National Small Business Network

Balanced Tax Reform for Sustainable Economic Growth

Policy Recommendations for the 116th Congress – November 2019

In 2017, the Congress passed the Tax Cuts and Jobs Act (TCJA) which included many major tax policy changes. We believe the legislation did not achieve the objectives of good revenue neutral tax reform and needlessly added to the federal deficit, with potential long-term economic consequences. The legislation also contained provisions which were inconsistent, inequitable, and economically illogical. Before considering proposals to extend any TCJA provisions, Congress should instead work to correct and improve them.

The following additional recommendations for corrections and additions to the tax code, are suggested as part of a balanced program of both tax policy and budget policy actions to restore a sustainable Federal fiscal process. The detailed recommendations build on many of the concepts developed by prior House and Senate working groups, and other tax reform advisory groups. They focus primarily on business tax reform issues, particularly for small and mid-sized businesses, because those will have the greatest impact on job creation and general economic growth.

Deficit financed tax cuts, at a time of relatively strong economic growth, were not the solution to sustainable economic growth. The GAO and CBO have concluded "The federal government is on an unsustainable fiscal path" with spending exceeding revenue by almost $1 Trillion in fiscal 2019, and the projected debt growing to 100% of total GDP in just 12 years. Since last year's deficit was 3.9% of GDP most of our annual GDP growth has actually been artificial and just the result of increased debt pushed onto future generations Most economists believe that continuing deficits added to our $22 Trillion national debt will reduce long-term economic growth, and are a very real threat to the future sustainability of our economy. We agree with the CBO and GAO recommendations, and those of other study groups. See our more complete Fiscal Policy Recommendations on our website at www.NationalSmallBusiness.net .

Our overall tax level is not the cause of our current economic and under employment problems. The total US average Federal, State, and local tax burden is the fourth lowest of all 34 OECD countries at 25.5% of GDP. Only Korea, Chile, and Mexico have lower average rates, and the average of all other OECD countries is 34.1% of GDP. With the exception of payroll taxes, most American businesses pay Federal taxes only when they are profitable. The current federal tax level on individuals and "pass-through" business entities is lower than it was during times of economic prosperity and growth. The pre-2018 stated business income tax rate on corporations was higher than other nations, but when adjusted for US business tax incentives and other taxes imposed by foreign countries, such as value added taxes, it was similar to other leading industrial nations. Even during a time of high corporation earnings, corporation income tax revenues have fallen from 5% of gross domestic product in 1952 to only about 1.9% today and will fall further with the lower TCJA rates.

General Tax Policy Recommendations for Future Tax Reform

To support sustainable economic growth, we believe that good tax code reform should meet these basic principles:

- **<u>Simplify and coordinate our overly complex tax code</u> to reduce both taxpayer and IRS administrative expense, and improve compliance.**

- **<u>Provide equitable tax incentives for the growth of small businesses that</u> provide over half of all new jobs. These are predominantly pass-through entities which require separation and equitable treatment of the net business income in the personal tax code.**

- **Incentivize <u>direct long-term investment</u> in businesses, buildings, and equipment that create new jobs, rather than short-term speculative transactions which may increase individual wealth, but create no new economic activity or jobs.**

- **Promote <u>domestic investment and job creation</u> to the greatest extent possible within the limitations of international agreements by focusing tax preferences on domestic investment.**

- **<u>Increase US international business competitiveness</u>, and also reduce the ability of multi-national corporations to avoid taxes by shifting profits under a territorial system to lower tax rate countries.**

- **<u>Assure that any tax code changes or federal expenditure increases are at least revenue neutral</u> and provide adequate overall revenue to gradually reduce our national debt and restore long-term fiscal stability.**

1**. Tax Simplicity, Clarity, Equitability, and Efficiency Recommendations:**

One of the key goals of tax reform was to simplify the complexity of the current code, and provide greater tax system clarity and equitability for different taxpayer entities. The TCJA actually complicated tax calculations by implementing the poorly conceived and poorly written Section 199A. The current code, which was built on successive layers of changes by past Congresses, has become too complex with too many adjustments, limitations and phase-outs for taxpayers to understand and comply with. Many provisions either purposely or unintentionally negate or limit the effects of other provisions. Other provisions have become outdated by changes in technology or business practices.

