PRO-GROWTH TAX POLICY: WHY SMALL BUSINESSES NEED INDIVIDUAL TAX REFORM

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

OF THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

HEARING HELD
NOVEMBER 3, 2011

Small Business Committee Document Number 112–043
Available via the GPO Website: http://www.fdsys.gov

U.S. GOVERNMENT PRINTING OFFICE

71–957 WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON SMALL BUSINESS

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THURSDAY, NOVEMBER 3, 2011

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON ECONOMIC GROWTH,
TAX AND CAPITAL ACCESS,
Washington, DC.

The Committee met, pursuant to call, at 10:00 a.m., in Room 2360, Rayburn House Office Building. Hon. Joe Walsh [chairman of the subcommittee] presiding.

Present: Representatives Walsh, Chabot, Mulvaney, Hanna, Schilling, Schrader, and Chu.

Chairman WALSH. Welcome. Good morning, everyone. I call this hearing to order.

I want to thank the witnesses for testifying today. We appreciate your participation. I will begin with a brief opening statement. But again, welcome and thanks for coming to this Subcommittee on Economic Growth, Tax and Capital Access hearing on Pro-Growth Tax Policy.

The news today for small business owners is not good. The economic recovery is weak. Small businesses are still struggling. Credit remains tight and forecasts indicate weak hiring will continue. Washington, which should be making job creation easier, is instead creating more hurdles with the constant threats of higher taxes, excessive regulations, and our unsustainable debt. It seems that no one has a bigger target on his back than the small business owner.

As Congress turns its attention to tax reform, the budget deficit, and pro-growth policies, today this Subcommittee will focus on the importance of tax reform to small businesses. Specifically, we will examine the need for individual tax reform for pass-through organizations—those that pass through their income and tax liability and pay taxes on their owner's individual tax returns rather than on a corporate return.

According to a recent study by Ernst & Young, about 95 percent of businesses, and over 80 percent of small businesses, are organized as pass-throughs. These companies, such as LLCs, partnerships, S corps, and sole proprietorships, represent 54 percent of all business activity and employ 54 percent of the private sector workforce. Our local small business, not the government, will create the jobs and pull us out of this recession. The Internal Revenue Service's national taxpayer advocate has said that the most serious problem facing taxpayers is the complexity of the tax code and the need for reform. Studies have shown that the cost of tax compliance for small business is 67 percent higher than for larger entities.

Pass-throughs are becoming more prevalent. Between 1986 and 2005 their number more than doubled, while the number of C corporations declined. Enacting policies that will keep pass-through entities taxes low will help small businesses to spur our economy. It is especially important that we consider revamping the tax code in a way that generates jobs and economic growth. Common sense tax and regulatory reform for small businesses will help us do just that.

I recently introduced legislation, H.R. 2945, to index the capital gains tax to inflation. Americans should not have to pay capital gains tax on an asset purchased 20 years ago and sold today but increased in value only due to inflation. Making this simple change would allow small business owners to create jobs and grow the economy.

Today we will hear from an economist and small business owners about why individual tax reform for these pass-through entities, and not just corporate tax reform, must be a fundamental part of tax reform.

Finally, I must say a word about President Obama's Jobs Plan. In August 2009, the president said the last thing you want to do is to raise taxes in the middle of a recession. But yet that is what he has proposed. Small business owners know that you cannot raise taxes and expect employers to create jobs especially in a recession. But let us listen to our nation's best job creators and consider policies that will truly jumpstart hiring and lead to long-term economic growth.

Again, thank you to our witnesses for participating today. I look forward to hearing input on how we can reform the tax code so our small businesses are able to expand, create jobs, and help our economy grow.

I now yield happily to our Ranking Member Schrader for his opening statement.

Mr. SCHRADER. Thank you very much, Mr. Chairman. Thank you all for being here today. Some of you have come quite a long way and I appreciate it.

I agree with the chair. Entrepreneurs today face many, many challenges when they are starting a business. I, myself, am a veterinarian, 35 years, small business, private enterprise. Labor, access to capital, just a myriad of different problems, marketing, the whole nine yards. But one of the most important decisions you all make at any point in time is how you organize yourself regarding your tax structure. How you want to operate as a business.

Today we are going to listen to the experts in the field, if you will, by boots on the ground, about how to—what is the best way to operate non-corporate business entities which most small business fall under? A lot of the discussion we have had to date has been about corporate tax reform, which I strongly support but corporate tax reform in and of itself would leave most small businesses behind. And a lot of us have operated as sole proprietors. I have been a sole proprietor, I have been a partnership, and I have been an LLC. And a lot of the discussions that I am hearing now would not really help me, or you, or most Americans out there that are the real job creators at the small business level.

