



**TESTIMONY OF PAUL HENSE
PRESIDENT
PAUL HENSE CPA, P.C.**

*“What is the Bush Administration’s Economic Growth Plan
Component for Paperwork Reduction?”*

**Before the House Committee on Government Reform
Subcommittee on Energy Policy, Natural Resources and
Regulatory Affairs**

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Introduction

I would like to thank Chairman Ose, Ranking Member Tierney and the other members of the House Committee on Government Reform, Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs for the opportunity to testify before you today. My name is Paul Hense and I come to you today from Grand Rapids Michigan. I am the President and owner of Paul Hense CPA, P.C. an accounting practice with a primary focus on small business and personal tax and financial advising. I sit on the board of the Small Business Association of Michigan, participate in the Grand Rapids Chamber of Commerce CEO roundtable and write a weekly column for the Grand Rapids Business Journal.

I also come before the committee today as a board member of the National Small Business Association (NSBA). The National Small Business Association, formerly National Small Business United, is the nation's oldest bipartisan advocate for small business. NSBA represents over 150,000 small businesses in all fifty states. Our association works with elected and administrative officials in Washington to improve the economic climate for small business growth and expansion. In addition to individual small business owners, the membership of our association includes local, state, and regional small business associations across the country. The goal of our association is to protect and promote our members and all of our nation's small businesses before Congress and the Administration. Before I start, I'd like to recognize the exemplary work of this committee under the leadership of Chairman Ose and Vice Chairman Schrock – you are friends to NSBA and we thank you for your efforts on behalf of all small businesses.

Overview

As most small businesses will tell you, compliance with federal regulations is difficult, time-consuming and costly. As the Office of Advocacy will tell you, federally mandated paperwork equates to eight billion hours, with the IRS accounting for 80 percent of that figure. Small businesses are at a severe disadvantage, facing costs of nearly \$7,000 per-employee just to keep up with regulatory and paperwork burdens, almost 60 percent higher than what large businesses pay.

By their very nature, unnecessary federal regulation and paperwork burdens discriminate against small businesses. Without large staffs of accountants, benefits coordinators, attorneys, or personnel administrators, small businesses are often at a loss to implement or even keep up with the overwhelming paperwork demands of the federal government. Big corporations have already built these staffs into their operations and can often absorb a new requirement that could be very costly and expensive for a small business owner.

Small businesses rely heavily on the following for help.

RFA – The Regulatory Flexibility Act, passed in 1980 directs federal agencies to consider the impact of new regulations on small businesses. Agencies must

analyze alternatives that would minimize impact on small-businesses and make those alternative analyses available for public comment. It is important to note that the RFA, along with small business collectively, does not seek special treatment, merely equal treatment and consideration under the regulatory process.

SBREFA – The Small Business Regulatory Enforcement Fairness Act, enacted in 1996 amended the RFA to give small businesses increased involvement in the regulatory process. The Chief Counsel for the Office of Advocacy, under this law, has the authority to file amicus briefs on behalf of small business when an agency is non-compliant with the RFA. SBREFA also enhanced the congressional role in major regulations as well as mandating issuing agencies to provide compliance assistance with any proposed rule.

SBPRA - The Small Business Paperwork Relief Act, passed in 2002, requires the Office of Management and Budget (OMB) to publish an annual list of compliance assistance resources, mandates each federal agency to establish a single point of contact to act as a liaison for small business, and to work on paperwork reduction. SBPRA also requires agencies to report to Congress on enforcement and abatement actions against small businesses as compared to large businesses.

Office of Advocacy – The most important government entity for small businesses, the Office of Advocacy is the federal government's primary watch-dog for small businesses. Charged with analyzing the role of small businesses in the economy, pursuing policies that support small business growth, and ensuring that small firms are heard by the federal government, the Office of Advocacy's role in regulatory relief is vital. Executive Order 13272, signed by President Bush in 2002, enhances and solidifies Advocacy's role of ensuring that regulations are reasonable and fair to small business.

Everyday Complexity

From the very beginning an entrepreneur faces an amazing array of complex tax based compliance requirements that can serve to muffle or dissuade the desire to strike out on their own. It is instructive to briefly examine the mounting tax compliance requirements that pile up as a business grows.

