Seven Ways
to Stimulate the Economy by Updating the Internal Revenue Code

A Report by the Committee on Small Business
of the U.S. House of Representatives

April 10, 2008

Introduction

As 2008 unfolds, the American economy is on the brink of a recession.[1] The sub-prime mortgage crisis is worsening and the financial market faces important challenges. Meanwhile, job cuts abound in construction and related industries, and the price of oil and other commodities has skyrocketed.

Small businesses can help get us back on track,[2] just as they have done so many times before. Unfortunately a remarkably outdated tax code stands in their way, and entrepreneurs are having to shoulder a disproportionate share of the tax burden. It is essential that these problems be addressed so that small firms can be treated fairly by the tax system and continue driving growth.

The U.S. tax code is more than 54,000 pages long, much of it dates back 40 years, and it has become nearly impossible for the average person to understand. A broad array of experts agree that comprehensive reform is needed, but a top-to-bottom restructuring of the Code would be arduous and time consuming.

The House Committee on Small Business believes a targeted modernization of particularly outdated provisions can be accomplished in a short period of time—and without delay. Descriptions of seven such provisions—and recommendations on how to modify them—are the core of this report.

[1] Chairman Bernanke highlighted the many struggles our economy is facing recently and even hinted that a recession is possible in his testimony before the Joint Economic Committee on April 2, 2008.
[2] SBA states that small businesses have generated 60 to 80% of net new jobs annually over the last decade.

Updating the Tax Code by Addressing Realities of the 21st Century Economy

The last major reform of the nation's tax code occurred in 1986. Since then, there have been dramatic advances in technology, which greatly alter the way small businesses operate in the modern marketplace. Many of the existing code provisions were written before computers and cell phones became ubiquitous business tools. These—and other outdated sections of the code—discourage entrepreneurial investment and growth. That hurts small businesses and the American economy as a whole.

Throughout the years, there have been numerous reports detailing the need for comprehensive tax reform to streamline the tax code and make it more fair. Thoughtful restructuring of fiscal policy must focus on meeting the following goals:

I. **Encouraging and Promoting Investment and Business Activity:** The tax code has been used as a vehicle to encourage economic outcomes. This includes tax incentives for employers to offer health care coverage as well as measures to encourage the purchase of new equipment by allowing immediate or advanced deductions for business equipment. In addition, the goal of many tax provisions/incentives is to foster an economic environment that allows entrepreneurship to flourish.

II. **Reflecting the State of Business Income and Business Liability:** For small business taxpayers, the amount of taxes they pay each year should generally reflect revenues less their expenses for that year. Their tax liability should be on actual profits *per annum*. Furthermore, the current code does not allow businesses to write off portions of equipment and buildings that may last beyond a single year.

III. **Limiting Complexity:** The aforementioned goals of promoting business activity and taxing only real profits should be done in a manner that does not add unnecessary complexity to the tax code. The tax code needs to be simple to understand, and designed for efficient and inexpensive compliance. The issue of compliance costs is something that creates a severe burden on smaller firms who lack financial resources to spend significant amounts on lawyers and accountants.

IV. **Maintaining Equity:** As reforms have been considered, one of the primary questions raised is whether similarly situated businesses or individuals are treated equally. Small businesses are put at a competitive disadvantage when their tax liability is higher when compared to similarly situated larger companies.

Scope of the Report

This report lays out a number of reforms that will achieve many of the aforementioned goals while helping small businesses stimulate the economy. These proposals should not be viewed as the complete list of necessary changes to the tax code to keep up with the current economy. Rather, the document provides a template for changes to establish immediate relief and simplification for millions of small business owners.

In recent years, our economy has shifted into one that is more interconnected, service and technology oriented, and increasingly mobile. It has also seen a dramatic shift in the nature of entrepreneurship with more and more individuals starting their business from home.

The current fiscal structure, however, has failed to adjust to the modern economy. Instead of providing opportunities for growth, giving entrepreneurs the incentive to enter the marketplace, and encouraging investment in small businesses, aging tax provisions have put considerable barriers in place.

Clearly, while the goal of a fair tax code has not changed, the manner in which to achieve it has. With the rising concern about ways to promote economic growth, the prompt implementation of well-designed updates would help small businesses grow.

The following pages describe seven specific problems rooted in outdated tax policy. They also provide suggestions on how each it may be addressed. All are offered as a means to creating a simpler tax code that addresses concerns raised by small business owner and strengthens the American economy.