So I really appreciate that you are having this hearing on pass-through entities so we can raise America's consciousness about what really goes on. And I have had many a tax statements at the end of the year that showed I was making $200– to $300,000 and all I know is I was taking $60,000 home in cash at the end of the day. And a lot of my stuff was going back into the business and the statement did not mirror what was actually going on. So I really am looking forward to your comments about, you know, what really is going on here.

The majority of small businesses use the pass-through structure. It offers the best opportunity for reinvesting savings back in the business and hiring employees. That is how you hire people. You make that investment. Small business non-corporate entities actually employ over 50 percent of the total work force and report over a third of the business receipts that are out there. So we are an important force, I think, in America's economic recovery and economic development at the end of the day.

So we have to really look at these unique challenges. I am very concerned on the super committee that there has been a lot of talk about tax reform. Some of my colleagues on the other side of the aisle have embraced the corporate without embracing the actual pass-through entities. Comprehensive tax reform is the way I think to bridge the differences between democrats and republicans. And so I am real pleased that my chair has held this hearing today because this is an area where we can actually have agreement. And frankly, by having this hearing and listening to you we can push the super committee to do the right thing and consider comprehensive tax reform that could lower all our rates, get rid of all these tax deductions, many of which do not benefit us compared to some of our bigger corporate entities, and actually get more money on the table at the end of the day to buy down our debt. That is I think the confidence that America has in not just Congress but our corporate and non-corporate business community to actually be competitive in the global environment hinges on, I think, to comprehensive tax reform.

People are looking for guidance. People are looking for someone to step up to the plate and make the big decisions that make us think that jeez, we actually have an opportunity to compete in this global economy. We can kick China's and India's butt instead of the opposite happening at this point in time. And a lot of American small businesses are the ones that are going to be doing that.

So with that I want to thank you all for being here and I yield back, Mr. Chair.

Chairman WALSH. Thank you, Ranking Member Schrader. This is so nice. We probably could have written each other's opening statements.

If Subcommittee members have an opening statement prepared, I ask that it be submitted for the record. To our witnesses, you will each have five minutes to deliver your testimony. The light will start out as green. When you have one minute remaining the light will turn yellow. Finally, it will turn red at the end of your five minutes. And depending on what I think about your testimony—just kidding.

STATEMENTS OF ROBERT J. CARROLL, PRINCIPAL, ERNST & YOUNG, LLP; GARY MAROWSKE, PRESIDENT, FLAME FURNACE, TESTIFYING ON BEHALF OF AIR CONDITIONING CONTRACTORS OF AMERICA; WILLIAM R. SMITH, PRESIDENT AND CEO, TERMAX CORPORATION, TESTIFYING ON BEHALF OF PRECISION METAL FORMING ASSOCIATION; STEPHEN CAPP, PRESIDENT AND CEO, LASERAGE TECHNOLOGY CORPORATION, TESTIFYING ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Chairman WALSH. Our first witness is Robert Carroll. Mr. Carroll is a principal with Ernst & Young, LLP's qualitative economics and statistics group. He is an advisor to public and private tax clients on federal tax policy, including revenue and economic effects. He received his B.S. from the State University of New York at Albany and his Ph.D. in Economics from Syracuse University.

Welcome, Mr. Carroll. You have five minutes to present your testimony.

STATEMENT OF ROBERT J. CARROLL

Mr. CARROLL. Well, thank you very much, Chairman Walsh, Ranking Member Schrader, distinguished members of the Subcommittee. I thank you for the opportunity to testify today regarding the taxation of flow-through businesses and tax reform.

I have had the opportunity to consider the taxation of flow-through businesses from a number of different perspectives inside and outside of government in the context of broad reform of the code and more narrow reform of the business tax system. Earlier this year I analyzed the economic footprint of the flow-through sector on behalf of the S corporation Association, and I have been working with various private sector clients to evaluate and understand various aspects of tax reform.

Today, I would like to share my perspectives and provide some results from the study on the flow-through sector we prepared earlier this year. Flow-through businesses, S corporations, partnerships, limited liability companies, and sole proprietorships play an important role in the U.S. economy. The vast majority of businesses in the United States have chosen to organize as flow-through businesses.

Today, flow-through businesses comprise more than 90 percent of all business entities, employ 54 percent of the private sector workforce, and report 36 percent of all business receipts. Individual owners of flow-through businesses report 54 percent of all business net income. These individual owners also pay 44 percent of business taxes when filing their individual tax returns. The flow-through business form provides firms with flexibility in how they organize and structure operations. Businesses can choose between several different organizational forms which may better match their management needs and capital requirements. With the increasing prominence of flow-through businesses, it is important to carefully consider how the flow-through form fits into the U.S. tax system and how any particular tax reform might affect this sector.

