



Statement of Roger Harris
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Before the U.S House of Representatives Committee on
Ways and Means

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Good afternoon, I am Roger Harris, President and Chief Operating Office of Padgett Business Services. For nearly fifty years, Padgett Business Services has been providing accounting, income tax planning and preparation, payroll and payroll tax services to thousands of small business owners through our network of 300 offices across the United States. Our clients generally have 20 or fewer employees and are what some people would consider “mom & pop” businesses. Based on recent studies almost 90% of all firms that have employees operate in our target market. In addition to my forty plus years with Padgett, I also had the honor of serving on the Internal Revenue Advisory Council for four years and was its Chair for two of those years. I believe this experience gives me a balanced approach to small business taxation – I have had the opportunity to see what works and what doesn’t work in the real world.

I think it would be difficult to find anyone in this country who does not believe that the current tax code is too complicated, too expensive to comply with, and needs to be replaced. I want to commend the work of this Committee and others that have started the process of looking at what can be done to reform our tax code. For many of our clients, the cost of complying with the tax code exceeds the taxes they pay each year. As someone that has spent an entire career working with small business owners I can tell you no group wants tax reform more than this country’s small business owners.

As you move forward with the tax reform process, I would suggest two objectives for small businesses. The first obviously is a simpler code. The second is to improve cash flow for small businesses so that they can survive and grow. The tax code should not stand as an impediment

to starting a new business. I am pleased to say the core components of the Ways and Means Committee Discussion Draft is a positive move toward meeting these goals.

Over the years it has become clear to me that for most small entrepreneurs, the business checking account is the focal point for their bookkeeping. It is how they measure cash flow and profits, and to a great extent is the foundation for their tax accounting as well. Anything that moves them away from this simple, yet effective, approach creates complexity. Further, small start-up businesses live or die on their cash flow: anything that creates a mismatch between taxable income and cash-on-hand is not only adding complexity but creates the practical problem of how do you pay the taxes when there is no cash in the till. Finally, it is important to keep in mind that while lower rates are always welcomed by small businesses, a base broadening exercise can result in significant added complexity and accounting costs for this group. It is for that reason that I commend the Committee's Discussion Draft. Including its recommendations in a tax reform package will help move small businesses to a truer cash basis environment and will serve to inoculate the small business sector from potential complexity brought about by a base broadening approach to tax reform. At the same time, I believe the Committee should consider additional proposals to provide small businesses relief from complex rules governing inventory accounting. These areas are two of the more significant examples of current tax rules that prevent small businesses from operating as a true cash basis taxpayer.

I applaud the following recommendations in the Discussion Draft:

Permanent Section 179 Expensing, Including Leasehold Improvements and Computer Software. The fact that this proposal is permanent and includes leasehold improvements and computer software ensures that it will provide concrete benefits to small businesses in both simplification and cash flow. The current approach of annually extending – many times retroactively – provisions intended to spur investment and growth such as section 179, have had just the opposite effect. For tax reform to truly stimulate economic growth it needs to engender confidence that we can count on the rules not changing every year. In short, volatility of the tax laws increases risk and risk dampens investment. I have seen this firsthand. If Congress gives business some certainty in this area, it will pay dividends to the economy.

We must also recognize the contribution this proposal makes to simplification. Having the ability to deduct the cost of equipment eliminates the need to keep detailed depreciation schedules on all of these assets and calculate on an annual basis what we can deduct for that year. For Padgett, the \$250,000 and \$800,000 dollar levels, indexed for inflation, are sufficient for the vast majority of our clients. Finally, this proposal is a great add-on to the expanded use of cash accounting because for many small business owners, they will be able to deduct all of the costs of new equipment in the year it is paid.

Increasing the Cash Basis Threshold for Small Businesses to \$10 million and Simplifying Its Application. This change will ensure that most small businesses will be covered by the general

cash basis exception. While the proposal also limits who receives this treatment, my experience tells me that the proposal will better target the benefit to the small business owners we all want to help survive and grow. Cash accounting allows a business to operate on the simple principle that money received is income, money paid out is an expense, and what's left is profit. This also has the effect of making cash flow and profits the same.

Today many small businesses have a hard time understanding why they must pay taxes on money they don't yet have or why they can't currently deduct money they just paid; therefore, resulting in a tax liability on money that is not in their bank account. To make matters worse, the business owner is required to keep more records to calculate this liability. At the end of the day the real difference between cash and accrual accounting is timing. Over time, the results are the same; it is just a matter of when it is reported.

