National Small Business Network

Bi-Partisan Tax Policy Recommendations for the 118th Congress

April 2023

These recommendations are suggested as part of a balanced program of both tax policy and budget policy recommendations (https://www.nationalSmallBusiness.net) **to restore a sustainable Federal fiscal process and stable economic growth.**

There is a clear need for both tax system reforms and for added tax revenue to reduce fiscal deficits and the unsustainable growing debt. Because of the tight distribution and split control of the 118th Congress, any effective fiscal or tax policy changes will also need to be very balanced, bi-partisan, and evidence based. We suggest these basic tax reform principles, tax code corrections, and broader tax reform recommendations be included in future tax or budget legislation.

General Recommendations:

1. There is an overall need for additional tax revenue and fiscal control.

The primary Constitutional responsibility of Congress is to pass a budget of necessary expenditures for the needs of the country. The Congress also has the Constitutional responsibility to collect the taxes to pay for those programs. In FY 2022 Congress spent $6.3T or 25.1% of GDP, but collected only $4.9 T, or 19.6% of GDP. The GAO and CBO have concluded "The federal government is on an unsustainable fiscal path". The latest CBO projections show deficits will average 5.1% of GDP over the next 10 years, even with current law. In effect, this means essentially all of our expected GDP growth, is just borrowed ahead from future years, and future generations. The total "Publicly Held" national debt is now projected to equal our total annual GDP in less than 5 years. Most economists believe that continuing deficits, added to our $31.4 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 warnings, and those of other research organizations. The bottom line is that we must increase our overall tax revenue to at least equal average Congressionally approved federal expenditures. Congress is the cause of the growing deficit, and only Congress can correct it.

2. Congress must first act to maintain the country's international fiscal integrity and avoid any image of credit default by increasing the debt limit.

We cannot risk playing political games that would impair the nation's credit rating and increase the cost of needed borrowing for many years into the future. Loss of trust in our nation and our dollar is a tipping point with severe long-term cost consequences for every citizen. We currently spend 3.6 % of our annual GDP just paying the interest on our $31.4 Trillion debt. Even a 2% higher interest rate on that debt, resulting from a lower credit rating, would result in an added $628 Billion annual budget shortfall, paid to our foreign debt holders. If the Congress finally has enough determination to stop our increasing federal deficits, the logical process is to adopt a bi-partisan Deficit Control Surtax.

3. Assure that a deeply divided Congress, and a highly political process, can stop the growing debt, and allow time for strategic tax reforms to generate adequate revenue , by adopting a Bi-Partisan Deficit Control Surtax Act!

Because of the very high level of division and partisanship that exists in 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 to increase revenue may be through a bipartisan pre-agreement on an "automatic" deficit control process similar to prior "pay-go" and budget sequestration legislation. They weren't perfect, but they helped control deficits without either party having to take the political "blame" for the necessary actions. Congress should always first try to balance expenditures with adequate tax revenue using regular order, but that will take time. As a "Fail-Safe" to prevent increased deficits, except in times of true national economic emergencies, we suggest the Congress adopt a provision which would provide for an automatic income tax surtax necessary to offset any prior budget year deficit.

The Congress would require the Congressional Budget Office to determine the amount of any net budget deficit for the prior fiscal year. Congress would then have one year to pass legislation for the current year either reducing expenditures, or increasing tax revenue which, by CBO projections, would be adequate to offset the prior year's deficit. When special economic conditions justify a budget deficit for stimulus, Congress could override the requirement for a year by a majority vote of both the House and Senate. If Congress failed to act, CBO would be required to calculate a surtax rate, which when applied to all income tax categories, including corporations, pass-throughs, individuals, trusts, etc., would raise the amount of income needed to offset the prior year deficit. This surcharge would then be added onto the following year's net tax due. Congress would still remain in complete control of the process, but as a last resort, the surtax would provide the needed revenue without members of Congress having to vote for any specific tax increase. The surtax would not change, or complicate, the initial tax calculation for any taxpayer, but would simply apply a percentage to the final net tax owed. To let taxpayers, adjust to the potential surtax, it should be phased in over 4 years.

Specific Targeted Tax Reform and Correction Recommendations for this Congress:

For sustainable economic growth, good tax policy should meet these requirements:

- Tax policy should incentivize direct long-term investment 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.

- It should promote domestic investment and job creation to the greatest extent possible within the limitations of international agreements by focusing tax incentives on domestic investment.

- It should increase U.S. international business competitiveness, while also reducing the ability of multi-national corporations to avoid taxes by shifting profits to lower tax rate countries.

- It should provide equitable tax incentives for the growth of small businesses which provide over half of all new jobs and are the greatest contributor to economic growth. These are predominantly pass-through entities which require separate and equitable treatment of business income in the personal tax code.