Flow-through businesses are subject to a single level of tax on the income earned and allocated to their owners. Thus, it is the tax rates faced by individual owners of flow-through businesses that affect decision-making and the economic health of these businesses. In contrast, the income of C corporations is subject to two levels of tax. First, when income is earned at the corporate level and again when the income is paid out to shareholders in the form of dividends or retained and later realized by shareholders as capital gains. Hence the phrase the double tax on corporate profits.

The double tax affects a number of important economic decisions. First, by increasing the cost of capital it discourages investment and thus, economic growth and job creation. Second, it leads to a bias in firms' financing decisions between the use of debt and equity. Third, it distorts the allocation of capital within the economy. The flow-through form provides an important benefit to the economy by reducing these economically harmful effects of the double tax.

There is a growing consensus for the need to lower the corporate income tax rate. The United States has the second highest statutory corporate income tax rate, second only to Japan. The U.S. corporate income tax rate is also high relative to several other measures. In today's global economy, the high U.S. corporate tax rate, combined with other features of the corporate income tax, make it more difficult for the U.S. to attract investment and also may be adversely affecting workers' wages.

With the substantial evidence that the U.S. corporate rate and tax system is out of step internationally, corporate tax reform is an important component of an overall approach to improving the current tax system. But the focus on corporate tax reform has also drawn attention to how flow-through businesses might be affected by such a reform. As with any such endeavor, it is important to keep in mind the potential for undesirable side effects. Corporate reform that eliminates business tax expenditures would have the unintended impact of raising the taxes of businesses organized using the flow-through form without offering the benefit of the lower corporate tax rate. Flow-through businesses would lose the benefit of widely used and longstanding provisions such as accelerated depreciation, the production activities or manufacturing deduction, and the charitable giving deduction.

In total, flow-through businesses use about 23 percent of the roughly 120 billion in annual business tax expenditures. Flow-through businesses are a large part of the U.S. business sector and important contributors to the economic vitality of the United States. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conclusive to increased growth and job creation. The path towards tax reform will need to take into account many features of our tax system and strike a balance between a number of sometimes conflicting and competing objectives.

This Subcommittee should be commended for holding this hearing to better understand the role the flow-through sector plays in the U.S. economy. Thank you, and I would be pleased to address any questions the Subcommittee may have.

[The statement of Mr. Carroll follows on page 23.]

Chairman WALSH. Thank you, Mr. Carroll.

I now yield to Ranking Member Schrader for the purpose of introducing our next witness.

Mr. SCHRADER. Well, thank you, Mr. Chairman. It is my pleasure to introduce Gary Marowske, president of Flame Furnace in Warren, Michigan. You have come a long way.

His company was founded in 1949. Still in business. That is a great thing. Currently has 70 employees. Hopefully more in the near future. And Flame Furnace is one of the leading HVAC residential services in the Detroit Metro area. So welcome to our Committee.

STATEMENT OF GARY MAROWSKE

Mr. MAROWSKE. Thank you. And thank you, Chairman Walsh. And again, Ranking Member Schrader.

I will flip through my comments. I appreciate the opportunity to testify before you here this morning.

Again, my name is Gary Marowske and I am the president of Flame Heating and Cooling, Plumbing, Electrical in Warren, Michigan. We supply services in heating, cooling, plumbing, and indoor air quality equipment throughout southeastern Michigan. Like a lot of small businesses in the HVAC industry, Flame is a family-owned company started in 1949 by my father, Bob Marowske, from a humble beginning. We have been blessed and grown steadily and today we employ—it is actually about 75 now. We screwed up on what we gave you—workers. We have a fleet of more than 60 vehicles and have installed over 75,000 comfort systems over the last 60 years.

I am a proud member of the Air Conditioning Contractors of America of where I am the chairman of the Government Relations Committee. The ACCA's member companies epitomize the spirit and entrepreneurship of America's small businesses. Nearly three-fourths of ACCA member companies have fewer than 25 employees and 92 percent have fewer than 100 employees. Most start out with technical skills, a truck, and the American dream as they are going to create their own business.

It is my honor and privilege to give voice to the small business contractors of the heating, ventilating, air conditioning, refrigeration industry on the ongoing and much needed debate about tax reform. The contribution of small businesses to our economy is often overlooked, but companies like mine employ 70 percent of the American workforce and are the chief source of new jobs in an economic recovery. I wholeheartedly agree that tax reform must address the individual rates because of their impact on small businesses. Not everyone understands that sole proprietors, partnerships, and S corps shareholders pay taxes on business income through individual tax rates.

Flame Furnace is organized as an S corp, as are most of the small businesses in the specialty construction trades, in part because it protects the owners and shareholders from business liabilities and debts. And on the debt part, 95 percent of all small businesses owners must also personally guarantee all bank debt, vehicle leases, office equipment, et cetera. And it also facilitates as a sub-S and easy transfer of ownership through stock, through family members, or whomever you would like to pass it on.

