Testimony of

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before the

Committee on Small Business
Subcommittee on Tax, Finance, and Exports

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Mr. Chairman, members of the Subcommittee, thank you for inviting me to speak this morning.

I am critically concerned with the potential breakdown in the American system of taxation.

1. Complexity;
2. An audit rate too low to ensure equitable compliance;
3. A perception of unfairness; and
4. An inability to resolve routine problems or handle routine transactions easily

threaten our system of self-assessment. The issue of complexity was a hot topic in the 1996 presidential election campaign. At that time, supporters of the Flat Tax or a National Sales Tax had a national platform. However, since the 1996 elections, Congress has insisted on making our tax laws more complex in, what appears to me, the interest of political expediency rather than in the interest of good tax policy.

It is obvious that our National Taxpayer Advocate, W. Val Oveson, realizes this. His FY 1999 Annual Report to Congress did an excellent job of highlighting the complexity problem. You will find in these materials an excerpt of my July 12, 2000 letter to Mr. Oveson commenting on his report.

I come to you with a diverse background as one who is a small businessperson, a small business advocate volunteer, and a professional who sees small businesses up close day in and day out. I also come with a clear understanding of the political process that pushes and pulls each of you toward complexity. Everyone wants their special deduction or their special benefit. Yet, everyone wants to see their overall tax burden reduced. So, you provide the deductions and then put in formulas that limit them. Then you find yourselves short on revenue and your creative staffs come up with phase-outs and other creative ways of increasing taxes but making the public think that you have not done so.

Today, I will only touch on the tip of the iceberg of complexity. It has taken Congress nearly 90 years to build in all of the current law's complexity. So, it will not go away overnight. However, you must take the first step. You must acknowledge that the complexity of the tax law is YOUR responsibility to end. You should promise to add no further complexity! And, then, begin to focus on eliminating complexity one step at a time. Keep in mind that minimizing change (and, thus, keeping the rules the same) helps ease the burden of complexity.

I. PHASE OUT THE PHASE-OUTS!

In the year 2000, married individuals with Adjusted Gross Income of \$193,400 through \$315,900 lose their personal and dependent exemptions ratably over that income range (IRC § 151(d)(3)(C)). However, the reality is that this is little more than a 3.3% increase in the tax rate for a family of four falling within that income range.[1] The current form of the legislation was enacted in 1990 as a means of raising revenue from higher income individuals. This same legislation introduced us to the phase-out of itemized deductions discussed below. The theory that supported this complexity was simple. "Rich people shouldn't get deductions meant to help the middle class." Yet, the premise just doesn't work and it has led to dozens of phase-outs and phase-ins that, today, impact heavily on the middle class, many of whom are small business owners.

Let us make no mistake about it. The reason for the phase-out of the exemptions was for Congress to increase the tax rate more than Congress was willing to tell the American public. In phasing out exemptions, Congress told America that a family with six children could reasonably pay the same amount of income tax as a family with no children, so long as their income was high enough. Hogwash! The basic premise is false! In addition, the marginal rate of a family within the phase-out zone is higher than wealthier people. Thus the very wealthy are paying a lower marginal tax rate than the upper middle class and the wealthy, depending upon what deductions are being phased out. The highest income individuals will never pay a federal marginal tax rate in excess of 39.6%. However, those subject to phase-in and phase-outs can easily be paying at marginal rates of 42%, 43% and higher.

Some argue that the phase-out is mandated by an ability to pay. Well, the tax system defines "Taxable Income" for that express purpose, to fairly measure one's ability to pay. By determining one's ability to pay based upon "Adjusted Gross Income" (the "above-the-line" amount) to phase-out deductions and exemptions, Congress distorts the purity of a progressive income tax system. For, with phase-outs as they are now, there are indeed many examples of a system of taxation that is neither progressive nor flat, but rather regressive in its operation.

Thus, you might be able to eliminate the exemptions phase-out which taxes a family of four an additional tax rate of 3.3% by increasing the top rate from 39.6% to 39.8%. (Yes, the rate might be 39.9% or even 40.2%, I don't pretend to have all the data.) By doing so, Congress would simplify the computations and add fairness to our tax system.