A. Increase the role of the Joint Committee on Taxation, Treasury Tax Policy and the IRS in assisting Members of Congress in the ongoing development of a simpler and better-coordinated federal tax code. Complexity makes it difficult for taxpayers, and even professional tax preparers, to understand and comply with the code. Complexity also increases the administrative burden on the IRS and makes it difficult for them to provide good taxpayer assistance and improve filing accuracy and taxpayer compliance. Often the IRS has to resolve legislative issues with hundreds of pages of detailed regulations which increases the administrative burden on the IRS, and often just further increases complexity for the taxpayer. The Congress should direct JCT, Treasury and the IRS to develop a joint working group to identify existing code issues requiring better legislative clarity or coordination, and a process to develop legislation to resolve them.

B. Continue to revitalize the management and business systems of the Internal Revenue Service to provide better taxpayer assistance and an efficient and equitable administration process. The ability of the IRS to properly and efficiently administer the tax code is currently hindered by incomplete improvements to vital business systems such as data processing and communication technology. The IRS is also facing increased administrative responsibilities, such as the TCJA, the ACA and FATCO, combined with declining budget allocations, and heavy turnover of key staff. With budget cuts, training has been reduced and staff expertise has declined. This is resulting in declining levels of performance in many areas and increased burdens on taxpayers and return preparers. The combination of a complex tax code, declining taxpayer assistance, inadequate IRS budgets, and reduced IRS training and staff levels will eventually threaten accurate and equitable enforcement of tax laws. If this happens, it will also reduce collection of the revenue needed for all other Federal programs and services.

Congress and the Administration need to recommit to the goals of the 1998 IRS Reform and Reorganization process by providing funding for better taxpayer assistance, support for improvements to technology systems, and stronger management emphasis on business process re-engineering for greater efficiency in the tax administration process. The IRS needs increased Congressional budget support and better proactive communication on agency issues. The Administration and the Senate also need to complete the revitalization of the IRS Oversight Board, rather than eliminating it, with additional nominations, to assist IRS management with continuing organizational improvements and improving communication with the Congress.

C. Provide <u>standard</u> tax code definitions and coordinated inflation adjustments for all limit and rate bracket provisions. Multiple definitions exist for many items of income and types of credits and deductions. These need to be standardized and simplified. Congress needs to review the Internal Revenue Code for fixed limitations and provisions, which are long overdue for inflationary adjustments, such as the business gift limitation, and update them. Then, adopt a single standard inflationary adjustment provision to replace the myriad of specific provisions in the code for rate brackets and all dollar limitations which should have periodic adjustment. The provisions should require a reasonable minimum inflation change before a periodic adjustment is made. We also support the tax clarity and simplification recommendations of the American Institute of Certified Public Accounts Tax Policy Committee.

D. Simplify <u>state income tax</u> nexus issues for multi-state businesses by adopting a modernized federal "Mobile Workforce" limitation on non-physical-nexus state income and business activity taxation, of both services and products. This should include digital products delivered from outside a state via public carriers and electronic transmission by businesses without state nexus. Modern electronic technology has greatly increased the ability of even small businesses to sell services nationally without any physical nexus in a state. Unfortunately, this increased capability, combined with increased legislative and enforcement activity by revenue starved state governments, is creating significant state income tax nexus problems for businesses.

Complying with out of state income tax or “business activity” tax laws for a small amount of out of state income often subjects small businesses to significantly higher accounting and tax preparation expenses, and a higher total tax liability.