Changes to the individual tax rates have a direct impact on pass-through entities, so Congress should be very careful before enacting any tax reform proposals that tinker with the individual tax rates. In 2009, only 7 percent of federal tax revenue came from the income taxes paid directly by C corps, what most people assume a corporation to be. Individual income tax revenue, including net from all the pass-through businesses was 44 percent of the federal tax revenue in 2009. Unfortunately, it is impossible to say exactly how much came from income tax on the pass-through companies.

As you contemplate changes to individual rates and the corporate and international tax codes, I want to take this opportunity to point out that America's small businesses are looking for a simple, rational, permanent tax code that will encourage prosperity and foster job creation. The tax code is a powerful tool that can affect individual corporate behaviors in a way that advanced beneficial public policies, like allowing homeowners to take a deduction on their mortgage interest, permitting small businesses, such as my company to use enhanced Section 179 expensing limits and bonus depreciation. These incentives work, and my company and thousands of ACCA companies have used them to buy new trucks, office equipment, other investments.

An example is the Homeowner's 25C Residential Energy Efficiency Tax Credit for installing qualified high-efficiency furnaces, boilers, air conditioners, et cetera. The 25C tax credits are easy to take advantage of and they do not favor the wealthy according to IRS statistics. Fully, 93 percent of tax credit claims under 25C and 25D for solar, geo, wind, and photovoltaic properties were made by taxpayers who have an adjusted gross income of no more than $200,000, which is indicative of a middle class tax.

The 25C tax credits highlight how a simple tax incentive can help individuals and small businesses create an economic benefit. Americans spent more than $25 billion on energy improvements to their homes that qualified for the tax credits. Now, consider the National Association of Homebuilders that estimates every $100,000 in remodeling expenditures generates 1.11 new jobs. Congress needs to extend the 25C tax credits beyond their expiration at the end of this year, restore the tax value to 1,500 as my associations. My personal opinion is if we want to drive individual behavior, save energy, create economic activity, we ought to raise the credit to 5,000 and you will see more than a payback on that.

Another important change to the tax code would be to bring the depreciation schedules for HVACR equipment and other building components more in line with reality. According to the tax code, commercial HVACR equipment must be depreciated over 39 years. And if any of you own a building, you know that the air conditioner does not last 39 years. This would include doctors' offices, home small businesses, car dealerships. That type of building this would apply to.

Let me close by saying the small business community needs certainty. We have all applauded the repeal of the Form 1099 filing provision in April. We are hopeful that the Senate can pass and repeal the 3 percent withholding tax on government contracts, but the effort to pass these two small business priorities highlights the piecemeal and short-term approach Congress has taken with regard to the tax code.

Last year extended more than 60 tax incentives that benefitted individuals and small businesses just two weeks before they were set to expire and that makes it tough for planning for a small business for advertising, marketing. Included in the bill were a temporary extension of the Bush tax cuts, short-term estate tax reduction, and short-term extension of bonus depreciation and modification to Section 179 expensing rules, a one-year extension of the alternative minimum tax patch, and a temporary extension of the residential energy tax credits described above.

While extension of these tax incentives is greatly appreciated, the timing and nature of their extension make it very difficult for businesses to make business decisions. America's small business owners are crippled and worried about what may or may not happen next year. By sending the right signals to America's small businesses, Congress can eliminate the fear of the unknown and I can assure you American small businesses will rise up and create new jobs.

With that I conclude my comments, and I will be happy to answer any questions. Thank you again for the opportunity to testify. I hope I did not put you to sleep.

[The statement of Mr. Marowske follows on page 35.]

Chairman WALSH. Not even close. Thank you, Mr. Marowske.

Let us keep our Midwest vent going here. Mr. Carroll, you are from Ohio, right?

Mr. CARROLL. I am actually originally from New York.

Chairman WALSH. Oh, okay. All right. Close enough.

Let us turn to Illinois. Our next witness is William R. Smith. Mr. Smith is president and CEO of Termax Corporation in Lake Zurich, Illinois, which I have the honor to represent. Termax is a small family manufacturing and engineering company specializing in metal and plastic fasteners. Mr. Smith is testifying on behalf, as well, of the Precision Metal Forming Association.

Welcome, sir. You have five minutes. Thanks.

STATEMENT OF WILLIAM R. SMITH

Mr. SMITH. Thank you, Chairman Walsh, Ranking Member Schrader, members of the Committee. Thanks for the opportunity to be here today.

My name is William Smith. I am the president and CEO of Termax based on Lake Zurich, Illinois. We are members of the Precision Metal Forming Association that has about 1,000 member companies representing $113 billion in precision metal products in that industry. About two-thirds of our member companies are structured as subchapter S corps or similar pass-throughs, as is Termax Corp. The industry average is about 50 employees per business, most of which are family-owned like ours.