The first cousin of the Exemptions Phase-Out is the Itemized Deductions Phase-Out of Internal Revenue Code section 68. This phase-out, starting at Adjusted Gross Income of $128,950 for married families, currently hits upper middle income families who support our nation's social programs and get little benefit from those programs (e.g. college grants/scholarships are generally unavailable for these families). Also, the phase-out hits those in high income tax states harder than those from low/no income tax states who are less likely to itemize.

Congress is now addicted to phase-outs. Here is just a sampling:

Description	Code Sec.	Phase-out Starts	Phase-out Ends
Child Care Credit	23	110,000	120,000
Adoption Credit/Exclusion	23/137	75,000	115,000
Learning Credits	25A	80,000	100,000
AMT Exemption	55	150,000	330,000
EE Bond Interest Exclusion	135	81,100	111,100
IRA Deduction	219	52,000	62,000
Roth IRA	408A	150,000	165,000
$25,000 Rental	469(i)	100,000	150,000

1 Assumes married filing jointly with the marginal rate of taxable income at 36%.

II. <u>REPEAL SUBSECTION 274(n) REGARDING MEALS & ENTERTAINMENT EXPENSES</u>

Repealing subsection 274(n) would eliminate great complexity and add fairness within the U.S. tax code. Generally, section 274(n) allows only 50% of meals & entertainment deductions which, otherwise, would be allowable after passing the many rigorous tests of section 274. (Section 274 already imposes many rules to make certain that the entertainment is directly related to one's business.)

Let's look at an example of the complexity brought about by this law. Consider a small business with three traveling salespersons. One salesperson turns in the hotel invoice for $105. The invoice can be paid and classified as travel, right? Nope, not the case. The bookkeeper for the company has to get a detailed listing and separate out meals into a separate account. This is <u>only</u> because the meals are only 50% deductible, while the hotel room is 100% deductible. What if the hotel room includes a breakfast? Must we secure a letter from the hotel allocating the overnight cost? Now, if the three salespersons each stay in two hotel rooms per week, 50 weeks per year, our poor bookkeeper is analyzing 300 hotel bills to determine what portion is for meals.

Now, let's say our small business has a summer picnic or holiday party for all of its employees, we can just treat that the same as other meals, right? No! These meals are 100% deductible, not just 50%. Thus, the bookkeeping system needs to be revised to separate firm outings from other meals and entertainment. What if I put on a sales presentation to prospective customers? How do I handle the cost of meals served during the presentation? Do you know? You need a CPA/tax attorney like myself just to tell you about all of the instances in which the 50% rule does not apply. There are over 10 exceptions to the disallowance of section 274(n). Also, there is the relatively new category for truckers in which the disallowance is being phased from 50% down to 20% over ten years.

And, how many law firms and large corporations (many of which have internal chefs) are burying the cost of the meals served at work to other categories?

Any of you know what a schedule M-1 or M-2 is on a tax return? It is the place where you place the other 50% of meals & entertainment so you can tie into your balance sheet. Also, in New Jersey, we get to make an adjustment for the federally disallowed meals & entertainment because New Jersey found the section to be unfair to small business.

And why all of this complexity? Well, Congress needed to plug a hole in its budget! Rather than raise the tax rate, Congress decided to unfairly focus on legitimate business deductions.

So, why is this so particularly unfair to small businesses? First, is the recordkeeping burden as I have described above. It falls disproportionately upon firms that cannot afford in-house tax specialists. Second, small businesses expend a higher percentage of their promotional budgets than big businesses for meals and entertainment. Think about it. How many $300,000 per minute commercials do you think I can buy on prime time television to advertise my business? Larger businesses rely more on print & media promotion. Whereas many small businesses are selling personal relationships. They do this over a round of golf (already limited) or a lunch. Look at me! (For those not seeing me in person, I am about 40 pounds overweight.) Do you think I really need to have lunch at a fancy place just to get the tax deduction? I would just as soon have a non-deductible soup and sandwich from the Wawa down the street and use the extra time to get myself to the gym. However, that is how we sell our services. Through intimate one-on-one meetings, which are enhanced over a meal.

