Impact of the FairTax on Small Business

The present tax system has adverse impact on small businesses. Replacing the federal income 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 would dramatically improve the economic environment for small businesses. It would reduce compliance costs and tax burdens and improve bottom line profits.

Under the FairTax, small businesses would enjoy a zero tax rate. Corporations, subchapter S corporations, partnerships, limited liability companies, and sole proprietorships would 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 would be abolished.

Compliance costs are a much more substantial economic drag on small business 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. In fact, 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.[1]

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 would 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 would 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 would receive an administration fee that would allow 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 will fall by more than 90 percent. [2]

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

[1] "Federal Tax Compliance Costs Climb to $225," Tax Features, Tax Foundation, March 1996, p. 3.
[2] "Ibid.

small businesses. Moreover, the service sector and the retailing sector typically have much higher effective income tax rates than other businesses.

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 that save and work hard to build an enterprise. In contrast, those that deplete their estate by heavy spending in their retirement years pay little or no estate tax.

Under the FairTax plan, the estate and gift tax will be 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 would disappear.[3] Heirs would 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.

Perhaps as important as these factors, is the impact that the FairTax would have on 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 would cause the economy to grow and become much more dynamic. In a recent paper, 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."[4] 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."[5]

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[3] William W. Beach, "The Case for Repealing the Estate Tax," The Heritage Foundation, 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.

[4] Dale W. Jorgenson, "The Economic Impact of the National Retail Sales Tax," unpublished report to Americans for FairTaxation, November 25, 1996.

[5] Laurence J. Kotlikoff, "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.