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Targeted Tax Reform: Solutions to Relieve the Tax Compliance Burden(s) for America's Small Businesses

Testimony of Professor Caroline Bruckner, Executive-in-Residence, Accounting and Taxation and Managing Director, Kogod Tax Policy Center, Kogod School of Business, American University, before the U.S. Senate Committee on Small Business and Entrepreneurship

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twitter: @carobruckner • cbruck@american.edu • (202) 885-3258

Members of the Committee and staff, thank you for the opportunity to testify today on targeted tax reform solutions to relieve the tax compliance burdens of small businesses. My name is Caroline Bruckner and I am a tax professor at American University's Kogod School of Business. As part of my responsibilities at American University, I am also the Managing Director of the Kogod Tax Policy Center, which conducts non-partisan research on tax and compliance issues specific to small businesses and entrepreneurs. The Center develops and analyzes solutions to tax-related problems faced by small businesses and promotes public dialogue concerning tax issues critical to small businesses and entrepreneurs.

Prior to my appointment at Kogod, I served on the staff of this Committee from 2009 until 2014, ultimately as Chief Counsel, under the leadership of its former Chair, Sen. Mary Landrieu. During my tenure with the Committee, I handled tax, labor and budget issues and worked with small business stakeholders across the country and political spectrum to develop small business tax legislation, including the Small Business Jobs Act of 2010, which provided more than \$12 billion of tax relief for small businesses. In addition, at the direction of Chair Landrieu, I organized multiple hearings and roundtables to discuss tax and compliance issues specific to small businesses and entrepreneurs, and advised the Chair and Committee Members on small business tax policy recommendations in response to Senate Finance Committee requests for tax reform proposals.

In my current role at Kogod, I direct our team of small business tax policy experts, economists and researchers, and we are currently focused on developing research on the tax and compliance issues impacting "Emerging Entrepreneurs," who are America's latest iteration of small business owners. Emerging Entrepreneurs are the new, self-employed entrepreneurs who are powering the evolving on-demand digital economy. These Emerging Entrepreneurs are renting rooms, providing ride-sharing services, running errands, and selling goods for consumers in business transactions coordinated online and through app-based platforms developed by companies such as Airbnb, Flipkey, Onefinestay, Uber, Lyft, Taskrabbit, Instacart and others. Emerging Entrepreneurs need maximum flexibility to grow their businesses and enhance their contributions to this dynamic new sector of the American economy (the "Emerging Entrepreneur Economy").

As you know, overwhelming complexity and inefficiency are hallmarks of the current tax code and the Congressional record is replete with examples of how unduly burdensome the current system is across taxpayers' experience.¹ This reality is particularly acute for many Emerging Entrepreneurs who are first-time, small business owners and have little experience with the

¹ See United States Senate Committee on Finance, The Business Income Tax Bipartisan Tax Working Group Report, July 2015, available at <http://www.finance.senate.gov/newsroom/chairman/release/?id=e9eefc66-7e11-4276-939f-3eca6fd6d959>.

requirements of quarterly estimated payments or self-employment taxes.² As a result, many Emerging Entrepreneurs are finding out for the first time that they are liable for tax underpayment penalties.³

In addition, as reported by the *Wall Street Journal* earlier this year, some Emerging Entrepreneurs are facing penalty and audit exposure, despite the fact that in some cases, income earned from short-term residential rentals coordinated through a platform provider (e.g., Airbnb, HomeAway, Onefinestay and Flipkey) is, in fact, tax free.⁴ Our preliminary research has identified these and other related issues as unnecessary burdens notwithstanding that, anecdotally at least, many Emerging Entrepreneurs “generally want to be honest and pay what they owe, but the tools and resources don’t exist.”⁵

The relative inexperience of many Emerging Entrepreneurs as small businesses owners is further compounded by the lack of uniformity in the income reporting forms used for Emerging Entrepreneur Economy transactions. Although some platform providers have attempted to designate the Form 1099-K, which is used to report credit card and third-party payments, as the industry standard, others use Form 1099-MISC, which is for miscellaneous income. Irrespective of whether taxpayers receive a Form 1099-K or Form 1099-MISC, neither of these forms was designed to accommodate these types of transactions and their increasing frequency. In fact, Congress enacted the Form 1099-K reporting requirements in 2008, well before the advent of the Emerging Entrepreneur Economy, and the information reporting thresholds for Form 1099-MISC have not changed since 1954.⁶

As one prominent economist recently noted in an article on the tax challenges of the Emerging Entrepreneur Economy “[p]robably most of those providing services through the new service companies have no experience with the tax obligations of businesses...to comply with tax laws, these microentrepreneurs will be spending relatively large amounts on return preparation assistance and devoting large hours to record keeping...the sharing economy will be bearing significantly larger than average tax compliance costs.”⁷ The predominately electronic payment nature of transactions conducted in the Emerging Entrepreneur Economy provides opportunities to both reduce the burden on and increase the compliance of Emerging

² Kathleen Pender, “Here’s why Uber and Lyft send drivers such confusing tax forms.” *SF Gate*, Feb. 20, 2015, “many [Emerging Entrepreneurs] are self-employed for the first time and unaware of the need to keep careful records and make estimated tax payments four times a year. They’ve never filed a Schedule C, or paid self-employment taxes.”

³ Derek Davis (founder, www.sharedeconomycpa.com), email message to witness, April 13, 2015.

⁴ Laura Saunders, “Airbnb income may be tax-free – but there’s a catch.” *Wall Street Journal*, April 2, 2015.