- It should stop trying to influence taxpayer behavior with only tax credits and deficit increasing revenue giveaways, It should instead put revenue raising taxes on behavior which conflicts with broader governmental policy objectives, such as adopting a carbon tax to reduce CO2 emissions.

- It should be progressive in rate and application, because the impact of any tax rate has a much greater impact on the sustainability of small businesses, or on the personal security and financial stability of low income individuals.

- It should assure that any net tax code changes or federal expenditure increases are at least revenue neutral and provide adequate overall revenue to gradually reduce our national debt and restore long-term fiscal stability.

Small Business Pass-Through Entity Tax Corrections:

4, Maintain tax equity and predictability for small pass-through entity businesses after 2025.

We believe that tax rates and tax incentives should be as equitable as possible for all sizes and types of businesses. To provide equitability, The 2017 Tax Cuts and Jobs Act (TCJA) reduced taxes on both corporations and on pass-through entities, which is how most small businesses are taxed. For bill scoring reasons, the corporation changes were made "permanent" but the matching pass-through rate reduction and other provisions were only done through 2025. To make business planning and investment decisions, pass-through businesses need longer term certainty of the tax structure before the end of this Congress. **In light of the nation's fiscal situation, we believe tax revenue from all types of businesses must now increase, but must also remain equitable.**

5. Provide a better method of pass-through business rate equity than the Section 199A Qualified Business Income (QBI) provisions of the TCJA. Or, if the Sec 199A approach is continued, then several corrections need to be made.

A. Remove the Specified Service Industry exclusions from the section 199A 20% Qualified Business Income adjustment on pass-through entities. Section 199A of the TCJA, though well intentioned, created a large amount of complexity, uncertainty, and inequity for smaller pass-through businesses who pay their business taxes on their personal tax return. One of the most inequitable provisions was the exclusion or phaseout of income from certain designated business sectors from the 20% reduction on Qualified Business Income.

   The designated business sector exclusions selected by the bill drafters were a carry-over from prior code provisions for special tax incentives, including Sec. 1202 small business investment incentives, and the old Section 199 domestic manufacturing – exporting incentives. However, Section 199A was not intended as a special incentive, but was simply intended as

a way to provide some equitable rate reduction for pass-through businesses to balance the rate reduction the bill made in corporation taxes.

It is important that the tax code differentiate between reasonable wages for personal services performed by business owners and true business income, but there is no logical basis for excluding all income from business sectors such as health care, accounting, and financial services from the lower rate given all other businesses. Congress needs, instead, to define a broader test to separate true business income from personal wage and investment income. A better set of criteria for "reasonable compensation" for personal services by owners of an S Corporation business should also be developed to assure that personal service income is taxed as wages for employment and income taxes.

B. Add Guaranteed Payments to partners to the definition of wages for the Sec. 199A wage-asset test. The use of the term "W2 wages" for the wage-asset test of QBI discriminates against partnership entity partners who receive their compensation as "guaranteed payments" which are subject to self-employment taxes.

6. As a start to better business tax equitability uniformly define and breakout pass-through entity income in the tax code so that it can be easily taxed separately in the individual income tax code.

Promoting economic growth through the tax code is complicated by the fact that there are two business taxation systems. Most large businesses pay their taxes through the corporate tax system. Most smaller businesses are S corporations, partnerships, LLCs, Schedule "C" or Schedule "F" filers, and pay the taxes on their business operating income on their personal tax return along with their other personal income. The SBA estimates that over 90% of small businesses are pass-through entity taxpayers. As a result, the provisions and rates of the personal tax code have the greatest impact on small business growth. When Congress considers economic stimulus measures or tax system reforms, it is important that both business tax systems be changed in unison. To reduce complexity, there should be a uniform definition of active and passive pass-through entity income applied to all tax code provisions.

Income resulting from direct business investment and active operation of a business that employs people and sells a product or service has a much higher value to our overall economy than income resulting from passive speculative activity. By differentiating income from active businesses, Congress can provide targeted tax stimulus with less revenue loss, by not having to provide the same tax treatment on gains from passive investments such as traded stocks.

7. Restore annual deductibility of business Research and Experimentation costs, at least for smaller businesses with under $5M in assets.

Research and innovation are vital to US economic growth, and should be incentivized. CBO estimates the true cost of returning to annual expensing for all businesses is only $6.3B after full phase in. The original 10-year scoring does not accurately reflect the continuing potential revenue of the change to amortization. Annual expensing is particularly important for small innovative businesses who do not have the cash assets, or borrowing capability, to withstand having to amortize a significant part of their R&E costs over 5 years. SBA research found small businesses did over $70B of R&D in 2019 employing over 500,000 workers. For small technology based businesses, R&D expenses are often the majority of their total expenses and cash flow. If the cost of full repeal of the amortization requirement cannot be justified, at least restore same year expensing for small businesses with under $5M in total assets.