Overview of Committee Recommendations for Improving the Tax Code

	Current Tax Code	Effects on Small Firms	Proposed Solutions	Benefits
	Outdated & Complex	**Loss of Valuable Time & Resources**	**Update & Simplify**	**Allows Small Firms to Grow & Strengthen the Economy**
1	Has inordinately complex provisions for a "Home Office" deduction.	The majority of home-based small businesses miss out on a deduction to which they are lawfully entitled.	Simplify the "Home Office" deduction provisions. Allow for a reasonable standardized deduction for people using their home as part of their business.	Millions of entrepreneurs would use the time and money saved to grow their businesses. Compliance with this and other Tax Code provisions would increase.
2	Has outdated limits on deductions and overly burdensome record keeping requirements for electronic business equipment.	Small firms lose time and money. Many forego investment in new technology and lose competitive edge.	Allow taxpayers who can prove substantial business use of electronic equipment to deduct a greater portion of the cost without having to keep detailed records.	Would promote innovation and make small firms stronger and more competitive.
3	Fails to accurately index for inflation the cost of vehicles used in a business.	Entrepreneurs lose thousands of dollars annually because they can't depreciate the true value of vehicles.	Allow a small business person who uses an automobile for work-related purposes over 75% of the time to recover the true cost of the vehicle (with a price of at least $25,000) during the standard 5-year recovery period. Continue to adjust the price for inflation.	Entrepreneurs would use the money to grow their businesses, hire new employees, and/or provide workers with additional benefits.

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4	Antiquated provisions force small businesses to use extended depreciation schedules.	Entrepreneurs end up paying taxes that are higher than necessary, and can't recover costs associated with improvements to their firms in a timely fashion. That prevents them from taking on new projects or expanding their business. Many new firms go out of business due to lack of cash flow or capital	Allow small firms to use shorter depreciation schedules--that are in line with today's technological and market realities.	Would give entrepreneurs access to greatly needed capital, Improve the likelihood of success of new businesses, and help bring new products and services to market.
5	Unlike large firms, self-employed entrepreneurs have to pay taxes on health insurance premiums twice--as employees and as business owners.	Small business owners lose money and competitiveness. Millions go without adequate (or any) health insurance.	Allow self-employed entrepreneurs to deduct cost of health insurance premiums in the same manner as large firms.	Would help expand health coverage to millions of uninsured American taxpayers, and make coverage more affordable for millions more who already have some level of insurance.
6	There is an arbitrary (50%) limit on small business deduction of business meals & entertainment costs.	Since most firms lack the ample advertising budgets of their large counterparts, business meals & entertainment are important tools used by entrepreneurs to grow their businesses. But the current tax code undermines those efforts.	Raise the small business limit for deduction of business meals and entertainment to 80% or 100%.	Entrepreneurs would regain a competitive edge and could use the savings to further strengthen their businesses.
7	Important incentives for investment in small firms have been eliminated by a reduction in long-term capital gains taxes.	Investors are made less likely to consider small businesses an attractive option. That denies entrepreneurs an essential source of capital.	Restore incentives to prompt those with capital to invest their money in U.S. small businesses.	Investors would get a higher rate of return. Small firms would gain access to needed capital, and use it to grow the economy.

1. Overly Complex "Home Office" Deduction

According to the National Bureau of Labor Statistics 3 of out every 10 homeowners operate a business out of their home, which represents 52% of all small businesses. Unfortunately, the inherent complexity of the Code hinders small business. Many home based businesses would like to take advantage of the home office deduction but it is extremely complex and confusing and the result is that many of home-based entrepreneurs miss out on the deductions they are lawfully entitled to.

The Internal Revenue Code allows entrepreneurs to take a tax deduction for business expenses occurring within their home. The deduction is available to self-employed taxpayers and employees who must use their home for business purposes at the request of their employer**.** However, many business owners consider these requirements to be too complicated, including record keeping obligations that are extremely time consuming.

According to a recent federal government study, over 8 million taxpayers use one or more rooms in their home for business purposes only.[3] However, according to the IRS, of the nearly 20 million Schedule C filers[4], only 2.7 million claimed the deduction. The fact that so few small business owners are taking the deduction indicates its complexity and ineffectiveness. This problem is extremely troubling, particularly given the fact that the SBA estimates that home-based businesses currently represent 52% of all firms in the United States and provide 10% of all the total revenue in the economy.

It is now more critical than ever to simplify this deduction. Millions of households have started home-based businesses to supplement their primary income in an effort to deal with the rising costs of consumer goods. Additionally, EBay alone reports that as many as 250,000 sellers make their full-time living as home-based businesses. These numbers will continue to increase as our economy becomes more mobile and the need for change is clear.

