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Advocacy: the voice of small business in government

September 29, 2009

VIA ELECTRONIC MAIL

Tax Reform Subcommittee
Presidential Economic Recovery Advisory Board
perab@do.treas.gov

Re: Recommendations for Tax Reform

Dear Subcommittee Members:

Thank you for this opportunity to submit recommendations for tax reform. Members of the small business community frequently appeal to the Office of Advocacy (Advocacy) for help in getting relief from tax requirements that are disproportionately burdensome for small businesses. According to Advocacy research, tax compliance is 67 percent more burdensome for the smallest businesses compared to their larger competitors.**(1)** Tax complexity prompts Advocacy to submit the following recommendations for tax reform: (1) simplify the home office business deduction; (2) equalize the tax deductibility of group health insurance costs; (3) eliminate the three percent withholding requirement for government contractors; and (4) continue to permit small businesses to use the last in, first out (LIFO) inventory accounting method.

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Congress established Advocacy to represent the views of small business before Federal agencies and Congress independently.**(2)** Among other things, Advocacy is tasked with determining "the impact of the tax structure on small businesses and mak[ing] legislative and other proposals for altering the tax structure to enable all small businesses to realize their potential for contributing to the improvement of the Nation's economic well-being."**(3)** Due to the Office's independence, the views expressed in this letter do not necessarily reflect the views of the U.S. Small Business Administration (SBA) or official administration policy.

Recommendations for Tax Reform

1. Simplify the home office business deduction

Fifty-three percent of all small businesses are home-based businesses. Small businesses in contact with Advocacy frequently identify simplification of the complicated home office business deduction as an area of great concern. Advocacy recommends that the current rules for the home office business deduction be revised to permit a standard deduction for home-based businesses. Similar to the Form1040 standard deduction, the standard home office business deduction should be optional. At-home workers could choose to continue to follow the current home office deduction rules, or they could choose the new standard deduction.

The complexity of the current home office business deduction rules is such a prominent issue in the small business community that Congress has introduced several pieces of legislation during the last few years to address this problem. Most recently, on June 25, 2009, Senators Conrad and Snowe along with U.S. Rep. Gonzalez announced the Home Office Tax Deduction Simplification and Improvement Act of 2009 – bipartisan, bicameral legislation that would establish an optional home office deduction to help ease the burden of the complex tax code on American small businesses.(4)

Internal Revenue Code (Code) section 280A(c)(1) permits a deduction for a home office if it is the principal place of business of the taxpayer, or used exclusively for business, or used to meet with patients, clients or customers. Final regulations do not provide a concise definition of the elements of Code section 280A(c)(1). In the absence of final regulations describing how to qualify for the deduction and how to calculate the deduction, complicated IRS requirements evolved.

The requirements to qualify for the deduction and to calculate the deduction are confusing for taxpayers and do not account for changes in technology that impact the way that business is conducted. Consequently, many at-home workers do not take advantage of the home office business deduction. Advocacy recommends that the home office deduction rules be revised to address these concerns.

2. Equalize the tax deductibility of group health insurance costs

Advocacy recommends permitting the over 10 million self-employed small business owners the ability to deduct the cost of group health insurance premiums.(5) Unlike C corporations that may obtain a deduction for health insurance premiums as an "ordinary and necessary" business expense, self-employed small business owners are unable to deduct the cost of their health insurance premiums. This occurs because Schedule C filers (sole proprietors) and Schedule E filers (partners in partnerships with earned income and S Corporation owners) do not receive a business deduction for health insurance premiums. The Form 1040 deduction for health insurance premiums is not included on Schedule C or Schedule E. Thus, those self-employed business owners who pay self-employment taxes – sole proprietors, partners in partnerships, and S corporation owners – are unable to deduct the cost of health insurance premiums.

3. Eliminate the three percent withholding requirement for government contractors

Advocacy recommends the elimination of the three percent tax withholding requirement on small businesses that contract with Government entities. Under Code section 3402(t), which was added by section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, all Government entities (except for certain small state entities) will be required to withhold three percent of all payments for services or property made after December 31, 2010.

The three percent withholding requirement will adversely impact all small businesses that provide services to Government entities. Most small businesses that provide services to Government entities will have to increase their debt level in order to ensure sufficient cash flows and will be forced to pass these additional expenses on to their Government customers. The three percent withholding requirement will force many other small firms that are unable to secure additional debt out of the Federal contracting business.

