TESTIMONY BEFORE THE COMMITTEE ON SMALL BUSINESS UNITED STATES HOUSE OF REPRESENTATIVES

Hearing on:

Paying Their Fair Share: How Tax Hikes Crush the Competitiveness of Small Businesses

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Mr. Chairman, Ranking Member Roger Williams, thank you for allowing me the opportunity to testify on how small businesses are impacted by federal tax legislation. I am a tax principal at Withum, a top 25 public accounting firm, and am responsible for monitoring, understanding, applying, and decimating information to Withum professionals and clients regarding current and pending federal income tax legislation.

I started my accounting career over twenty years ago, which includes working for public accounting firms, private industry, and teaching taxation at the University level. I currently specialize in federal domestic tax planning for businesses pursuing cash optimization.

In my previous work, I was responsible for developing and leading training surrounding the Tax Cuts and Jobs Act, with a focus on pass-through entity deductions and interest expense limitation rules. In relation to the Tax Cuts and Jobs Act, I also implemented a process to assist in method of tax accounting changes for small business, allowing more simplified methods for cash accounting and tracking inventory.

During the pandemic I established and co-led the Paycheck Protection Program and Employee Retention Credit consulting team regarding the Families First Coronavirus Response Act, CARES Act, Consolidated Appropriations Act, 2021, and American Rescue Plan Act. This included leading multiple external webinars with over 3,000 participants, writing client alerts, and helping clients understand the appropriate governmental funding that was available to them to ensure their businesses could continue operations during the pandemic.

Most recently my focus has been on helping clients understand the changes that were originally included in the Tax Cuts and Jobs Act that are being implemented in the 2022 and 2023 taxable years. This includes the requirement that research and experimental expenditures are no longer immediately deductible but required to be spread over five or fifteen years for purposes of determining taxable income, the significant changes made when calculating the interest expense limitation rules, and the tiered decrease of bonus depreciation to zero over the next five years.

Coupled with the existing law changes, I also monitor significant tax law changes that would increase taxes on closely held and small businesses, including provisions to:

- Increase of the top individual tax rate to 39.6% for single filers making more than $400,000 ($450,000 for joint filers);
- Expand the base of the Net Investment Income Tax to apply to active pass-through business income above $400,000 ($450,00 for joint filers);
- Increase the net investment income tax to 5% (from 3.8%) for earnings of more than $400,000;
- Limit the total 199A deduction to $400,000 ($500,000 for joint filers) or eliminating for all taxpayers whose taxable income exceeds $500,000; and
- Make permanent the pass-through business loss limitation rules.

While business owners understand the need to be pay their "fair share" of federal income taxes, there is an overriding concern that coupling an already expanded tax base with the proposed increases tax rates could cause a crucial tipping point where businesses are no longer be able to invest back into the economy and secure growth. The significant increase in federal tax payments will continue to cause negative effects on savings, investment, and entrepreneurship that could ultimately have a much broader impact on the United States economy. The challenge for Congress is to determine what is indeed a "fair share" of taxes while not negatively impacting a teetering economy and exhausted business community.

Broadening of the Tax Base Under Existing Legislation

Interest Expense Limitation Rules Modified (Effective for Taxable Years As Of January 1, 2022)

With the average fixed business interest expense rates increasing at least 5% between the 2021 and 2023 taxable year, and a substantial modification to the limitation of interest expense taking effect in the 2022 taxable year, it has become harder for small businesses to receive a tax deduction for needed capital. Businesses are often surprised that the amount of interest expense allowed as a tax deduction has been reduced d while their financing structure has remained the same.

Section 163(j) limited the amount of business interest expense to 30% of adjusted taxable income plus floor plan financing interest. For taxable years beginning before January 1, 2022, taxpayers were allowed to add back depreciation, amortization, and depletion when determining the amount of adjusted taxable income for purposes of this calculation. This provided a broader base, thereby increasing the amount of allowable business interest expense. However, starting in the 2022 taxable year, the addback of depreciation, amortization, and depletion is no longer available. This change creates a smaller base, and further limits the allowable business interest expense deduction.

The impact that the adjusted interest calculation can have on taxable income in the 2021 versus the 2022 taxable year is illustrated below.

Interest Expense Limitation	2021 Taxable Year	2022 Taxable Year
Interest Expense Rate	2.6%	5.39%
Preliminary Taxable Income	$300,000	$300,000
Plus Interest Expense	$195,000	$404,250
Plus Depreciation	$500,000	Not Allowed in 2022
Adjusted Taxable Income	$1,295,000	$1,004,250
30% Limitation	$388,500	$301,725
Disallowed Interest	**$0**	**$102,975**

Even worse for industries that utilize floor plan financing (essentially a revolving line of credit to purchase inventory), such as the automotive dealership industry, if their floor plan financing and their business interest expense exceeds 30% of adjusted taxable income no bonus depreciation is allowed for qualified property purchases.

