



A FairTaxSM White Paper

The impact of the FairTax on small business

Small businesses create a large effect in the U.S. economy.

Over five million strong, small businesses (those employing less than 20 people) account for 89 percent of all U.S. employers and employ over 20 million people, about 4.5 per business.¹ All this, despite the adverse effects of the current tax system on small businesses. In the words of one small business owner, “*Starting a small business means doing the one thing I love . . . and 99 that I hate. . . . A simpler, fairer, and growth-oriented tax code will ease the compliance burden on the small business owner – allowing them to again focus on the one thing they love.*”²

Tax regulations create the most difficulty for small businesses.

According to testimony given to President Bush’s Advisory Panel on Federal Tax Reform in 2005, of the 600,000 members of the National Federation of Independent Businesses that replied to a 2001 member survey on the regulation of small businesses, 36 percent responded that tax regulations create the most difficulty for them, more than any other category (health/safety, employment, environmental, occupation, other). In a 2003 survey on the burden of paperwork and record keeping, NFIB membership response showed that record keeping costs were the highest for tax related records and that two out of three respondents used an outside person to do tax records.³

Most small businesses pay taxes via the individual income tax.

Although many small businesses are not subject to the corporate income tax, the individual income tax affects most businesses in the United States. That is because business earnings are often paid through the individual income tax when “passed through” to business owners. The business income from sole proprietorships, S corporations, etc. is all taxed at the owners’ individual income tax rates. In 2004, 31 million business owners are estimated to receive this type of income and pay tax on this income through the individual income tax.⁴ Research suggests that across-the-board tax cuts, regardless of income level, would increase entrepreneurial start-up and survival.⁵

¹ U.S. Small Business Administration, Office of Advocacy.

² Harris, Roger, President of Padget Business Services, presentation to the President’s Advisory Panel on Federal Tax Reform, March 8, 2005.

³ Hurley, David L., testimony to the President’s Advisory Panel on Federal Tax Reform, March 8, 2005.

⁴ “Fact Sheet: The Tax Burden on Investment and Entrepreneurship,” prepared for the President’s Advisory Panel on Federal Tax Reform,” U.S. Treasury Office of Tax Analysis, March 11, 2005.

⁵ Bruce, Donald, “Taxes and Entrepreneurial Endurance: Evidence from the Self-Employed,” *National Tax Journal* Vol. 55, No. 1, pp. 5-24, March, 2002.



The impact of the FairTax on small business

The FairTax Plan (which replaces federal individual and corporate income taxes (including self-employment taxes and the alternative minimum tax), the payroll tax, and the estate and gift tax with a single rate, simple national retail sales tax on the retail sale of all goods and services) dramatically improves the economic environment for small businesses. It reduces compliance costs and tax burdens and improves bottom line profits.

Under the FairTax, small businesses enjoy a zero tax rate. And zero compliance cost. Corporations, subchapter S corporations, partnerships, limited liability companies, and sole proprietorships pay no tax on their income. Both the employee and employer share of payroll taxes, the self-employment tax rate, and the estate and gift tax are abolished.

Compliance costs are a much more substantial economic drag on small businesses than they are for larger businesses. According to the Tax Foundation, small businesses spend \$724 to comply with the income tax for every \$100 they pay in tax. More than 90 percent of all U.S. corporations have assets of \$1 million or less and, therefore, bear tremendous relative compliance burdens. Small corporations bear a compliance cost burden about 27 times greater than the largest U.S. corporations, those with \$10 billion or more in assets.⁶

A small business today must use tax accounting rules (which are different than generally accepted accounting principles) to keep track of: Income, inventories, various types of expenses (some deductible, some partially deductible, some not currently deductible, and some never deductible), depreciation (which must be recorded in at least two ways for regular and alternative minimum tax purposes), tax basis for assets sold, various pension and deferred compensation rules (including participation, top-heavy and non-discrimination rules), various employee benefits rules, and so on. The small business must also keep track of payroll taxes, including Social Security, Medicare, and unemployment taxes as well as file a plethora of information returns on its payments.

Small business compliance costs drop dramatically under the FairTax because the only question relevant for sales tax purposes is, “How much did you sell to consumers?” *Period*. Businesses that sell to other businesses have virtually no compliance costs, since intermediate business-to-business sales are not taxed under the FairTax Plan. In addition, under the plan, retail businesses receive an administration fee that allows them to keep a portion of the sales tax they collect to compensate them for collection costs. The Tax Foundation estimates that overall compliance costs fall by more than 90 percent.⁷

Small businesses are found in service, retailing, and other labor-intensive industries. Both complying with and paying the payroll tax and the income tax impose a major burden on these small businesses. Moreover, the service sector and the retailing sector typically have much higher effective income tax rates than other businesses.

⁶ “Federal Tax Compliance Costs Climb to \$225,” Tax Foundation, *Tax Features*, Vol. 40, No. 3, March 1996, p. 3.

⁷ *Ibid.*, page 2.



Kill the estate tax.

Each year, many small businesses and farms must be sold out of the family to pay estate and gift taxes when the founding generation dies. After a lifetime of hard work and risk-taking, the estate and gift tax deprive the small business owner or family farmer of the right to pass his or her life's work on from father and mother to son or daughter. The estate tax punishes those who save and work hard to build an enterprise. In contrast, those who deplete their estates by heavy spending in their retirement years pay little or no estate tax.

Under the FairTax Plan, the estate and gift taxes are repealed. The need for small businesses and farmers to engage in expensive estate planning involving attorneys, complex estate freeze transactions, and expensive life insurance plans in anticipation of future estate and gift tax liability disappears.⁸ Heirs no longer need to sell the business or farm out of the family or borrow heavily, putting the business at risk, to pay the estate tax.

The FairTax Plan increases economic growth.

Small businesses thrive in a healthy, growing economy, but because of inadequate capitalization and lack of access to sufficient bank credit, they have much more difficulty in a stagnant or shrinking economy. The FairTax causes the economy to grow and become much more dynamic. In a research paper, economist Dale Jorgenson of Harvard University states that, "...the revenue neutral substitution of the FairTax for existing taxes would have an immediate and powerful impact on the level of economic activity. GDP would increase by almost 10.5 percent in the first year."⁹ Laurence Kotlikoff of Boston University found that implementation of the proposed tax reform plan "...raises the economy's capital stock by 42 percent, its labor supply by 4 percent, its output by 12 percent, and its real wage rate by 8 percent. It also lowers real interest rates by more than one quarter."¹⁰

⁸ Beach, William W., "The Case for Repealing the Estate Tax," The Heritage Foundation, Backgrounder # 1091, August 21, 1996, estimates using both the Washington University Macro Model and the U.S. Macro Model of Wharton Econometric Forecasting that repeal of the estate and gift tax would increase Gross Domestic Product by \$11 billion per year, create 145,000 new jobs, increase personal income by \$8 billion per year and increase federal revenues marginally.

⁹ Jorgenson, Dale W., "The Economic Impact of the National Retail Sales Tax," unpublished report to Americans for Fair Taxation, November 25, 1996.

¹⁰ Kotlikoff, Laurence J., "Replacing the U.S. Federal Tax System with a Retail Sales Tax – Macroeconomic and Distributional Impacts," unpublished report to Americans for Fair Taxation, December 1996.



The impact of the FairTax on small business

What is the FairTax Plan?

The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?

FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

TAW/km 6-05

(AFFT Documents\Papers on a specific subject\The impact of the FairTax on small business)