Recommendation: Home based businesses should have a simple, optional way to deduct a reasonable standardized amount for using their home as part of their business. To simplify the complexities associated with the deduction, taxpayers should be given the option of taking a standardized home office deduction which would increase compliance and reduce administrative costs for many small firms.

[3] IRS Taxpayer Advocate Report, 2007.
[4] Schedule C is the form used to report profit or loss from a business

2. Outdated Equipment Deduction Limits & Unreasonable Record Keeping Requirements

The tax code has simply not kept pace with certain day-to-day small business realities. The most frequently cited problem in this area is the use of equipment. Many of the code provisions that apply to the use of electronics were put on the books over two decades ago and have not been updated since. Additionally in an attempt to limit the abuse of tax deductions on equipment that could also serve a personal use, the Tax Reform Act of 1986 required extensive record keeping requirements for these 'listed properties.' This places an added burden on firm owners.

When these provisions were written into the tax code, cell phone technology and other electronic equipment were expensive technologies worthy of detailed log sheets. However, since that time technological changes have revolutionized the way cell phone and mobile communications devices are used today. Cell phones, blackberries, computers and PDA's are now widespread throughout all types of businesses and are integral devices for small business survival. Employers provide their employees with these devices to enable them to remain connected 24 hours a day, 7 days a week.

Additionally, the cost of these devices has been reduced and most providers offer unlimited airtime for one monthly fee. This is an example of the tax code not keeping up with technology and the result is that small businesses are burdened by outdated and impractical record keeping requirements and deduction limitations. Worse yet, the IRS has targeted those taking these deductions for audits.

Recommendation: Remove business computers, PDAs and similar equipment—whether used in a regular office, a home office, or on the road—from listed property requirements. Allow taxpayers who can prove substantial business use to expense a portion of the cost without having to keep detailed records.

3. Business Automobile Depreciation Limits Based on 1984 Prices

Like computers, and cell phones, automobiles are considered a listed property. However, in addition to burdensome record keeping requirements, there are certain impediments to taking tax deduction on a personal automobile used in business. In 1984, Congress became concerned that the tax code was allowing businesses to take deductions for vehicles whose cost and luxury far exceeded what was needed for strictly business purposes. Subsequently, legislation was enacted which limited the amount businesses could depreciate for automobiles.

These limits have only increased approximately 20% since 1987 under the current formula. The current limits on depreciation or §179 expensing for automobiles purchased in 2007 is limited to $3260 the first year, $4900 the 2nd year, roughly $2900 the 3rd year and $1800 for each succeeding year. That means that during the 5-year recovery period, even with 100% business use, a business could only fully depreciate a vehicle costing $14,460.

As an example, a traditional sales representative's car is the Ford Taurus.[5] Typically, a new Ford Taurus costs approximately $23,000, and is not a "luxury" vehicle by any realistic standards.

There are many people in the transportation sector who do not meet the current transporting "for hire" exception [6] who could benefit greatly from an updated tax code. A prime example is a real estate agent, whose car is also their office, and business image. To be successful, they must take a family from house to house in a comfortable vehicle, with room in the trunk for signs and other equipment.[7]

Recommendation: Adjust the listed property limits for automobiles to allow a person who needs to use an automobile over 75% of the time for business to fully recover the cost of that vehicle with a price of at least $25,000 during a standard 5-year recovery period. Adjust the amount for inflation.

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5 Tax Code Modernization for Small Business Economic Growth: *A policy analysis.*

6 Vehicles used "for hire", such as taxi cabs or airport transporter vans are not subject to the luxury automobile limitation.

7 Tax Code Modernization for Small Business Economic Growth: *A policy analysis.*

4. Drawn-Out Depreciation Schedules

Currently, small firms are unable to recover costs associated with improvements to their firms in a timely fashion. Due to extended depreciation schedules, small businesses must pay higher yearly taxes, restricting much needed capital. The access to and availability of capital is critical for small firms for two reasons. First, it puts cash into a small business early on in the business life, when many start-up businesses have very little cash flow. According to the SBA, over half of all small businesses will fail within their first 4 years. These start-ups usually rely on personal savings or high interest credit cards to stay in business. Also, limitations on cost recovery hinder small businesses that are looking to expand or grow. The tax code should encourage all businesses, especially small ones, to invest in new equipment and improve their infrastructure.

A. Personal Computer

A familiar example that illustrates the outdated code structure is the personal computer. Currently, the personal computer is on a 5-year depreciation schedule. However, any small business owner will tell you that the economic life of even the most up-to-date computer is two to three years. In order to better reflect a computers useful life, businesses should be able to depreciate them over two or three years. Small businesses, probably much more so than larger companies, rely on new technologies as a way to maintain efficiency and control costs. By updating this code provision, small firms would be able to keep their technologies up to date, and be more competitive.