Modification of Rules for Capitalization and Inclusion in Inventory Costs of Certain Expenses.

A current area of complexity for many small business owners is inventory. Inventory issues are more complicated than just looking to see what is sitting on the shelves. How the inventory is valued, what to do with inventory that is yet to be paid for, what accounting method should be used to track inventory, and what other costs must be included? The Ways and Means Discussion Draft makes a modest improvement toward a true cash basis system. It is limited, however, to small businesses that produce tangible goods. My recommendation is that the Committee considers additional changes that would provide further relief from the uniform capitalization and inventory rules for small businesses. The inventory rules affect small retailers the most and almost always require expensive accounting advice and return preparation. So, while the businesses these rules affect are what you and I might consider unsophisticated, the tax laws treat them like a national retail business.

One possible reform would be to create safe harbor guidelines that establish a materiality bright line for a small business owner. Current law allows a deduction for inventory that is not material to the business. Under such a safe harbor rule, a business owner that otherwise meets the \$10 million limit for cash basis could deduct increases in inventory as long as their inventory did not exceed a percentage of sales or a fixed dollar amount at the end of the year. Small business inventory meeting these rules would be deemed non-material. The Committee would need to consider special "smoothing out" rules for fast growing businesses to avoid a spike in income when the first year inventory must be reported. I believe something could be developed in this area that would not lose significant revenue to the Treasury but would further simplify the tax rules for the truly small, small business.

Combining Three Existing Provisions for Start-up and Organizational Expenses into a Single Provision Applicable to all Businesses and Increasing the Threshold to \$10,000. The committee's Discussion Draft recognizes the value of new business startups by establishing a unified deduction for start-up and organization expenses. I applaud the committee's recommendations, which are an improvement over the current rules. I would suggest, however, an even more aggressive approach to start-up expenses for the small business owners

that qualify for use of cash accounting. I would suggest that all start-up expenses be allowed as a deduction in the year the business opens. The only carryover or capitalization required would be for expenses that were incurred in a year before the business was opened. Those expenses would be allowed in the year the business opens its doors.

Once again, this is an attempt to promote the simple concept that when money comes in it is income and when it goes out it is an expense. It would also minimize their tax liability in that critical first year of a business, when cash is usually very tight if non-existent. Here again I fall back on my experience of trying to explain to a small business owner that has just opened their business that the expenses that he paid in July are fully deductible but those same expenses when he paid them in February may not be currently deductible because he was still opening the business. When it comes to small business start-ups, we should be willing to do all we can to encourage that activity.

Ease Tax Compliance by Changing the Due Date for Business Tax Returns. One of the big headaches of tax filing season has become waiting for partnership K-1s. The main reason for the late availability of these K-1s is that the due date for the partnership return is April 15 which, as we all know, is the due date of the individual return as well. For this reason I commend the Committee's proposal to make the partnership return due on March 15. By moving the date to March 15 we will now have 30 days to complete the individual return. However, I do question why the proposal moves the due date of a S corporation return from March 15 to March 31. I believe all pass-through returns should have the same due date. If we believe that we should create a 30 day window between a partnership return and the partners return why would we not want to have that same window for an S corporation return and that shareholders return?

Pass-through Entity Reform Options. In regard to the two options presented in the Committee Discussion Draft, the changes proposed in option 1 are very beneficial to businesses that operate as S Corporations. For our customers, this is a very common business structure and these proposed changes would be welcomed. While few of our clients operate as partnerships those that do would also welcome most of the proposals. There are some proposed changes to payments made to partners that will require some different thinking but as a whole these too would be beneficial for our clients. As to option 2, I think it is important to say that this represents more of a radical change from the current tax structure. As we all know, change can be a scary thing for some people. I do have some concern about the proposal to require entity level withholding on income for the smallest of small businesses. For this group, withholding on payments to the partners instead of income would be simpler for them to comply. Also, option 2 could generate more need for transitional relief. Over all, though, this option would still be an improvement over the current system.

In conclusion, the Committee's Small Businesses Discussion Draft definitely heads in the right direction for entrepreneurs looking for a fairer system that simplifies their lives and lets them

just focus on running and building their business. Thank you for this opportunity to testify today and Padgett Business Services looks forward to working with the Committee on Ways and Means on this crucial area of the tax code.