My father founded the company in 1971, and in 1998, my brother and I took over the operations where we have seen the company grow to about 250 employees and we hold over 60 patents. Now, while primarily servicing the automotive industry, our company manufactures clips and fasteners for many industries, including appliances, lighting, toys, construction, automotive, and we are the number one exporter of parts in the world for these sorts of things.

Now, before taking over the family business in '98, I worked as a CPA, certified public accountant, for roughly 20 years, also a small business, giving me a unique perspective to understand both the production and finance sides of manufacturing in America. In my experience as a CPA, the vast majority of manufacturers are structured as S corporations, LLCs, and partnerships, or other pass-through entities. Everybody has statistics. Our statistics showed that 50 percent of all private employers are structured this way, and among the PMA member companies we know that 64 percent are also pass-through entities.

We are structured this way because we are family-owned. We have a limited number of shareholders and owners who are often our siblings and increasingly our children and grandchildren. It just makes sense. Manufacturers like us pay our income taxes at the individual rate. We claim deductions and credits at that personal level. This means that the financial and manufacturing success of our employees and businesses are directly tied to that of the business owners. The Smith Family.

The majority of manufacturers leave most of the money in the business, directly reinvesting in our employees, facilities, and equipment. And this is really the important point there. We are getting taxed on monies that we never see. It is just being held there. Now, due to our current U.S. tax code, we are taxed on income we do not take out of the company but leave in the business to reinvest. This means we have fewer resources to put towards hiring, training, and buying new machines. In my experience, smaller manufacturers, based on wage and K–1 income, pay 36 percent in taxes. They distribute 18 percent to owners and reinvest 46 percent in the business. And that is conservative. We, at Termax, we distribute 10 percent to the owners. The rest is either used for taxes or reinvestment. So the more money that goes into taxes, the less that is reinvested for our employees and machinery.

These funds are taxed at the current 35 percent individual rate, set to increase to 39.6 percent. If statutory rates increase by nearly 5 percent as scheduled, business owners have to take it out of the pie somewhere, either from the owners' families, or from the reinvestment in the employees and company, usually both. Tax increases result in reduced cash flow in the business, causing a major unintended ripple effect, limiting access to capital.

Banking and other lending requirements have toughened, forcing most owners to leave retained earnings in the business for the sole purpose of meeting collateral requirements. The current system penalizes and taxes business owners who leave money in the business for reinvestment, resulting in reduced ability to secure loans. Therefore, increased tax liability means less money in the business, which will restrict the ability of a small business to access timely and sufficient credit to purchase machines, expand their facilities, hire new employees. This is particularly true for a pass-through entity like ours, who is taxed regardless of the actual distribution made to the owner.

This is clearly a politically charged issue. But from the standpoint of the small business owner we must do what we can to reduce our effective tax rate so we can increase our investment in new technologies and people to remain globally competitive. Over the last few years Termax has seen our American competitors decrease to just two from approximately eight, while our foreign competitors have increased dramatically, four to five times what they were previously.

This is where tax deduction credits come in as the only tool we have to reduce our effective tax rate and give us an incentive to take action at that time. All manufacturing companies claim deductions and credits, from the R&D credits to bonus depreciation. Our company expects to spend $1.5 million in 2011 on R&D just to develop new technologies for the automotive and construction industries. This is why removing deductions credits such as the Section 199 deduction for all businesses will increase the effective tax rate burden on all S corporations and pass-throughs.

So some have asked why S corporations simply do not convert to becoming your traditional C corporation. First, the costs associated with the conversion are astronomical, especially for a small business. Another reason is due to the family-owned structure of the business. When an owner passes a company down to the next generation there is a much greater tax liability in a C corp. This is akin to the family farm being sold to pay taxes.

If you ask them, most manufacturers want stability simplification of globally competitive effective rates. A prime example is the alternate minimum tax, the forerunner of the current millionaire's tax that is being discussed. As a business owner, the most important questions are what is my total federal, state, and tax liability? What is left over for me to invest and grow my business and create jobs?

Thanks for the opportunity. Sorry it took a little long.

[The statement of Mr. Smith follows on page 41.]

Chairman WALSH. No, thank you very much.

Our last witness is Stephen Capp. Mr. Capp is president and CEO of Laserage Technology Corporation of Waukegan, Illinois, which I am also honored to represent. Laserage specializes in custom laser services for diverse material applications. Mr. Capp is testifying on behalf of the National Federation of Independent Business. Welcome, sir. You, as well, have five minutes to present your testimony.

STATEMENT OF STEPHEN CAPP

Mr. CAPP. Thank you. Good morning, Chairman Walsh, Ranking Member Schrader, and members of the Subcommittee.