Due to the rising inflation, businesses are being forced to either maintain or increase their borrowings. I encourage the committee to consider providing relief to businesses during this high inflation period and allowing depreciation and amortization to be included in the adjusted taxable income when calculating the interest expense limitation.

Research and Experimental Expenditures (Effective for Taxable Years As Of January 1, 2022)

Businesses making investments in research are baffled that the current federal tax code severely limits tax incentives for innovation. The Tax Cuts and Jobs Act requires the capitalization of research and experimental ("R&E") expenditures over a 5-year period (a 15-year period for foreign research) starting for taxable years beginning after December 31, 2021. For the 2022 taxable year, domestic R&E expenditures are not only required to be amortized over a 5-year period, but taxpayers can only begin at the midpoint of the taxable year, resulting in a 10% deduction. This is a stark contrast from the 2022 taxable year when entire amount of R&E expenditures were allowed to reduce taxable income.

Many businesses were anticipating a modification to the capitalization policy before the end of the 2022 taxable year, allowing immediate R&E expensing to boost business and economic growth, but Congress failed to address tax extenders at year-end.

Our current policy provides for only 10% of R&E expenses incurred in 2022 to be deducted in the same year, with the remaining costs required to be spread over an additional 5 years. This is in drastic contrast to many OECD countries that provide for a "super-deduction", allowing businesses an additional fictitious deduction for eligible research expenses. For example, in the United Kingdom small companies can deduct up to 230% of qualifying costs and convert the deduction to cash if there is no tax liability. China provides a 175% deduction for qualifying research expenses and recently raised that amount to 200% for manufacturing enterprises until December 31, 2023.

Not only do many OECD countries provide for super-deductions, but nineteen of thirty-seven countries provide further innovation incentives through a patent box which allows for revenue income related to intellectual property to be taxed at lower corporate income tax rates. For example, the lowest patent box rate is in Belgium which provides an 85% deduction for income related to eligible intellectual property, resulting in a 3.75% tax rate on designated income. Alternatively, Italy has the highest patent box rate which results in patent income being taxed at 13.95%. China's patent box regime reduces their general corporate tax rate from 25% to 15% for eligible high and new technology enterprises. The United States does not have a patent box regime.

It would only be reasonable to conclude that the United States' policy of limiting R&E expenses, coupled with the lack of a patent box regime, would be a significant economic factor when businesses are deciding whether they should continue to be involved in research. The R&E capitalization policy also confuses many who have been monitoring the Inflation Reduction Act clean energy initiatives. On the one hand, Congress is investing $369 billion for energy security and climate change as part of the IRA, but then appears to be stifling a clean energy transformation by requiring capitalization of R&E expenses. While the two policies were developed separately, it would make more sense if the two policies worked in tandem to promote clean energy modernization. For example, Belgium provides for an increased research deduction and credit for environmentally-friendly investments.

The R&E capitalization policy has a direct impact on business compliance costs as well. It not only raises their federal and state tax payments, it also results in an administrative nightmare. Businesses must determine whether a cost is considered an R&E expenditure that requires capitalization or an ordinary and necessary business deduction that can be immediately expensed.

Here is a simple example for a start-up company whose only income is related to research funded by grants. The grant requires that the funding be spent within the year on qualified

expenses. The company can retain the rights to any useful research (i.e. know-how, design, formula, process, etc.) if developed.

R&E Capitalization	**2021**	**2022**
Grant Income Received	$5,000,000	$5,000,000
Grant Expenditures		
R&E Expenses	($5,000,000)	($500,000)
Taxable Income	$0	$4,500,000

The requirement to capitalize R&E expenditures has some start-up businesses concerned they will be unable to continue their business as they do not have the cash required to pay the federal taxes due under the revised law.

I fear that this policy will significantly decrease innovation in the U.S. by limiting existing businesses research spending and detracting new businesses from forming the in the United States. It is important for the R&E capitalization policy to be reversed as soon as possible for the U.S. to remain competitive. At the very least, I would expect a small business exception be provided which would allow small business the ability to immediately expense R&E.

Bonus Depreciation Tiered Decrease (Effective for Taxable Years As Of January 1, 2023)

For any qualified property placed in service in the 2023 taxable year, bonus depreciation is reduced from 100% to 80%. Based on the current legislation, bonus depreciation will continue to decrease by 20% each year until it is no longer available starting in the 2027 taxable year.