Additionally, there does not appear to be any equitable, practical, or cost-effective way to implement the three percent withholding requirement. The requirement would impose financial and resource burdens on local, state, and federal entities, including the IRS. As an example, the Department of Defense reported to Congress that it estimates that the cost for it to comply with the three percent withholding requirement will be in excess of $17 billion over the first five years.(6) This cost of compliance exceeds any revenue estimate of the three percent withholding requirement.

4. Continue to permit the LIFO Method of Accounting

Advocacy recommends that small business be permitted to continue to use the LIFO accounting method. In recent years, several federal agencies, including the IRS, have contemplated plans to unify America's current Generally Accepted Accounting Principles (GAAP) with the International Financial Reporting Standards (IFRS). Small businesses that have been in contact with Advocacy have expressed concern that under the IFRS they would no longer be permitted to utilize the LIFO accounting method.

Prohibiting businesses from using LIFO would raise business taxes in two ways. First, a business would see higher future taxes because it would be unable to use LIFO to protect itself from rising inventory costs. Under LIFO, the most recent (higher) costs of goods are expensed to the cost of goods sold, while the older (lower) costs remain in inventory. Absent LIFO, businesses would be taxed on the basis of the larger first in, first out (FIFO) cost of inventory (i.e., the difference between the older (lower) costs of goods and the more recent (higher) price realized once the goods were actually sold).

Second, a business would be required to pay taxes on its existing "LIFO reserves." The LIFO reserve is an inventory account that will reflect the difference between FIFO cost and LIFO cost of a businesses inventory. As a consequence of consistently increasing costs due to inflation, the balance in the LIFO reserve account will have a credit balance. This credit balance is used to offset costs reported in a business' inventory, and therefore, results in lower taxes on the business.

To illustrate how a business utilizes LIFO, and why prohibiting LIFO would be detrimental to the business, consider the following example: a business maintains a consistent inventory of ten units; every year, the business uses ten units for production and buys ten units to replace them; units cost $1 in year one and inflation is 3 percent per year.

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Inventory Purchases					LIFO Reserve	
Year	Number	Cost per Unit	Total Cost		Year	Reserve
1	10	$ 1.00	$ 10.00		1	0
2	10	$ 1.03	$ 10.30		2	$ 0.30
3	10	$ 1.06	$ 10.61		3	$ 0.61
4	10	$ 1.09	$ 10.93		4	$ 0.93
5	10	$ 1.13	$ 11.26		5	$ 1.26
6	10	$ 1.16	$ 11.59		6	$ 1.59
7	10	$ 1.19	$ 11.94		7	$ 1.94
8	10	$ 1.23	$ 12.30		8	$ 2.30
9	10	$ 1.27	$ 12.67		9	$ 2.67
10	10	$ 1.30	$ 13.05		10	$ 3.05

This example illustrates that, in an inflationary environment, LIFO helps the business by enabling it to match up its current inventory costs with its current income, producing a more accurate picture of its annual income. Even mild inflation results in the LIFO reserve exceeding 20 percent the business' inventory value in less than 10 years. The longer that the business uses LIFO, the larger its reserves will be relative to its inventory. If LIFO were no longer permitted, these reserves would be taxed at rates up to 35 percent, even though the reserves reflect nothing more than the impact of economic inflation on the value of the business' inventory over ten years.

Ultimately, eliminating the ability to use LIFO would result in a tax increases for small business that could ultimately force many small businesses to close.

We appreciate this opportunity to voice the concerns of small businesses. We look forward to working with you to reduce the tax burdens facing small businesses. If you have any questions or require additional information please contact Assistant Chief Counsel for Dillon Taylor at (202) 401-9787 or by email at Dillon.Taylor@sba.gov.

Sincerely,

/s/

Shawne McGibbon
Acting Chief Counsel for Advocacy
Chief Counsel for Advocacy

ENDNOTES

1. W. Mark Crain, *The Impact of Federal Regulations on Small Firms* (2005). http://archive.sba.gov/advo/research/rs264tot.pdf.

2. 15 U.S.C. § 634a (1976).

3. 15 U.S.C. § 634b(4) (1976).

4. See http://www.opencongress.org/bill/111-s1349/show.

5. Office of Advocacy, Quarterly Indicators, Second Quarter 2009. http://archive.sba.gov/advo/research/sbqei0902.pdf.

6. Department of Defense report available at http://www.withholdingrelief.org/NR/rdonlyres/e4ru7v6dxjmyjdmgfg65s6pkybltxnt3d3hyeceshtodquackhcmkcblv7dz5xbx42oqucmbfmauhq7f4iq3ear54ga/DoDLetterstoChairmanonCostImpact.pdf