My name is Steve Capp. I am the president and CEO of Laserage Technology Corporation. I am pleased to be here as a small business owner and member of the National Federation of Business (NFIB), the nation's leading small business advocacy organization, to discuss the impact of federal income taxation on Laserage.

My father and I started Laserage in 1979. Now we are based in Waukegan, Illinois. When we started Laserage, we were a tiny contract manufacturer with one laser. Over 32 years we have added 135 employees and 65 lasers. We specialize in laser processing materials for the medical device industry, but we also work with the electronics, LED, aerospace, and other industries. Currently, we export about 50 percent of the product that we manufacture.

Like many small business owners, taxes are a major concern for us. In fact, 4 of the top 10 issues in the latest NFIB Problems and Priorities Surveys are tax issues, particularly, tax rates and complexity. Small business owners are encouraged that Congress is considering tax reform, but reform must recognize the issues impacting small businesses and pass-throughs.

First, I want to discuss why a business like mine chose a pass-through entity. An owner chooses a pass-through business structure for a variety of reasons, generally because of liability protection or tax efficiency. Laserage is a pass-through business, an S corporation. Not unlike a lot of closely owned businesses, we were originally organized as a C corp. Ending the double taxation of our profits and gains as a C corp was our primary reason for converting into an S corp. Simply put, double taxation of our shareholders' profits and gains made their investment in our company less attractive.

Frequently, business sales of closely held businesses are structured as asset sales, unlike sales of public companies which are usually stock sales. As a C corp, an asset sale would first be taxed at the corporate level and then a second time when the after-tax proceeds are distributed to the shareholders. As an S corp and an asset sale, the sale only faces one layer of taxation at the shareholder level. Obviously, the single layer of tax makes the investment in our company more attractive. While the conversion adds complexity, this was a good decision for our company, and we urge that the S corporation pass-through structure continue to be supported by Congress.

Second, as a pass-through business, individual tax rates are especially important. As an S corporation, we pay tax on our business income at the individual level. Keeping these rates low is important to keeping my company competitive. Over the last few years, my company's operating costs have increased steadily. My company has been getting strong pressure from some of our largest customers to begin production in a low cost country. To this point we have successfully resisted taking that action by remaining price competitive without resulting to leaving the United States, primarily by adopting what is known as lean manufacturing techniques and improving the efficiency of our production methods.

But there are limits to what productivity enhancements can accomplish. And we anticipate that at some point we will have to establish some offshore production capacity or lose very significant customers. If federal tax rates increase, that will simply add to the pressure on us to move some of our manufacturing offshore. For this reason, mindful that all of the current individual income tax rates are set to expire at the end of this year, I encourage Congress to keep tax rates low for all small business owners.

Third, tax reform must recognize the issue impacting pass-throughs and small businesses. Much of the debate surrounding tax reform is focused on eliminating deductions and closing loopholes to reduce taxes. If that is the path for tax reform, Congress should keep some basic principles in mind pertaining to first, the tax rate; second, encouraging capital investment; and third, reducing complexity and compliance costs.

First, rates must be kept similar to pass-throughs and C corps. The current tax rates for pass-throughs are similar to C corps. If the rates were to go down for C corps but remain unchanged or go up for my S corp, it would put Laserage at a distinct disadvantage.

Second, tax policies do affect capital investments. Let me explain. As a manufacturer, I operate a capital-intensive business. Last year we purchased $1.1 million in capital equipment, and this year we will purchase another $850,000 of equipment. We were able to use accelerated depreciation for these costs, and it absolutely influenced our capital investment program. We simply could not have afforded this level of capital investments without these benefits. In addition, as a manufacturer we rely on Section 199 domestic production deductions. Losing these deductions and credits without corresponding relief will also place our company at a disadvantage.

Finally, one simple step that Congress can take is to simplify the tax code and make permanent expiring provisions. Last year, Laserage's income tax return, technically an information return, was 416 pages long. Apart from costing an enormous amount of internal accounting personnel time and efforts, Laserage was forced to pay an outside auditing firm $9,100 in professional fees to prepare the tax filing. My own return, which includes my share of Laserage's S corporation taxable income, was 28 pages and cost me $2,500 to prepare. We should not have to spend so much time and incur so much expense for tax compliance. It is not good for us, it is not good for the economy, and it is not good for Uncle Sam.

In conclusion, tax reform can be an effective tool for economic growth but must include small business and pass-throughs. The majority of private sector employees, 54 percent, work for pass-through businesses. Small businesses in particular account for a vast majority of new jobs. The Congress has the opportunity to reform our complicated tax code but you must make sure to do it right. Tax reform must add the concerns of both pass-throughs and corporate businesses.

Thank you for this opportunity to appear before this Committee on these important issues, and I look forward to any questions. Thank you.

