama's Capital Gains Tax Hike Unlikely to Increase Revenues," Heritage Foundation Backgrounder #2391, March 24, 2010 http://www.heritage.org/research/reports/2010/03/obamas-capital-gains-tax-hike-unlikely-to-increase-revenues; Stephen J. Entin, 'President Obama's Capital Gains Tax Proposals: Bad for the Economy and the Budget," Tax Foundation January 21, 2015 http://taxfoundation.org/blog/president-obama-s-capital-gains-tax-proposals-bad-economy-and-budget.

[5] Then Ways and Means Committee Chairman Dave Camp proposed this in his Tax Reform Act of 2014 discussion draft. See section 3301 http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf.

JOBS Act which will allow companies to raise small amounts from a large number of investors using the internet once the SEC promulgates rules fully implementing the JOBS Act. It is preferably for the S corporation rules to emulate the partnership rules so there would be no shareholder limit but S corporation status would not be available to publicly traded corporations. See Internal Revenue Code §7704.

6. **Repeal the Obamacare Health Insurance Tax.** Obamacare imposes an excise tax on health insurance premiums that effectively is aimed at small businesses because larger firms self-insure (with or without stop-loss insurance) and therefore do not pay health insurance premiums. It is roughly equivalent to a 2.5 percent tax. This tax should be repealed.[6]

7. **Reduce Tax Rate of Pass-Through Entity Income to the Corporate Tax Rate.** Reduce the tax rate paid on income from S corporations and other pass-through entities (e.g. LLCs) to no more than the top corporate tax rate (currently 35 percent).

8. **Increase the Incentive Stock Option (ISO) Cap Limitation from $100,000 to $250,000.** Internal Revenue Code section 422(d) limits incentive stock options to $100,000 in aggregate stock value (not gain). This limits the utility of ISOs as a means to attract talent.

9. **Full Deductibility for Health Insurance Purchased by the Self-Employed.** Currently, health insurance costs incurred by the self-employed (which includes partners and LLC members) are deductible for income tax purposes but not for purposes of the 15.3 percent self-employment tax. This creates a special tax burden on the self-employed not borne by anyone else in the economy. There should be parity for the self-employed with those who are employed. Internal Revenue Code §162(l)(4) should be repealed.

10. **Clarify Rules Governing to What Extent Distributions from Pass-Through Entities are Subject to Payroll Taxes.** This issue has existed since at least the 1980s and it has never been adequately resolved. It causes a lot of audits and a lot of uncertainty. Reasonable, clear and uniform rules governing “reasonable compensation” and investment income should be adopted for partnerships, S corporations and C corporations.

11. **Clarify Employee/Independent Contractor Rules.** This issue has existed since at least the 1970s and it has never been adequately resolved. It causes a lot of audits and a lot of uncertainty. This is of even greater importance given the employer mandate in Obamacare. Provisions should be adopted allowing the employer to choose in ambiguous

[6] David R. Burton, "Obamacare’s Health Insurance Tax Targets Consumers and Small Businesses," Heritage Foundation Issue Brief #4075, October 31, 2013. http://www.heritage.org/research/reports/2013/10/obamacare-s-health-insurance-tax-targets-consumers-and-small-businesses.

cases, subject to 1099 reporting and moderate backup withholding, whether a payee is an employee or a contractor.[7]

12. **Estate and Gift Tax Reduction.** The unified credit should be increased so that $10 million is effectively excluded from the estate and gift tax. For 2015, the amount that is effectively excluded is $5.4 million. Family farms and businesses should not either have to be sold to pay estate taxes when parents die or incur huge life insurance premiums to provide the means of paying the tax.

Sincerely,

David R. Burton
Senior Fellow in Economic Policy
The Heritage Foundation

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[7] For general background see "Present Law and Background Relating to Worker Classification for Federal Tax Purposes," Joint Committee on Taxation, [JCX-26-07] May 8, 2007 http://www.jct.gov/x-26-07.pdf.