Through the interplay of these three Internal Revenue Code Sections, taxpayers are already seeing a significant increase in their federal income taxable income and corresponding federal income tax payments. Any proposed legislation limiting the pass-through deduction or individual business losses, coupled with increasing individual income tax rates and expanding the applicability of the Net Investment Income Tax will only drive cash federal income tax payments higher.

Proposed Legislation

Increased Individual Income Tax Rate

Starting in 2026, the top individual income tax rate will increase from 37% to 39.6%. In the most recent Fiscal Year 2023 Budget proposal, the increased rate of 39.6% would be effective sooner and apply to a lower threshold amount of taxable income: $400,000 for single filers ($450,000 for joint filers). In addition, the same proposal would subject pass-through active business owners to an additional 3.8% net investment income tax. If the active business owners have modified adjusted gross income exceeding $400,000, it is proposed that the net investment income tax rate increase to 5%.

It is important to stress that while pass-through owners are required to pay tax as soon as the business has earnings, that does not necessarily equate to the owner receiving the cash from the business. In the event a pass-through business has positive earnings, oftentimes the earnings need to be put back into the business for additional investment, improvements, expansion, etc. Therefore, even though a pass-through entity owner is required to report the earnings of the business on their personal tax return, the owner's cash distribution from the pass-through entity is often limited to the taxes they will have to pay on the earnings of the business. In short, the S corporation shareholder is not left with significant cash to spend at the individual level as the cash remains in the corporation for additional investment. This concept is extremely important when statements refer to only raising taxes on the wealthy.

The taxation of pass-through entity owners is in direct contrast to the tax treatment of C corporation shareholders. The C corporation shareholders do not pay tax on the earnings of the C Corporation that is being reinvested in the corporation, rather they only pay tax when the C Corporation makes a dividend distribution to the shareholders.

Ignoring the pass-through deduction, a pass-through entity owner that is taxed on every dollar of income earned during the taxable year (but not received in cash) would increase their marginal tax rate from the current 37% to a shocking 44.7% (39.7%+5%). For every dollar the pass-through entity earns, approximately 45 cents will be remitted to the federal government as income tax, regardless of whether a cash distribution was made to the pass-through owner.

This is in addition to the assorted other taxes also assessed on the business, including state income tax, sales tax, and real property taxes. The significant increase in required taxes discourages businesses to reinvest, or even continue operations considering how much of their profit they must immediately remit to various governments.

Pass- Through Entity Deduction

The Pass-Through Deduction was originally enacted as part of the Tax Cuts and Jobs Act to provide some tax rate parity between pass-through entity owners and C corporation shareholders. With the C corporation tax rate dramatically decreasing from 35% to 21%, pass-through entity owners also required tax relief. The first income tax rate decrease provided to pass-through business owners was to lower the highest individual income tax rate from 39.6% to 37%. The second income tax decrease was provided through a fictious 20% deduction pass-through entity owners receive in relation to their pass-through taxable income.

For example, assume a pass-through entity owner is allocated S corporation taxable income of $100,000. Provided that the taxpayer qualifies for the pass-through deduction, they will be allowed a $20,000 deduction, resulting in taxable income of $80,000 (ignoring the standard deduction). This allows the owner of the pass-through entity business to decrease their marginal tax rate from 37% ($100,000 x 37%) to 29.6% ($80,000 x 37%).

In its most basic form, pass-through entities welcome an effective tax rate of approximately 30% when utilizing the pass-through entity deduction. However, the application of the pass-through deduction is far more complicated. The first step is in relation to taxable income. For the 2023 taxable year, a taxpayer's taxable income must be below $182,100 ($364,200 for joint filers); otherwise the ability to utilize the deduction could be limited. If a taxpayer's taxable income exceeds $232,100 ($464,200 for joint filers) in the 2023 taxable year and they are involved in certain designated businesses, then the ability to utilize the pass-through deduction disappears. Taxpayers no longer will receive the benefit after a taxpayers' taxable income exceeds $232,100 ($464,200 for joint filers) in the 2023 taxable year if the pass-through business involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services.

In addition, even if a taxpayer's taxable income exceeds $232,100 ($464,200 for joint filers) in the 2023 taxable year and they are not operating a designated business, additional hurdles must be passed in order to claim the deduction. These include limiting the deduction to 50% of the wages incurred at the business level or 25% of the wages incurred at the business level plus 2.5% of qualified business property.

Based on the complexity, and variations, pass-through entity owners often confront additional barriers to receive the deduction and thereby reduce their effective tax rate. While the pass-through deduction is a benefit to small business owners, it is not as simple of an application experienced by C corporation's when their tax rate was decreased to 21%.