[The statement of Mr. Capp follows on page 47.]

Chairman WALSH. Thank you. Thank you, Mr. Capp, and thanks to all of the witnesses for our testimony.

Let me begin our questioning with sort of a broad issue that each of you touched upon, and I would like it if you could give me sort of your broad overview.

Generally speaking, would a system with lower marginal rates and a much broader tax base be preferable to pass-through entities than what we have now with a code with its numerous rates and deductions? Generally speaking, would that sort of move be preferable?

Let us start with Mr. Carroll and work our way down.

Mr. CARROLL. Generally, that approach, a lower rate, a broader base follows in the tradition of the 1986 Tax Reform Act. Economists will tell you that the welfare loss or efficiency cost of the tax system is related to the square of the tax rate as opposed to just the tax rate, so high marginal rates are particularly harmful from an economic perspective. So that is, I think, an important consideration. Lower tax rates are usually beneficial from an economic perspective.

In the area of flow-throughs, high tax rates, high individual tax rates have been found to adversely affect investment decisions, hiring decisions, and the growth of small businesses. So that is clearly a consideration. In evaluating a broad tax reform, I think one needs to really look at the effects of the broad reform on job creation and economic growth and where low tax rates will, I think, be generally conducive to that goal.

Chairman WALSH. Mr. Marowske, in general, a move toward lower marginal rates, a broader base, and in general getting rid of a lot of these deductions, is that preferable?

Mr. MAROWSKE. Oh, I would say most definitely. You know, by basically sharing the wealth and spreading it over and reducing the rates you are going to put more capital back into the market. You are going to have more investment. You are going to have much more activity. And you will see a definite growth. I do not know all the numbers like Ernst & Young off the top of my head but anything you can do to reduce the rate and then spread the tax base around is going to be nothing but positive on our whole economy.

Chairman WALSH. Mr. Smith.

Mr. SMITH. I think it depends. A company that is highly capital intensive, such as our two companies are going to have, if you take away the deductions that relate specifically to capital investment—machinery, that sort of thing—those are going to have a very negative effect, a bigger effect on a manufacturing company than they would on a restaurant or a service industry. So I think it needs careful consideration on both sides.

Chairman WALSH. Mr. Capp.

Mr. CAPP. I agree with Mr. Smith. You have to be careful what you do. Obviously, I think overall it is a good thing. But those tax deductions and credits, there is a purpose for giving incentives to, especially in capital intensive businesses like ours to invest and reinvest in our company and create more jobs. So you know, within reason, I think, as long as they are carefully considered, I think the answer to that is yes.

Chairman WALSH. Last quick question from me and how about a brief answer from each of you? Tax reform is being bantered about up here as we all know and probably will continue to be. If you were in front of the super committee right now and you could weigh in, when it comes to this issue, tax reform and specifically how it impacts pass-through entities, what is one word of caution or one word of advocacy—what would you advocate for if you had a moment or two in front of the super committee? Let us start with Mr. Capp and then quickly work our way down.

Mr. CAPP. I would say lower taxes and also certainty. There are a lot of things that we are not doing because we are not sure what the tax code is going to be. I mean, lower taxes and put some certainty in it so we know what we have to do and where we have to go.

Chairman WALSH. Mr. Smith.

Mr. SMITH. Well, as I stated in my testimony, I agree with Mr. Capp here. The problem we have is uncertainty. We would like for years and years of consistency. We can compete with anybody in the world if we know where things are going to be. But because of the state of flux that our tax code has been in for years it creates very big disincentives for companies like ours.

Mr. MAROWSKE. As I said in my testimony also is the same thing, is the uncertainty, not being able to plan, not knowing what is going to happen. You are doing one thing one year, one thing the next year. Frankly, I am a national sales tax—my personal opinion is, you know, it is fair and it is even and it allows the capital to stay within the companies.

Chairman WALSH. Mr. Carroll, conclude. What is one specific tax reform you might advocate for when it comes to these pass-through entities?

Mr. CARROLL. I think I would have some difficulty advocating a specific reform. I would think that one would want to take a very broad view. In addition to the certainty, also a stable tax system that will not change—that is going to provide some certainty over a period of time. One of the things that did happen in the '86 Act is the tax system changed fairly quickly several years after the '86 Act. It in a sense unraveled with some important risk to the tax base—even though the '86 Tax Reform Act lowered rates and broadened the base, the tax base was narrowed and tax rates went back up.

The other thing I would think that they should carefully consider is trying to avoid unintended consequences. There are a lot of interrelationships in the tax system as well as the economy and trying to avoid unintended consequences, and I think that would be a very useful objective.

Chairman WALSH. Thank you. Let me now turn to my California colleagues, Congresswoman Chu.

Ms. CHU. Thank you, Mr. Chair.