E. Pass Marketplace Fairness legislation to facilitate each state’s right to use sales and consumption taxes, and simplify retailer remittance of interstate consumption taxes.
The Supreme Court’s Wayfair vs South Dakota decision clarified the right of states to require out of state sellers to collect state sales taxes, but created major new problems for both the states and retailers. Congress should support effective and efficient interstate, and international, collection of state sales and use taxes. Market Place Fairness legislation would provide an equitable business environment for those businesses that properly collect state sales taxes. A federal interstate sales tax administration legislation would not create any new taxes, but would simply enable states that have chosen to use consumption-based taxes to efficiently collect them on the growing volume of internet purchases. Because an increasing volume of internet direct to consumer sales are originating from outside the US, the Congress should also consider international agreements and other actions that can help states collect use taxes on foreign direct sales.

2. Capital Gains Tax Reform Recommendations:

Congress should encourage <u>long-term,</u> <u>direct,</u> capital investment by re-focusing the incentive on long-term capital gains, to remove taxation of the phantom gain from monetary inflation on assets held more than 10 years, to properly reflect the true constant dollar value of the gain. The provision should only be applied to <u>direct</u> economic investment in businesses, property, or business equipment, not in traded securities or other speculative investments that do not produce new economic activity.

Calculation of the adjustment would be simple, and require only a multiplication of the dollar gain using IRS supplied existing data on the cumulative inflation change from the year of purchase to the year of sale.

The current personal income tax code provides a lower tax rate for a “long-term capital gain” on an asset held for more than 365 days. This actually progressively penalizes longer-term investments that are held more than one year because of the failure to adjust for monetary inflation over the investment life. The investments that America needs to build a sustainable economy by starting or growing businesses, and building business infrastructure, are not 366-day investments. True long-term business investments may not provide a capital return for 10, 20, 30, or 40 years or longer. Even owners of relatively small businesses will generally be in the maximum rate bracket in the year they sell their business or business property resulting in taxation at the maximum rate.

The current law also provides the same tax treatment for individuals who invest in speculative secondary market investments such as traded stocks. Less than 1% of total traded stock purchases are for new or IPO stock that actually provides business capital for economic growth. Most traded stock purchases contribute no more to economic growth than gambling. Ironically, secondary economic investments like stocks currently have a greater tax benefit because they can be easily sold after 1 year when the tax benefit is greatest. Where the asset is a business or investment property, this short tax incentive peak also encourages the owners to focus on short-term “paper” profitability and the potential for resale, rather than long-term growth and sustainability. The 366-day incentive peak also encourages financial speculators to purchase and sell off asset rich businesses, rather than operating and growing them.

Almost all other value comparisons that extend over long periods such as economic statistics, government budgets, and other tax code provisions, are adjusted to remove the artificial effect of inflation. Although compensating for some inflation distortion is part of the justification for having a lower tax rate on capital gains, this is a classic case where a “one size fits all” approach is not appropriate. Based on the last 40 years of inflation, Federal taxes would actually exceed the total real economic gain on the sale of an asset after about 40 years at a 23.8% tax rate.

State Capital Gains Taxes, which are usually based on the federal calculation, can also add up to 10% additional tax on the inflationary increase. We recommend that an adjustment should be made on assets held for more than 10 years. The cost of correction legislation could be reduced by limiting the adjustment to business property or direct business investments where the taxpayer is an active participant. Potential revenue offsets for an inflation adjustment might also include increasing the “long-term” capital gains holding period to 2, 3 or 5 years, or slightly increasing the capital gains tax rates.

3. Other Small Business Tax Reform Issues

A. Permanently equalize the deductibility, up to a reasonable cost limit, of employee individual or group health insurance at the entity level for all forms of businesses.

For the year 2010 ONLY, the Small Business Jobs Act of 2010 finally allowed self-employed taxpayers, and partners, to deduct the cost of their health insurance, without paying payroll taxes on the insurance cost, as all corporations can. The equal and simple deductibility of owner health insurance, regardless of the legal form of business entity, has been a key issue for small businesses for many years. Prior Congressional action partly corrected this problem for S Corporation stockholders, but 21 million self-employed individuals are still required to treat their own health insurance as a non-business expense even if they provide identical coverage for their employees. This results in the taxpayer paying an additional 15.3% on the insurance expense. Because of their small group sizes, the self-employed already pay the highest relative insurance rates. This inability to deduct their own insurance has always been an emotional disincentive for small business owners to provide group health insurance for their other workers.