B. Depreciation of Retail Improvements

Currently, retailers must depreciate improvements to their stores over a period of 39 years. However, stores generally remodel every five to seven years, due to changes in their customer base and to help remain competitive with newer establishments. Moreover, many improvements such as interior partitions, ceiling tiles, restroom accessories and paint may only last a few years before requiring replacement.

Studies conducted by the U.S. Department of the Treasury, and private economists have all found that the 39-year depreciation life for buildings is too long, and that the 39-year depreciation life for building improvements is even worse. The only exception to this rule is that leased stores may depreciate improvements over 15 years; however this provision expired on December 31, 2007.

The tax code should recognize the realities that retailers face, and equalize tax treatment between retailers that own and lease their stores. Specifically, Congress should consider (1) permanently extending the 15-year straight-line cost recovery period for qualified leaseholder improvements; and (2) expand it to cover new retail property improvements. Both of these changes would encourage small businesses to invest in their establishments; something the tax code should be doing anyway.

C. Goodwill Amortization

Modernizing the depreciation schedule for intangible assets to better reflect their useful economic life is another way to encourage small business economic development. Intangible assets, such as customer lists, are currently required to be depreciated over 15 years. However, this time frame does not reflect the marketplace reality and is often far longer than the actual, useful life of these assets. Business experience has shown that an intangible asset has a shelf life closer to five years, while a covenant not to compete is generally between two or three years.

In recent years our economy has transformed from one that relies predominantly on manufacturing to one that is more service-based. Much of that shift has been fueled by rapid technological changes that have made it easier to provide financial, legal, accounting, consulting and medical services, along with business-to-business solutions. Today, many of those operating in the service-based industry are small companies. However, many of these firms have found that the marketability and value of their intangible assets – such as customer lists, trademarks or patents – are diminished by the long write-offs that potential purchasers face.

A quicker depreciation schedule would allow these businesses to reinvest more cash in their operations. Most importantly, this would encourage economic growth and development by allowing companies to more accurately amortize intangible assets they purchase from eligible small businesses.

D. Heating, Ventilation, Air Conditioning and Refrigeration (HVACR) Equipment

Under current law, a building owner must treat heating and cooling equipment as a non-residential real property asset. As the result, the costs may only be recovered over 39 years. Because the lifespan of properly maintained HVACR equipment is 15 - 20 years, commercial building owners have little or no incentive to replace old equipment with newer, more energy efficient HVACR equipment. This schedule discourages business investment and may prevent small businesses from upgrading their old, inefficient heating and cooling equipment.

Using a more realistic life for HVACR equipment would promote energy conservation. In the past 15 years there have been dramatic advancements in HVACR technology, making the equipment manufactured today extremely energy efficient. Providing a financial incentive to building owners now would encourage them to upgrade to more energy efficient equipment instead of waiting until their outdated equipment breaks down beyond repair, and would likely result in lower utility bills.

By reducing the 39-year depreciation holding period, the tax code could be updated to both encourage investment and promote the use of green technologies. Today, this is an issue of utmost importance as our nation tries to become less dependant on foreign oil.

Recommendation: Shorten depreciation schedules.

5. Self-employed Entrepreneurs Not Allowed to Deduct Cost of Health Insurance Premiums

As the report mentions earlier, there are instances where smaller entities face different tax consequences than larger businesses. This is partly because, effectively, there are two business taxation systems in the United States. Most large entities pay their taxes through the corporate tax system while most small businesses are Sub-chapter "S" corporations, partnerships or Schedule "C" or "F" filers that pay taxes on their business earnings on their personal return. As a result, many small firms lose business deductions that that are not available on their personal return. As a result, small business owners often have to pay taxes on an item that a larger entity, filing a corporate return, would be allowed a tax deduction.

This inequity occurs with the deductibility of health insurance premiums for self-employed business owners. Currently, corporations are able to deduct health insurance costs incurred on behalf of their employees as a pre-tax business expense, and therefore do not pay FICA (Social Security and Medicare) taxes on these expenses. However, Schedule C tax filers, which include all sole-proprietors, partners in partnerships, LLC owners and S Corporation owners, do not receive a deduction for health insurance premiums. They must pay for their health insurance premiums out of earnings that *are* subject to the 15.3% FICA self-employment tax. According to IRS statistics, this affects nearly 4 million small business owners who paid self-employment tax on their health insurance premiums.