The 1995 White House Conference on Small Business chose the repeal of section 274(n) as its number 2 issue and endorsed the following proposal:

"Small businesses typically rely on close personal relationships and customer service to

compete for sales rather than on expensive advertising campaigns. Expenditures for meals and entertainment are often an important part of this effort. The recent changes in the tax laws to disallow 50 percent of these expenditures for tax purposes has disproportionately increased the selling costs for many small businesses. Accordingly, Congress and the President shall enact legislation that will allow a tax deduction for 100 percent of the expenditures for meals and entertainment."

III. ELIMINATE SECTION 179 ELECTION TAX TRAP

In the year 2000 businesses may, generally, take a current year deduction for up to $20,000 of capital assets. The trap is that an election under the Treasury Regulations governing section 179 (using form 4562) is required. I urge Congress to revise the law so as to deem the election as having been made if the taxpayer takes the deduction.

Here is the problem. Taxpayer X knows that he can write-off up to $20,000 of capital assets in year 2000 pursuant to section 179. Accordingly, he purchases a computer and a photocopier for a total of $4,500 and classifies those items as office supplies when he prepares his/her return. On audit, the IRS auditor correctly disallows the $4,500 and allows only a depreciation deduction of $900 in year 2000. The auditor points out that an election using form 4562 was not made. Also, because of the manner in which the regulations are written (§1.179-5), the election may not be made on an amended return. (The normal rules for amending a return give a taxpayer 3 years from the normal due date. For section 179, the taxpayer is given only 6 months.)

The IRS position has been upheld under several tax court cases (see V.J. Genck, 75 TCM 1984, TC Memo. 1998-105 and R.C. Fors, 75 TCM 2221, TC Memo. 1998-158).

Congress can correct this unintended inequity by amending Section 179(c) by adding new subpart (3):

"(3) Election deemed made. –An election shall be deemed made by a taxpayer by the filing of a return which claims deductions for any section 179 property acquired during the year, whether or not such deductions are identified as section 179 property on the return."

With the amendment which I propose, the unfair results of Genck and Fors will be avoided. However, the taxpayers will still have the burden of proving the expenditure and that the property acquired is, indeed, section 179 property.

IV ESTIMATED TAX REFORM

If a taxpayer's tax obligation is not satisfied by income tax withholding, such taxpayer is, generally, required to make estimated tax payments. Failure to do so would subject a taxpayer to a penalty which is, in essence, a reimbursement to the U.S. Treasury for the taxpayer's use of funds. Throughout the 1980s, there were two safe havens frequently available and used by most taxpayers making estimated tax payments:

A. Pay in an amount equal to 90% of the current year tax liability; or

B. Pay in an amount equal to 100% of the prior year tax liability.

Due to increasing income and simplicity, most taxpayers adopted alternative B above when determining how much to pay in estimated taxes. It was simple. In the early 1990s, Congress attempted to take away alternative B for taxpayers with over $150,000 of adjusted gross income. This was simply a move to raise revenue. However, the burden on taxpayers, particularly small business, was so outlandish, that Congress agreed on a compromise with the tax professionals. That compromise was to require the high income individuals to pay 110% of the prior year tax liability to get the safe harbor.

The 110% safe harbor worked very well until new legislation was adopted in 1997 to be effective for 1998. That legislation (P.L. 105-34) adopted a 105% safe harbor for 1998 through 2000, a 112% safe harbor for 2001, and returned to the 110% safe harbor thereafter. In 1998 Congress again amended the safe harbor with P.L. 105-277 by increasing the safe harbor for 1999 and 2000 to 106%. Not wanting to make life simple, Congress again amended (P.L. 106-170) the safe harbor to 108.6% for 1999 and 110% for 2000. This is unconscionable! The table below clearly reflects Congress' insanity:

Tax Year	Pre-1998	P.L 105-34	P.L 105-277	P.L. 106-170
1997	110%	110%	110%	110%
1998	110%	105%	105%	105%
1999	110%	105%	106%	108.6%
2000	110%	105%	106%	110%
2001	110%	112%	112%	112%
2002	110%	110%	110%	110%

This is simply bad tax policy no matter how you look at it. However, it allows you to move revenue from one year to another without really letting the American public know about it. This is "smoke & mirrors" legislation at its worst! Keep it at 110% going forward and never again change it. You should, however, adjust the threshold level for inflation. I also recommend that the $150,000 threshold be adjusted upward (rounded to the nearest $10,000) to reflect inflation once a decade.