At the most basic level, an individual who decides to give up the predictability of an employer's paycheck can begin as a sole proprietor. The sole proprietor soon learns that the days of simply filing a 1040 with the IRS are gone. The new business owner is now responsible for both furnishing and filing information with the IRS. As a pass-through entity, the business owner must calculate their own Social Security and Medicare taxes and report them on Schedule SE for form 1040. Owners must keep track of business expenses and file deductions on Schedule C for form 1040. Owners who are involved in a simple partnership must report earnings on a Schedule K-1. Sole-proprietors must also file estimated quarterly payments with the IRS.

A business owner who decides that they want the benefits of limited liability protection and forms a Subchapter S corporation or Limited Liability Corporation increases both their startup costs and IRS paperwork burden. In addition to reporting salary on form 1040, owners must report dividend income on an attached Schedule E. Since the corporation is a separate entity, owners must report corporate income on form 1120-S. Owner's individual stake in the corporation must be recorded on Schedule K. Dividend disbursements must be submitted to the IRS on form 1099-DV. Owners who form a traditional C corporation face similar filing requirements as those who operate S corporations but with additional levels of taxation.

When an owner takes on employees the paperwork situation rapidly escalates. Employees must be issued W-2 and W-4 forms to enable income tax withholding and reporting. W-5 forms begin the long and involved process of providing the Earned Income Credit to eligible employees.

Social Security and Medicare withholding creates great complexity and serious liability concerns for employers. Employers must file quarterly payroll tax returns on form 941 and ensure that all payroll trust funds are in perfect order or face severe personal penalties.

Federal Unemployment Tax (FUTA) must be reported on form 940 and calculated quarterly. An owner's FUTA requirement will be affected by varying state unemployment tax rates.

Owners who wish to provide their employees or themselves (when possible) with fringe benefits further increase the amount of paperwork and liability they face. Section 125 accounts, qualified retirement plans, group life insurance and other benefits increase costs to employers and require special reporting measures.

The Alternative Minimum Tax in both its personal and corporate form continues to be selected by those business owners brave enough to attempt it on their own as some of the most burdensome and complex calculations required by the IRS. While the small corporation exemption is welcome, the IRS must continue its efforts to notify small businesses of their eligibility. As noted in a Treasury Inspector General for Tax Administration report from 2003, (Reference number 2003-30-114) over 3,600 taxpayers have paid more than \$37 million in corporate AMT even though they were eligible for exemption. For those that do not qualify for the exemption, pages of calculations and varying depreciation tables relegate AMT reckoning almost exclusively to computer programs.

Statutory vs. Administrative

Now, while I will tell you time-and-again that the underlying problem with tax paperwork is a painfully complex tax code, I must tell you that there are a number of administrative steps that can and should be taken. In past hearings with this very committee, the National Small Business Association has testified on the difficulties with

regulatory compliance. Chairmen Ose and Representative Schrock, have both agreed that the problem needs to be dealt with.

In January, when my colleague, Harold Igdaloff, testified, he told me that he perceived a lack of accountability on the part of the agencies. Granted, this wasn't inclusive of the IRS, but when we have various laws mandating agency compliance, we cannot simply shake our heads and allow agencies to continue disobeying the law simply because there isn't an agency or administrative office willing to take on the job of enforcement. The Office of Information and Regulatory Affairs (OIRA) has taken some leadership in dissemination and collection of information with the agencies, but seems unwilling or unable to act as the enforcement mechanism small businesses deserve.

NSBA has supported and will continue to support the following broad-based approach to reducing IRS paperwork. First and foremost, the IRS must actively seek ways to eliminate duplication of paperwork. In discussing our recent April 15th deadline, former witness to this committee Igdaloff noted that his tax returns weighed a pound and a half. As one of the few small business owners who still does his own taxes by hand, I can assure you this took valuable time away from his business. We also support and urge compliance assistance without the threat of penalty. I am confident that many more small businesses would seek assistance if there were guidelines established to prevent an overzealous agency from severely penalizing the small business seeking to right a wrong. I want to note that the IRS has been good to small businesses in that aspect. According to the IRS FY 2003 Regulatory Enforcement Report, nearly 68 percent of all abatements made were to small businesses. Finally, an increase in the importance of burden reduction will help exponentially. Giving OIRA the tools necessary to work on agency enforcement is a good start.