B. Provide equitable employee cafeteria benefit options for small business owners.

Small businesses compete for workers with large businesses and the public sector. Because of differing family situations, differences in benefit options available through other family members, or because of personal preferences, many employees often want different benefits than fellow workers.

The 2010 PPACA Health Care Bill included provisions for a simplified Cafeteria Plan. However, current restrictions make them unattractive for most small businesses, other than C corporations, because business owners cannot be part of the plan. Current law specifically prevents sole proprietors, partners, and sub chapter S corporation shareholders from participating in a cafeteria benefit plan. These limitations discourage small businesses from offering employees a very logical form of employment benefit and make small businesses less attractive for prospective employees.

C. Reinstate the employee business expense deduction and simplify the qualified home office deduction by allowing de-minimus personal use and the conducting of business using electronic technology.
The TCJA eliminated deductibility of all employee business expenses. Therefore, this deduction is no longer allowed to employees who are required to work from their home. This should be reinstated along with other employee business expenses.

Currently, <u>home</u>-based businesses represent about 52% of all American firms and generate 10% of the country's total GDP, or economic revenue based on SBA research. In the future, that percentage is likely to grow as new technologies and the Internet make new business models possible, and increase the ability of people to work remotely.

In 2012, the IRS provided a regulatory standard for a simplified home office calculation with a maximum deduction of $1500, but could not address some the basic statutory limitations of the existing code without Congressional action. Internal Revenue Code Section 280A(c) (1) defines the requirements that must be met to deduct home office expenses. It generally permits a deduction for a home office in a taxpayer's residence <u>only</u> if it is used "<u>exclusively</u> on a regular basis. This is a much higher standard than required of regular business or governmental offices. The code also requires the office to be "used by patients, clients, or customers". This language in the code has been interpreted by the IRS to require clients or customers to be <u>physically</u> present in the home office. Today, many businesses do business with their customers without any physical presence. Congress should change the code to allow some de-minimus personal activity in an otherwise qualified home office area, and to allow the use of digital business practices without requiring physical presence of the customer.

D. Simplify the matching of third-party payment reporting on Form 1099 K by correcting the law to require NET income reporting.
Congress made a technical error in the legislation *requiring* third party payment processors to report annual proceeds as an enforcement provision on a <u>gross</u> basis. The IRS has tried to work around this flaw in the legislation by building average estimates of what percentage of net income might result from gross transactions, but many businesses are not "average", and it is resulting in too many "false positive" examinations.

E. Return the contribution due date for IRA investments to the extended return due date.
Prior to the Tax Reform Act of 1986, standard IRA contributions, like all other retirement plan contributions, were permitted up to the earlier of the extended due date of the return, or when the return was filed. Their due date is now April 15, with no extensions. This causes a burden on taxpayers who have to make IRA contributions at the same time that both prior year final tax payments and their current year first quarter estimated tax payment are due.

F. Maintain a reasonable Federal Estate Tax exemption of at least $5M to allow better long-range estate planning, and protect mid-size family businesses and farms, but do <u>not</u> repeal the Estate Tax.
The current estate tax exemption of about $11 Million per person, or $22 Million per couple, which will end in 2026, is more than adequate to protect 99% of small family businesses and

farms from a federal estate tax impact. However, the estate tax is still an important business continuity issue for faster growing mid-size businesses and larger farms because of rising land values. The Estate tax <u>should not be repealed</u> though, because far more small businesses and farms would be hurt by high capital gains taxes when the businesses are sold to children or others, without the step-up in basis as part of the current Estate Tax**.**

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4. International Corporate Tax Policy Recommendations:

We believe Congress erred in adopting a territorial tax system for multinational corporations combined with lower tax rates as a way to make US businesses more competitive. The reduction of corporation taxes rates by other nations has been a race to the bottom, with a significant loss of tax revenue from businesses. Adoption of a territorial system, even with base erosion provisions will actually make permanent the incentive to move business activity to lower tax countries. We believe the Congress should either move to a Value Added Tax, or work with other nations to change the taxation of multi-national businesses (MNB) to a formulary allocation system based on their percentage of sales in each country. Either of these changes would remove the incentive for profit shifting to lower tax countries and corporate inversions. Either option would put US businesses on the same tax basis as foreign owned multinational businesses with US taxable income and remove some or all of the US income tax cost burden on exported goods.

The World-Wide Sales Factor Allocation Option: The current corporate income tax system allows multinational corporations, particularly those with high intellectual property values, to use inter-division accounting manipulations to shift taxable profits to divisions in lower tax countries where the earnings can multiply. This not only reduces US tax income, but also creates a tax incentive barrier to recognizing and re-investing those earnings in the US for domestic business growth.

If the US decides to continue to tax total net business income, it should tax the profit of Corporations from all their controlled foreign business subsidiaries and other investments on the "world-wide" basis. The worldwide taxable profit, and any tax credits, should then be apportioned on the basis of the percentage of final sales, or a combination of sales, assets, and employment in the US.

Allocating taxation of profits based on the location of sales or other factors has long been used to allocate profits of national businesses between the states. Currently 21 states use a single sales factor for allocating taxable profit and 17 states use a double weight sales or other factors allocation formula. It is also a logical way, with careful limitations and interaction with other countries, to allocate taxable profits internationally. Taxing on the basis of national sales would remove the incentive for profit shifting by multi-nationals. It would also discourage the game of countries bidding down their tax rates to attract tax shifting and allow them to increase revenue for their countries.

Formulary Allocation (FA) would be the simplest of "border adjustable" options, with few transition or regulation issues, and no negative impacts on domestic businesses. It would utilize the existing US corporate tax code and international accounting standards, up to the final step of per country allocation. MNBs, with US tax nexus would calculate taxable income on a worldwide basis, but only pay US income tax based on their percentage of sales, or other economic impact factors, in the US. FA meets the stated bi-partisan Congressional objectives for international tax reform, including removal of US income tax cost on American exports.

FA would make it easier for corporations to correctly calculate their US taxes, and for the IRS to accurately audit them since it would more closely match the unified reports MNBs produce for financial reporting purposes. The US states, and political subdivisions in some other countries, have used a sales factor, or multi factor allocation system including sales, employment, and assets, for many years. Most multi-national corporations with US state nexus already report their state income tax liability on that basis now. The US already taxes multinationals on a worldwide basis, except for foreign headquartered corporations, who are treated on an activity nexus basis very similar to the way they would be treated under a formulary allocation system. Although there is some potential for misrepresenting sales destinations, WTO regulations and the rules used by the states should provide a good basis for accuracy.

FA removes the incentive for “profit shifting" to lower tax countries by dividing total world-wide profit to be taxed based on a fairly clearly definable percentage of sales, or other factors, by country. Businesses would not want to reduce sales in the US, regardless of the tax rate. FA also removes the incentive for corporate inversions by taxing both domestic, and foreign corporations that have US tax nexus, on the same percentage of sales basis which should meet WTO standards for equal treatment.

FA removes the need for the US, and also for other nations, to try to "bid down" their corporation tax rates to undercut other countries and encourage profit shifting and asset relocation in their direction. If FA was adopted by other countries, it would also allow them to return their tax rates on MNBs to higher levels without losing revenue due to profit shifting.

FA would not be a "New Tax" that could be blamed on either political party. And FA is inherently border "adjusted". It would remove some or all of the US federal income tax cost from goods sold outside the US, making them more competitive. FA would also not disrupt most state corporate income tax systems, which are generally based on the current federal corporation code with formula allocation of unitary profits just as the federal tax would be. FA would give US multinational businesses permanent tax relief on export sales, rather than allowing permanent tax avoidance from MNB profit shifting, under a territorial system.