Previous proposals have included limiting the pass-through entity deduction to a maximum amount of $400,000 ($500,000 for joint filers) or even eliminating the pass-through deduction for taxpayers with taxable income exceeding $500,000.

If taxpayers are no longer allowed the pass-through deduction their effective tax rates will increase by as much as 6%. For small business owners who are immediately paying tax on their earnings (though not necessarily receiving a distribution of the cash from the pass-through entity), a 6% increase in an effective tax rate is severe. In addition, the original intention to provide some equality between small business owners and C corporation would no longer exist.

I strongly encourage the committee to remember the reasoning for the pass-through deduction implementation and continue to ensure that pass-through businesses can retain this benefit to ensure closer parity to C corporations.

Loss Limitation For Non Corporate Taxpayers

One of the more unexpected legislative changes provided in the Tax Cuts and Jobs Act relates to the limitation of losses for noncorporate taxpayers. Under current legislation, noncorporate taxpayers are disallowed from deducting excess business losses for tax years 2021 through 2028. Excess business losses are defined as the excess of current-year net business losses over a specified amount (for 2023, $578,000 for married couples filing jointly and $289,000 for other taxpayers).

Under recent proposals, the loss limitation would become permanent and treat excess business loss carry forwards as current-year business losses, rather than net operating losses. The removal of excess business loss carryfowards from net operating losses could be catastrophic to the small business community.

It is important to remember that losses that flow from a pass-through entity to the owners often time reflect true-economic loss. For example, decreased sales, increased inventory costs due to supply chain issues, or increased costs in salary and employee benefits in order to maintain a strong workforce. In addition, there are a variety of tax limitations that must be applied before a business loss can be reported on a pass-through entity owners tax return. For example, pass-through owners must have enough basis in their S Corporation stock or partnership interest to reflect the business loss on their individual tax return. In addition, if the pass-through owner is deemed to be passive, they are only allowed to reflect the amount of the passive loss to the extent of passive income. Many pass-through owners were surprised, and dismayed, that yet another limitation was being added to prevent their ability to utilize business losses in the year incurred.

Limiting a taxpayer to total business losses of $578,000 for married couples filing jointly ($289,000 for other taxpayers) and then allowing them to utilize these excess losses going forward as a net operating loss is already challenging for small business. For example, assume that an S corporation shareholder who is single generates a loss of $3,000,000. Assuming the taxpayer passes the various other limitations, the business loss limitation would only allow the shareholder to utilize $289,000 in the current year taxable income. If the shareholder received reasonable compensation from the S corporation of $400,000, they would still be required pay tax related to the $111,000 of income (400,000-289,000) even though they incurred an overall business loss of $3,000,000. The remaining $2,711,000 (3,000,000-289,000) would be considered the excess loss and included in the net operating loss for the individual in the following taxable year. However, net operating losses can only be utilized to offset 80% of taxable income.

Under the proposed legislation, generating a loss would be debilitating for business operations. Using the same example from above, the S corporation shareholder would be limited to a $289,000 business loss every year. The excess loss of $2,711,000 would no longer be classified as a net operating loss and instead would be limited to $289,000 per year. For start-up businesses that generate losses in the beginning years, or for businesses negatively impacted due to an economic downturn, it would be difficult to overcome the minimal loss being allowed and the corresponding federal tax payments.

Cumulative Example

In the comprehensive example below, the same income and deduction items were evaluated under the tax law that existed in the 2021 taxable year versus the 2023 taxable year. Based on the existing tax law changes already incorporated in the Internal Revenue Code, the taxpayer in our example will increase their taxable base by 47.9% or $243,030, which is related to the decrease of allowable bonus depreciation starting in the 2023 taxable year and the new interest expense calculation requirement starting in the 2022 taxable year. The increase in taxable income between 2021 and 2023 results in additional income tax of $86,619, a 3.74% increase in the taxpayer's effective tax rate and a 2% increase in their marginal tax rate. Even with the changes that have gone into effect in the last two years, it is clear that small business taxpayers will be forced to pay more taxes.

	2021	**2022**	**Difference**
Taxable Income	$507,134	$750,164	$243,030
Tax Due	$121,286	$207,475	$86,189
Marginal Tax Rate	35%	37%	2%

In the far right column of the comprehensive example below, the same fact pattern is considered and continues to the decrease of bonus depreciation an additional 20%. The last column also continues to reflect the change in the interest expense calculation requiring adjusted taxable income to include depreciation and amortization deductions. Both the proposed increase in the individual income tax rate from 37% to 39.6% as well as the application of net investment income tax on materially participating pass-through owners is also applied. Lastly, the pass-through deduction is disallowed.
The contrast in the amount of taxes due in the 2021 taxable year and under the proposed legislation results in an increase in federal income taxes of over 100%. In addition, the marginal tax rate spikes to 10%. Based on these examples many small businesses will be forced to close as they will be unable to bear this cash impact.