Now, since I am all-too-willing to criticize, I want to also relay to you some of the improvements NSBA members have commented on. The IRS Web site is improving, the ease by which we can find answers and solutions is increasing. E-file has significantly helped many of our members and we applaud your efforts on that. Efforts to reach out to the small business community and trade associations have sparked valuable dialogue. However, please keep in mind that repetition is still a problem. There are a multitude of computer programs for the sole purpose of completing tax forms. So while it is an annoyance for tech-savvy small businesses, imagine the difficulty a small business owner faces without a computer.

The Role of Congress

Regulatory solutions can only take us so far. It would be incorrect to conclude that the IRS was the sole source of paperwork burden for small business owners. In reality, we know that, while they can be a difficult and intimidating organization to work with, the IRS is carrying out the intentions of Congress.

A 2001 CATO report by Chris Edwards titled "Simplifying Federal Taxes" documented the startling growth of the Internal Revenue Code (IRC). According to the report, the

IRC has grown from 500 pages in 1913 to over 45,662 pages in 2001 with an astonishing 51 percent of the growth occurring since 1986. In the same period since 1986 there have been over 7,000 changes to the IRC with the vast majority of those changes affecting businesses. To keep up with these changes, the IRS website encourages tax professionals to review the Internal Revenue Bulletin for updated changes to rules. This is a weekly publication ranging from 45 pages to 260 pages per issue

It is beyond belief that any full time entrepreneur, who should be focusing on growing their business, could devote the time necessary to keep up with IRC changes. Evidence supporting this fact is the explosive growth in tax preparation and consulting services for both consumers and businesses. Since 1993, H&R Block has seen a 253 percent increase in revenues from its tax preparation services.

Lawmakers have also begun to readily adopt taxes that are phased in and phased out to improve the cost estimates for proposed legislation. While many of the tax changes exposed to these phase outs are positive developments for small businesses, a constantly changing tax landscape only makes long-term planning more difficult and serves to increase filing and paperwork burden.

The worst offenses are tax laws passed by Congress that place small business operators at a disadvantage. Many areas of the IRC, either unintentionally or on purpose, act as disincentives for people who might wish to start their own business. Many cases are documented in NSBA's report "The Internal Revenue Code: Unequal Treatment Between Large and Small Firms." Examples of inequities written into the law include statutes that prevent business owners using a SIMPLE 401(k) from saving as much for retirement as participants in a traditional 401(k), the exclusion of business owners from participation in Section 125 plans along with their employees and the Self-employment tax on health care.

The Tax Code is Broken

The tax code as it currently exists is unacceptable. Compliance costs are a dead weight loss to the economy. Complexity harms those looking to create businesses and aids those looking to avoid paying their fair share. The code decreases our national competitiveness and exposes us to international tax disputes like the Extraterritorial Income Exclusion Act rewrite currently before Congress.

It is understandably difficult for Congress to resist trying to fix small parts of the code in fits and starts. Many organizations like our own have legitimate quarrels with the IRC. However, the continuation of small fixes only further degrades the entire system.

Many proposals before Congress provide for fundamental tax reform that would vastly reduce compliance costs for individuals and businesses while collecting government revenues in a more efficient manner than we have today.

The Tax Reform Action Commission (TRAC) Act (H.R. 3215) proposed by Representative Jim DeMint would create a bipartisan commission to explore fundamental tax reform. The commission's recommendations would require expedited action from Congress serving to spur the debate on fundamental tax reform. I encourage all members of the committee to support H.R. 3215.

A better approach would be the adoption of the Fair Tax. The Fair Tax (H.R. 25), introduced by Representative John Linder, would repeal the entire IRC and replace it with a single rate national sales tax on the purchase of all new goods and services at the final point of consumption, while providing a rebate to families equal to the cost of essential goods and services. The Fair Tax would collect the same amount of tax revenue as current law while allowing consumers to see the actual cost of government with every purchase. The Fair Tax would do away with complicated tax returns and depreciation tables freeing individuals to spend their time more wisely.

Fundamental tax reform is an important goal for the future. I hope that members of this committee, while focusing on the important task of reducing regulatory burden, keep the ultimate goal of tax reform in mind.