Although a detailed analysis is needed, FA could also increase overall US corporation tax revenue, based on historical data, while reducing tax avoidance and broadening the tax base, without creating a disincentive for US manufacturing and investment due to comparative tax rates. JCT should be asked to do an analysis using the most current and projected data, but FA would appear to be revenue positive. The increased tax revenue could be used to reduce the corporate tax rate, or pay down the deficit.

The Value Added Tax Option: The size of the national debt and annual budget deficits in relation to current income tax revenues makes it unlikely that Federal corporate and individual income taxes could significantly pay down the debt, even if quickly returned to previous levels. The only additional revenue generator with the potential to stabilize and reduce the deficit in conjunction with the income tax is probably a Value Added Tax. During the 2017 tax reform debate, many Republicans showed an interest in moving to a "consumption tax" and to also allow a refund of the tax on US exports, to promote international economic competitiveness. A VAT meets those requirements far better than previous proposals, and even at low rates has the potential to generate significant revenue, with relatively low complexity and lower potential for tax avoidance in an increasingly less "traceable" and international economy. We recommend that the Finance and Ways and Means Committees, with the leadership of the Joint Committee on Taxation, start a bi-partisan review of value-added taxation as a potential supplement to the income tax. Because consumption taxes tend to be somewhat regressive in impact, some adjustment would need to be made to income taxes to off-set the impact on lower income citizens.

5. Regaining fiscal stability will probably also require a Deficit Control Surtax Act:

Because of the very high level of partisanship that exists in this Congress, it will be very difficult for either party to take any leadership in balancing the budget by increasing taxes or reducing major expenditure programs. The only possible way to get agreement on increase revenue may be through a bipartisan <u>pre-agreement</u> on an "automatic" deficit control process similar to prior "pay-go" and budget sequestration laws. They weren't perfect, but they helped control deficits without either party having to take the political "blame" for the necessary actions. Congress should first try to balance expenditures with adequate tax revenue to pay for them using regular order and the process improvements suggested earlier. But as a "Fail-Safe" to prevent deficits, except in times of true national economic emergencies, we suggest the Congress adopt a provision which would provide for an <u>automatic income tax surtax</u> necessary to offset any prior budget year deficit.

Within 60 days of the end of each Federal fiscal year, the Congressional Budget Office would send to the Congress, a Budget Reconciliation Report listing the estimated amount of all federal expenditures and all estimated Federal revenue for the preceding fiscal year. If the estimated expenditures exceed the projected revenue, the report shall specify the amount of the deficit which will be collected under the Act as adjustments to the following years specified tax rates.

Within thirty days after a determination by the Congressional Budget Office that a revenue deficit existed for the prior fiscal year, the Department of the Treasury shall send to the Congress a determination of the uniform percentage of increase in tax rates for corporations; Individuals; heads of households; unmarried individuals other than surviving spouses and heads of households; married individuals filing jointly; married individuals filing separate returns; estates; and trusts that would be needed to collected the deficit amount.

Sixty days after the Congress receives notice of an automatic rate adjustment percentage determined by the Department of the Treasury, the rate adjustments would then be added by law, to the currently adopted tax rates for each income tax category for following calendar year, unless the Congress approves by a two-thirds majority vote of both houses a "Declaration of Economic Emergency Requiring Deficit Financing" to rescind or reduce the automatic tax rate adjustment. At the end of the following fiscal year, any revenue collected as a result of an automatic rate increase which exceeds the amount the original CBO determined deficit for the prior year, shall be used to reduce the outstanding national debt.

These recommendations were prepared for the National Small Business Network by
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The NSBN is a non-partisan, nonprofit, group that evolved from the 1995 White House Conference on Small Business Regional Tax Issue Chairs and does not represent the interests of any other organization or business.

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