> **Example**: Mr. Smith, a self-employed individual, pays $5,000 per year in health insurance premiums. The self-employment tax on health insurance premiums for Mr. Smith is factored by multiplying his annual insurance premiums ($5,000) by the self-employment tax rate (15.3 %). This comes out to be a $765 tax detriment for Mr. Smith.

This calculation illustrates that Mr. Smith is paying an extra $765 in taxes on his insurance each year. Only self-employed individuals pay this additional tax on their health coverage. If we are truly concerned about access to affordable health care and making it as easy as possible for small businesses to offer health care, it is important that this inequity be fixed.

The tax code offers large businesses many tax incentives to provide health insurance for their employees, and self-employed individuals should not be put at a disadvantage. Correcting this inequity would help expand health coverage to millions of uninsured American taxpayers, and make coverage more affordable to millions more who already have some level of insurance.

Recommendation: Allow self-employed entrepreneurs to deduct cost of health insurance premiums.

6. Arbitrary Limit on Small Business Deduction of Business Meals & Entertainment Costs

Generally, there is an allowable deduction of 50% of the cost of meal and entertainment expenses. These include expenses for any activity considered to provide entertainment, amusement, or recreation. For example, entertaining guests at a nightclub, athletic club, theater, sporting event, or on a vacation would constitute entertainment. Meeting the personal, living or family needs of an individual (by providing meals, a hotel suite, or a car to business customers or their families), can also be considered an entertainment expense.

However, in the same way that big businesses rely on expensive advertising campaigns for their marketing efforts, small businesses rely on building and maintaining personal relationships. Yet while advertising costs for marketing campaigns are 100% deductible, meals and entertainment costs incurred by small businesses when promoting strong business relationships are only 50% deductible.

Small businesses would benefit from an increased meal and entertainment deduction; whether that is a 100% deduction or raising the percentage from 50% to 80%, as has been proposed in the past.

Recommendation: Raise the small business limit for deduction of business meals and entertainment to 80% or 100%.

7. Incentive for Investment in Small Firms Eliminated by Reduction of Long-Term Capital Gains Tax

The Internal Revenue Code uses tax preferences, such as deductions and credits, to encourage capital to flow to business investments. The potential for a higher rate of return, due to the lower tax rate, is intended to spur investment. With small businesses playing such an important role in the overall health of the nation's economy, it is important for our tax policy to prioritize tax incentives that encourage investment in small firms.

Whether it is because of changes in technology, or structural deficiencies with the way the provision was written, there are many tax code provisions that do not provide benefits to smaller businesses simply because of the entity classification that most small businesses operate under. This is partly because, effectively, there are two business taxation systems in the United States. Most large entities pay their taxes through the corporate tax system, while most small businesses are Sub-chapter "S" corporations, partnerships or Schedule "C" or "F" and pay taxes on for their business earnings on their personal return. As a result, many small firms lose business deductions that that are not available on their personal return.

In 1993, in an attempt to promote small business investment, provision §1202 of the code was included to allow non-corporate taxpayers the ability to exclude 50% of any gain from the sale or exchange of qualified small business stock (QSBS) that has been held for more than 5 years. At that time, the maximum long-term capital gain rate was 28%. Therefore, excluding half the gain from the sale of small business stock would lower the tax rate to 14% -- significantly less than the standard capital gain rate.

In recent years, both the Taxpayer Relief Act of 1997 and the Jobs and Growth Tax Reconciliation Act of 2003 have lowered capital gains rates further. The current maximum rate on long-term capital gains is 15%.

The intent of Congress when it enacted this provision in 1993 was to make it easier for small, start-up firms to raise equity capital by providing an incentive for investors. But today, with the long-term capital gains rate practically the same as the rate for sales and exchanges of QSBS, the goal of moving investment to smaller businesses has been thwarted.

Without this incentive, business investment will increasingly go to larger companies with less risk. This can only have a negative impact on our economy. The SBA reports that small businesses generate 60 to 80% of new jobs each year and are responsible for hiring 40% of all high tech workers.

Recommendation: To allow small businesses to continue their leadership role in innovation and growth, the tax code should restore incentives for those with capital to move their money to small firms.

Conclusion

Throughout the years, there have been numerous attempts by the federal government to use fiscal policy to stimulate the economy. Tax policy can—and should—be used to foster innovation and growth. In order for the approach to succeed, however, it must address the needs of small firms.

Entrepreneurs have always been at the forefront of the nation's economic success. Giving them the opportunity to grow their businesses just makes sense.

Antiquated fiscal policy that is overly complex and fails to meet the needs of the small business owner only hinders the ability of these crucial drivers of innovation and growth. Implementing the recommendations contained in this report would yield long-term benefits to our economy and restore American competitiveness around the globe.