8, Correct the excessive reduction in the 1099K "payment processor" reporting threshold and correct the original error in basing the reporting on gross payments, rather than net payment income.

We strongly support logical and efficient reporting of payments to both businesses and individual service contractors because of the positive impact on tax compliance. However, the reduction of reporting threshold from $20,000 to $600 was too much for existing reporting technology. Such a low reporting threshold, without clearer ways to separate out non-taxable payment transactions, will result in an excessive number of false income reports that will be costly for both businesses and the IRS to resolve. We suggest correcting the reporting threshold to $10,000 or 100 transactions per year, and developing better, clearer reporting processes.

At the same time, It is also important to correct the error in the original reporting requirements which specified gross payments to businesses, rather than **net** payments, after return credits, fees, and cash advances. As a result, the IRS has had to guess how much of the gross amount is actual income, which often results in wasted audits for businesses with high return ratios. Some payment processors also now include personal monetary transfers that are not taxable income for the recipient. The net income amount is what is reported to businesses on their monthly statements and should be the amount to match against their 1099K report.

9. Permanently equalize the deductibility of worker health insurance at the entity level for all forms of businesses including the self-employed.

Changes in the economy accelerated by the pandemic have caused many people who were formerly employees to become self-employed contractors out of necessity. As employees, they usually received group health care that was tax deductible for their employer. As an independent self-employed worker, however, they cannot deduct the cost of their insurance and have to pay the 15.3% self-employment tax on the income they use to purchase it. This often means they can't afford the cost of insurance for themselves and their family.

Prior Congressional action partly corrected this problem for S Corporation stockholders. But, over 25 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. Because of their small group sizes, the self-employed already pay the highest relative insurance rates. The self-employed should be allowed to deduct insurance premiums up to the average ACA coverage cost at the business tax entity level.

Corporation Taxation Recommendations:

10. Increase the tax rate on large C corporations to 25% - 28%.

Even before the 2017 TCJA rate reductions, the percentage of total US tax revenue coming from corporations has declined significantly over the last 25 years, A recent GAO report found that the TCJA rate reduction cut the effective Corporation average tax rate by 39% from 14.6% in 2017 to 7.8% in 2018. The GAO also reported that 33.9% of corporations with $10M or more in assets paid no corporate income tax. A 25% to 28% maximum rate range for large corporations, and proportional increase for pass-throughs would restore some balance of revenue collection.

11. Correct the imposition of a much higher tax rate on small C corporation start-ups by re-instating graduated small corporation tax rates.

Congress has always said that they understand the critical importance of small innovative businesses to the economy. The TCJA, however, actually increased the tax rate on small startups by 40% by deleting the lower 15% tax bracket on the first $50,000 of income. Most high growth potential start-ups, who may become the base of future economic growth, have to be organized as C corporations because of the need to attract equity capital. Based on the most current IRS numbers available, over 560,000 small business are in this category and have had their taxes increased by the TCJA. We recommend legislation to reinstate the 15% tax rate on C corporation income below $100,000 and provide graduated rates between $100,000 and $5M of corporation taxable income.

12. Reduce Multi-National Corporation Tax Avoidance.

We believe that Congress erred in 2017 by adopting a territorial tax system for multinational corporations combined with lower tax rates in an effort to make US businesses more competitive. The reduction of corporation tax rates by other nations has been a race to the bottom, with a significant loss of tax revenue from businesses for all countries. We support Treasury's work on international agreements to reduce base erosion, but believe more changes are needed. We recommend Congress work with other nations to change the taxation of multi-national businesses (MNB) to a formulary allocation system based on their percentage of sales or goods and services, and investment in each country. Or, as an alternative, consider a Value Added Tax on business activity. Either of these changes would remove the incentive for profit shifting to lower tax countries and corporate inversions. Either option would also 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 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 businesses on 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. Most other large nations balance a lower business income tax with some form of value-added tax on business activity.

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. JCT should be asked to do an analysis using the most current and projected data.

13. Phase-out, as scheduled, 100% Bonus depreciation, or immediate expensing, of general long-term capital investments.

Although accelerated expensing can be a useful tax tool during a recession, its use at the peak of an economic cycle, when the JCTA was passed, was not needed and significantly increased the federal deficit and growth of the debt. This also contributed to inflation which the Federal Reserve is now having to control. If extended or made permanent, the Congress would have few practical tax incentives left for stimulating the economy when we need it for the next recession.

Individual Income Taxation Recommendations:

14. Increase the top marginal Individual Income tax rates progressively on income over $1Million.

Many of those who have become ultra-wealthy owe much of their success to the structure and systems of the US government and its patent, copyright, and general legal protections. It is appropriate that they share a greater percentage of their income to help pay for those protections. We support higher graduated tax rates on taxable income over $1Million, $10Million and $100Million. We do not, however, support the concept of a "wealth tax" on existing personal assets because of the complexity of calculation and the variability of valuing many asset types. Excessively high existing wealth is best taxed through the estate tax system.