	2021	2022	Proposed Legislation Changes	Difference between 2021 versus Proposed Legislation
Taxable Income	$507,134	$750,164	$1,026,130	$518.996
Tax Due	$121,286	$207,475	$382,795	$261,509
Marginal Tax Rate	35%	37%	44.6%	9.6%

COMPREHENSIVE EXAMPLE

	2021 Taxable Year	2023 Taxable Year		Future Years With Proposed Legislation
Married Filing Joint				
W-2 Wage Income:				
Spouse Wages	100,000	100,000		100,000
S Corporation Wages	125,000	125,000		125,000
S Corporation Taxable Income *(See calculation below)*	384,043	688,830		828,830
Standard Deduction	(25,100)	(25,900)		(27,700)
Pass Through Deduction (Assumed Pass-Through Deduction is removed or sunsets in future legislation)	(76,809)	(137,766)		-
Taxable Income	507,134	750,164		1,026,130
Federal Tax Due Using Current Tax Rates	**121,286**	**207,475**		**309,582**
Effective Tax Rate	**23.92%**	**27.66%**		**30.17%**
Marginal Tax Rate	**35%**	**37%**		**37%**
Proposed Federal Tax Rate Increase to 39.6%				343,454
Modified AGI exceeding $400,000			5%	32,692
Remaining S Corporation Income			3.8%	6,650
Proposed Net Investment Income Tax on S Corporation Income For Materially Participating Owners				39,342
Federal tax Due Using Proposed Rates				**382,795**
Effective Tax Rate				**37.30%**
Marginal Tax Rate In Relation to S Corporation Income				**44.60%**

Current Income Tax Rates Are Applied To All Years for Consistency & Comparison Purposes

Income brackets	***Tax Rate***		***Tax Due***
$0-$22,000	10%	22,000	2,200
$22,000-$89,450	12%	67,450	8,094
$89,450 to $190,750	22%	101,300	22,286
$190,750 to $364,200	24%	173,450	41,628
$364,200 to $462,500	32%	98,300	31,456
$462,500 to $693,750	35%	231,250	80,938
$693,750 or more	37%		

Proposed Tax Rates: Brackets have not been released as part of the proposals, but a rate of 39.6% will start to apply for joint filers with more than $450,000. The below brackets are for illustrative purposes.

Income brackets	***Tax Rate***		***Tax Due***
$0-$18,650	10%	18,650	***1,865***
$18,650-$75,900	12%	57,250	***6,870***
$75,900-$153,100	22%	77,200	***16,984***
$153,100-$233,350	24%	80,250	***19,260***
$233,350-$416,700	32%	183,350	***58,672***
$416,700-$450,000	35%	33,300	***11,655***
Over $450,000	39.60%		

S Corporation Taxable Income			
Manufacturing	*Note 1*	*Note 2*	*Note 3*
Gross Receipts	10,086,287	10,086,287	10,086,287
Cost Of Goods Sold	(7,479,919)	(7,479,919)	(7,479,919)
Gross Profit	2,606,368	2,606,368	2,606,368
Salaries/Wages	(582,173)	(582,173)	(582,173)
Payroll Taxes and licenses	(56,015)	(56,015)	(56,015)
Rent	(52,737)	(52,737)	(52,737)
Interest Expense	400,000	400,000	400,000
Allowed Interest Expense	(400,000)	(295,213)	(355,213)
Disallowed Interest Expense	-	*104,787*	*44,787*
Employee benefit programs	(131,400)	(131,400)	(131,400)
Depreciation	(1,000,000)	(800,000)	(600,000)
Ordinary Business Income	**384,043**	**688,830**	**828,830**
Interest Expense Limitation			
Adjusted Taxable Income	1,784,043	984,043	1,184,043
30% Limitation	535,213	295,213	355,213

Note 1: In the 2021 taxable year the applicable rate for bonus depreciation was 100% and the interest expense calculation is based on adjusted taxable income after adding back depreciation and amortization.

Note 2: In the 2023 taxable year the applicable rate for bonus depreciation is 80% and the interest expense calculation is based on adjusted taxable income reduced by depreciation and amortization.

Note 3: In the 2023 taxable year the applicable rate for bonus depreciation is 60% and the interest expense calculation is based on adjusted taxable income reduced by depreciation and amortization.