The high income safe harbor problem, along with other complexities inherent in estimated taxes, is well documented in the June 5, 2000 Annual Report from the Commissioner of the Internal Revenue Service on Tax Law Complexity at pages 36 through 38.

Currently, estimated taxes are paid on the 15th day of April, June, September and the following January for each year. The Commissioner recommends, and I agree, that estimates should be made by the 15th day following each calendar quarter (April, July, October, and the following January). For small businesses, this would tie into the natural reporting which they normally do for payroll. It would allow more businesses to look at the current year safe harbor for avoiding estimated tax penalties. I understand that this would shift one payment (the September 15th/October 15th) from one fiscal year to another. However, in light of our budget surpluses, this would be the time to make the move....a time when the country can afford a one-time deferral of approximately $50 billion.

Consideration should also be given to simplifying estimated taxes (for example, by the enactment of a meaningful safe harbor) for all corporations. This proposal was made earlier this year by the AICPA Tax Division in conjunction with the ABA Section on Taxation and the Tax Executives Institute.

V. TAX EQUITY NOW! ALLOW 100% MEDICAL INSURANCE DEDUCTION TO SMALL BUSINESSES FOR BOTH INCOME AND FICA TAX PURPOSES

Over the past 20 years, many portions of the tax law have been changed so as to place those working in small businesses as owners at a disadvantage to those providing similar services for large corporations. Issue #385 of the 1995 White House Conference sought to bring small business back to equity.

Under current law, a regular "C" Corporation can fully deduct certain fringe benefits, e.g. medical insurance premiums and dependent care benefits, paid for its employees, including shareholders. Such benefits are also excluded from the income of "C" Corporation employees. If one is an owner, partner, shareholder, or member of a sole proprietorship, partnership, S Corporation, or Limited Liability Company, respectively, such exclusion is not available. Instead, one must personally report as income amounts paid on his or her behalf for such benefits, and then try to deduct them at a personal level if the law permits it. The exclusion of such benefits should not be based upon the type of entity chosen for the business. Why should the William Gates & Michael Eisners of the world get to exclude their fringe benefits, while the owners of many small businesses cannot?

Relative to the issue above, Issue #385 as reported by The White House Conference is stated as follows:

> *Tax Equity Now! Congress & the President shall enact legislation which shall place large and small businesses on a level playing field for tax purposes... that is provide tax equity... in situations where small businesses are currently at a disadvantage. This should be done by uniformly applying the tax law to all forms of business (e.g. proprietorships, partnerships, C Corporations, S Corporations, limited liability companies) with regard to tax rates, deductions, and exclusions as follows*:
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> - *That all forms of business entities be allowed to take deductions for 100% of the medical insurance premiums, dependent care, and other fringe benefits not currently deductible by self-employed individuals, partnerships, S Corporations, and Limited Liability Companies on behalf of all of their employees who are owners, partners, shareholders, and/or members. As long as fringe benefits continue to be excluded from the income of employees of large C Corporations, then such benefits should be excluded from the income of employees of all small businesses, regardless of form, as well as from the income of self-employed individuals.*
>
>   ...
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>   ...
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> *The privilege of deducting legitimate business expenses should no longer be based upon the entity chosen to operate such business. The choice of an entity within which one will operate a business should be a legal issue, not a tax issue.*

The essence of the proposal was to allow the deduction for both income tax and FICA tax purposes. Current law phases in a deduction for medical insurance premiums only for income tax purposes. Even when fully phased in, it will provide only half a loaf. Medical insurance premiums for self-employed individuals should be deducted in computing one's self-employed income for FICA/Medicare tax purposes as well as income tax purposes.