⁵ Derek Davis, in discussion with witness, April 9, 2015.

⁶ Mark P. Keightley, “Economic Analysis of the Enhanced Form 1099 Information Reporting Requirements.” *Congressional Research Service Report for Congress* (R41400), Jan. 21, 2011.

⁷ Martin A. Sullivan, “10 Tax Challenges for the Sharing Economy.” *Tax Notes*, July 13, 2015.

Entrepreneurs. In the coming months, we will publish tax research and corresponding policy recommendations for your Committee and colleagues to review.

In the meantime, we applaud the Committee's initiative in discussing targeted tax solutions for America's small businesses. As many of you know, a one-size fits all approach for small business' tax compliance burdens is inefficient and fails to recognize the specific attributes and various criteria policymakers, academics, government agencies, and legal authorities rely on to characterize small businesses as opposed to other firms. The latest U.S. Government Accountability Office (GAO) research on small business tax compliance issues illustrates just how challenging it is to define small businesses as a distinguishable category of taxpayers and readily acknowledges "a consensus does not exist on a definition of small businesses, including which specific attributes or thresholds distinguish small businesses from other firms."⁸

For example, the Internal Revenue Service (IRS) Small Business and Self-Employed division is responsible for individual with business income and business returns with less than \$10 million of income, which is one official threshold for defining small business. Alternatively, the U.S. Small Business Administration (SBA) generally considers a small business to be an independent business with fewer than 500 employees, although even that definition can vary by industry.⁹

The definition of "small business" has very significant implications for policy consideration purposes as the numbers can vary widely. Using taxpayer reporting data, the U.S. Department of Treasury's Office of Tax Analysis (OTA) has developed a methodology to identify more than 23 million small businesses, however, SBA's Office of Advocacy, relying on U.S. Census Bureau data, has identified more than 28.2 million small businesses.¹⁰ Consequently, a discussion of targeted tax solutions for small business should include some facts about small business as generally defined for tax administration purposes.

According to GAO's research using data from OTA, the great majority of small businesses are individuals with business income. That is, most small businesses are individuals who report some business income as a sole proprietor or as a landlord on a separate schedule, together with their Form 1040s. This group of approximately 16 million small business taxpayers (69% of all small businesses), on average, earns \$100,000 (or less) per year and generates \$1.4 trillion of the total small business income reported to the IRS.¹¹ In contrast, the remaining 7.3 million small businesses (31% of reporting small businesses) are partnerships, S corporations or C corporations that earn, on average \$450,000 (or more) per year, and generate approximately

⁸ GAO, "Small Businesses: IRS Considers Taxpayer Burden in Tax Administration, but Needs a Plan to Evaluate the Use of Payment Card Information for Compliance Efforts." GAO-15-513 (June 2015) [hereinafter GAO-15-513].

⁹ SBA Office of Advocacy, Frequently Asked Questions about Small Business, March 2014, *available at* https://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf. [hereinafter SBA Advocacy FAQ]

¹⁰ GAO-15-513, *supra* note 8; SBA Advocacy FAQ, *supra* note 9.

¹¹ GAO-15-513, *supra* note 8.

\$4.5 trillion of total business income.¹² In contrast to the estimated average total income of \$121 million for larger businesses, \$250,000 is the “estimated average total income across all types of small business.”¹³

Given the foregoing facts regarding small business taxpayers, it is no great surprise that millions of small business owners—mostly individuals running businesses and earning less than \$100,000 each year—are unnecessarily burdened by an antiquated tax code and an IRS that cannot address their questions.¹⁴

Targeted tax proposals can alleviate some of the burdensome recordkeeping requirements or inequitable treatment small business owners sometimes encounter in complying with the requirements set forth in the Internal Revenue Code. For example, at Kogod, we have done extensive research on how liberalizing tax laws to permit more small businesses to adopt the cash method of accounting, as opposed to being required to adopt the more cumbersome accrual method, will reduce record-keeping and tax compliance costs with a minimal loss of accuracy or tax revenues to the government.¹⁵ We were encouraged to see bipartisan support for expanding the number of businesses eligible to use the cash method as discussed in the U.S. Senate Committee on Finance Business Income Tax Bipartisan Tax Working Group Report.

This Committee has a long history, dating back to its days as select Senate committee, of working on behalf of America’s small businesses on tax issues. Beginning in 1953, the SBC prepared a comprehensive survey of the impact of federal taxes on small businesses, culminating in an annual report to the Senate with key recommendations. Since then, the SBC has held more than 38 hearings over the years on tax-related concerns of small businesses. The work continues. Again, I thank you for the opportunity to testify today for the work you do on behalf of America’s small businesses. I welcome any questions from the Committee or its staff.

¹² *Id.*

¹³ *Id.* at 9.

¹⁴ Lisa Rein, “A standard dejection in the IRS helpline.” *Washington Post*, April 7, 2015.

¹⁵ Cash Method of Accounting: A Simpler Method for Small Firms: *Hearing Before the Subcomm. on Economic Growth, Tax and Capital Access of the House Comm. On Small Business*, 113th Cong. (2014) (written testimony of Prof. Donald Williamson, Kogod Eminent Professor of Taxation, Howard S. Dvorkin Faculty Fellow, Executive Director, Kogod Tax Policy Center, American University Kogod School of Business) available at http://smbiz.house.gov/uploadedfiles/7-10-2014_williamson_testimony.pdf.