15. Refocus Capital Gains taxation incentives to encourage <u>longer-term,</u> <u>direct,</u> economic investment. Improve the incentive for long-term capital investment by removing taxation of the phantom gain from monetary inflation on assets held more than 10 years, to properly reflect the true constant dollar value of any gain.

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, which is currently over 5%, over the investment life. The investments that America needs to build for a sustainable economy such as 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 also generally be in the maximum tax rate bracket in the year they sell their business or business property resulting in capital gains 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.

Based on the last 40 years of inflation rates, which are significantly increasing again, the Federal Capital Gains taxes would actually exceed the total real economic gain on the sale of an asset after about 40 years at the 23.8% tax rate.

We recommend an adjustment of the capital gains tax calculation on real property and business assets held more than 10 years to remove the impact of monetary inflation. The provision should only be applied to direct economic investment in businesses, property, or business equipment, not to traded securities, other than direct offerings, or other speculative investments that do not produce new economic activity. Calculation of the inflation 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.

16. Maintain a Federal Estate Tax exemption of at least $12M to allow for long-range estate planning, and protect mid-size family businesses and farms.

The current state tax exemption of about $13 Million per person, adjusted for inflation, which would currently end in 2025, is probably adequate to protect 95% 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 and should not be allowed to revert to previous exemption levels. However, the Estate tax should not be repealed. Without the re-valuation of assets at death, family members who inherit small businesses and farms would be hurt by high capital gains taxes when they later have sell**.** We also suggest adding progressive graduated rates above the exemption amount starting at 20% and going to 70% for larger estates, rather than the current flat rate which is inequitable for smaller estates.

17. Re-authorize the personal deduction for employee business expenses, which was eliminated by the TCJA.

With the pandemic and changes in technology and the workforce, more employees are working outside of a conventional business location and are being required by employers to fund more of their own expenses for equipment, technology, transportation and home-office work space. Since this job related costs reduce their effective income, they should be deductible against their wage income, at least over a 2% of AGI threshold, as would be allowed for a self-employed contractor, in addition to their personal exemption. To enable deduction of home office expenses, Congress also needs to change the outdated requirement for “exclusive” business use and allow for electronic based business transactions.

18. Increase the general State and Local Tax deduction limitation to $25,000 and allow deduction of up to $100,000 of state income tax paid on small business pass-through income.

The TCJA $10,000 state and local tax deduction limitation was particularly harmful to small business owners. Most small business are pass-through entities and have to pay the state income tax on their business income, which can be as high as 10% in some states, in addition to the taxes on their personal income and property. This often makes all of the state tax on their small business income non-deductible. We recommend that the overall cap on personal state and local taxes be increased to $25,000. In addition to any general cap, small pass-through entity business owners should be allowed to deduct up to $100,000 of state income tax paid on their net active business income. The “work-around” business entity tax alternatives that have been adopted by some states have just added more confusion and complexing to the tax system

Tax System Recommendations for Improved Compliance:

One of the key goals of tax reform should be to simplify the complexity of the current code, and provide greater tax system clarity and equitability for different taxpayer entities. 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 and business practices, or cost inflation, such as the $25 limit on business gifts Most of these changes will not have a major effect on total taxes owed, but will increase tax revenue by improving tax collection and reducing non-value-added costs for both taxpayers and the IRS

19. 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.

20. Continue to fund and update 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 has faced increased administrative responsibilities, such as the ACA and FATCO, and pandemic subsidies combined with declining budget allocations, and heavy turnover of key staff. This has resulted 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 adequate 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 should also develop better on-line tax compliance assistance and provide free on-line filing for most taxpayers. The Administration and the Senate also need to complete the revitalization of the IRS Oversight Board, rather than eliminating it, to assist IRS management with continuing organizational improvements and improving communication with the Congress.

21. Provide standard tax code definitions and coordinated inflation adjustments for all limits 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 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.

Longer Term Tax Alternatives That Should Be Evaluated:

22. Supplement Income Taxes with a Value Added Consumption Tax:
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, and again recently, 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. Even at low rates, a VAT 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 coordination 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 regressive in impact, some adjustment should be made to the income tax code to off-set the higher impact on lower income citizens.

These recommendations were prepared for the National Small Business Network by Eric Blackledge and Thala Taperman Rolnick CPA.

The National Small Business Network is a small non-partisan, nonprofit, group that evolved from the Regional Tax Issues Chairs from the 1995 White House Conference on Small Business.

National Small Business Network 4286 45th Street South St Petersburg, FL 33711
Phone 541-829-0033
Email Info@NationalSmallBusiness.net

Related research and information are available on our website at www.NationalSmallBusiness.net