By adopting such a law, Congress would not only resolve the inequity of current law, it would reduce the compliance burden on small business. The current need to segregate the health insurance premiums of the self-employed from the premiums of his/her employees would be eliminated in that all such premiums could then be reported on the face of Schedule C, form 1065, or form 1120S.

Under current law, an individual making $50,000 per year at a large corporation, along with a $5,000 medical package, pays taxes only on $50,000. One who is self-employed and receiving the same compensation pays income taxes on $52,000 ($50,000 plus 40% of $5,000) and social security taxes on $55,000. This is patently unfair.

I urge Congress and this committee to take the lead in allowing small business owners to take a full deduction of medical insurance premiums on their business returns which will be effective for both income tax and FICA/Medicare tax purposes.

VI. REPEAL/REFORM THE ALTERNATIVE MINIMUM TAX ("AMT")

On pages IV-42 and IV-43 of his FY 1999 Report to Congress, the National Taxpayer Advocate set out excellent reasons for repealing and/or reforming the AMT. The need for the AMT was largely eliminated by the Tax Reform Act of 1986 and the implementation of the Passive Loss rules. It is complex and no longer required to ensure equity.

However, if Congress decides to retain the AMT, certain reforms are absolutely necessary:

A. Index the AMT rate bracket and exemption amount. Congress gets kudos for eliminating hidden tax increases in the regular tax by indexing rates. However, the failure to index the AMT rates has brought it into play with ever-increasing frequency to taxpayers it was never intended to cover.

B. Eliminate the phase-out of the exemption amount. Remember, this is merely a hidden tax bracket increase (see my discussion above regarding phase-outs).

C. Eliminate the adjustment for state income taxes. The payment of state income taxes reduces one's ability to pay federal taxes, and is an appropriate deduction for both computing one's regular and alternative tax. Recently I had a client who incurred a $100,000 tax liability to New York State and New York City as a result of the sale of their home. The bulk of their life savings were tied up in this home. We were unable to structure the payment of the State and City taxes to avoid the impact of the alternative minimum tax. In addition, the State of New York does not provide a lower tax rate for capital gains. Accordingly, these taxpayers are facing a full rate of 32% on the gain from the sale of their home. Without the alternative minimum tax deduction for state taxes, these taxpayers paid an additional $28,000 in federal tax.

D. Allow deductions for purposes of alternative minimum tax with respect to home equity loans which are deductible under the regular tax computations. Most people are unaware of this difference and compute it incorrectly anyway. In addition, the same policy reasons for allowing interest on a $100,000 equity loan would seem to apply at the alternative minimum tax level also. You should note that there are other minor differences in a deductibility of home mortgage interest when one compares the alternative minimum taxable income base with the regular taxable income base. In the interest of simplification, these differences should also be eliminated.

VII. CASH METHOD OF TAX ACCOUNTING/INSTALLMENT METHOD DEBACLE

Currently, small businesses may use the cash method of tax accounting as long as annual gross receipts do not exceed $5 million. This method of accounting is less burdensome on small businesses and should be used as long as it is reasonable to do so.

In 1986, Congress made a judgment as to how large a business should be before it should be required to adopt the accrual method. I am assuming that your judgement was sound at that time. If that is true, a business doing $6 million today was likely doing less than $5 million in 1986 and should not be required to adopt the accrual method. Accordingly, I am requesting that the $5 million threshold be adjusted now for any inflation which has taken place since 1986 and to adjust the threshold each decade to the nearest $100,000.

Finally, the 1999 legislation eliminating the installment method for the sales of businesses must be reversed. That legislation represents another narrow attempt by Congress to avoid telling constituents that it is raising taxes. It should be reversed. If additional tax revenue is needed, you need only go to the tax rates and adjust them.

Rule XI, clause 2(g)(4) statement:

My curricula vitae is enclosed. I have not received any federal grants, contracts or subcontracts at any time.

Respectfully submitted

_______________________________________ E. Martin Davidoff