Mr. Carroll, I am interested in your opinion as an economist. If we do tax reform we want to make sure that we do it right so that it is effective, helps the U.S. economy, and will create jobs. And there was new data from the U.S. Department of Treasury that shows that the ownership of these larger pass-throughs, in particular subchapter S corporations, is highly concentrated amongst wealthy taxpayers. If we are trying to help small businesses, is a high-end rate tax cut the best strategy? And how can we ensure that we are hitting the right set of small business owners that really need the tax relief?

Mr. CARROLL. I think one needs to take a very broad review on tax reform and really consider the interrelationships. One of the problems I think that exist in our current tax code is the double tax on corporate profits and the idea that the corporate tax is basically a second layer of tax on equity finance investment that distorts a number of very important economic decisions. And it raises the cost of capital on investment generally. It leads to the misallocation of capital by creating a wedge between investment and the corporate and the non-corporate sector. It accentuates or increases—it leads to a tax bias for debt finance resulting in greater leverage of firms, which is problematic in periods, particularly problematic in periods of economic distress, economic weaknesses. Companies that are more highly leveraged may have more difficulty.

So I think the double tax is a very, very significant issue. And so if one is looking for—I think it is very important to, when one is thinking about the pass-through sector and flow-throughs, that is a vehicle, a way in which businesses are able to avoid the adverse effects of the double tax and it is very, very helpful to the economy. So rather than trying to push more firms into the double tax I think one needs to kind of look at it the other way and think about how relief from the double tax can be expanded.

Most other developed nations have explicitly provided relief from the double tax by either providing relief at the shareholder level or at the company level. In the U.S., it is only recently, since the beginning of the last decade in 2003 through the lower rates and dividends and gains that we provided some relief. But even with that relief we are still at the high end of the overall tax on corporate dividends and capital gains combined with the corporate level tax.

Ms. CHU. But I guess my question really is would it be beneficial equally to all strata of business owners?

Mr. CARROLL. Again, I think one needs to—one needs to really think about what is going to be most conducive to job creation and economic growth. And I think the more equal treatment between the two sectors would probably be very helpful.

Ms. CHU. The report also mentions that some pass-throughs are passive holding companies in which there are no entrepreneurial activity. These companies do not hire any employees. And many are sole proprietors and independent contractors. But on the other hand there are pass-throughs like the small businesses that have testified here today that are, indeed, doing entrepreneurial work and hiring people. So how could we refine the tax strategy so that we really emphasize the job creators?

Mr. CARROLL. Yeah, I guess I would go back again to the double tax. I really see the double tax as a significant problem, the high corporate tax rate and trying to address that issue. Rather than trying to expand the scope of the double tax by perhaps subjecting—a lot of the debate is really focused—this part of the debate is focused on where do you draw the line between the corporate sector and the non-corporate sector? I think because of the harmful effects of the double tax, the way in which it raises the cost of capital, increases the bias for debt finance, drives a wedge between the two sectors, redrawing the line so more economic activity is subject to the double tax I think is problematic.

Ms. CHU. Let me ask about the Joint Committee on Taxation analysis, which showed that the proposal to reduce the corporate tax rate to 25 percent could require some pretty hefty repeals of the tax expenditures that encourage job creation. How would the repeal of some of these job creation tax expenditures impact small businesses?

Mr. CARROLL. Well, I think weighing the benefits of corporate rate reduction base broadening, one has to be very careful. I agree with the sentiments of Mr. Smith and Mr. Capp in terms of talking about some of the capital intensive provisions. I think one has to go through each tax expenditure, each special tax provision and really think about and weigh the positive benefits that those provisions provide to the economy, provisions like accelerator depreciation, like the R&D credit, many other provisions. All of these provisions were put into the code by the Congress with good intentions with the notion that they were providing some economic benefit to the tax code. And there are significant economic benefits from a lower corporate tax rate, but I think one has to weigh that very carefully.

Ms. CHU. In fact, Mr. Marowske, you talked about the fact that you have, of course, a lot of equipment in your air conditioning business. And how important are certain tax cuts to your business? Which tax credits would be most critical to your business and other small businesses like yours?

Mr. MAROWSKE. We are not nearly as capital intensive as Mr. Capp or Mr. Smith's company. We do not have large investments in machinery. Ours is mostly vehicles. For us, you know, it used to be the investment tax credit, which was a great thing for purchasing vehicles and machinery. If I remember there was a 10 percent credit on the purchase of equipment. That was back in the 70s and 80s.

In our industry, incentives on training and human resources issues would be a tremendous advantage because we are very labor intensive in the service industry. We have basically no minimal capital investment.

Ms. CHU. Thank you. I yield back.

Chairman WALSH. Thank you. Let me now turn to a fellow Illinois, Congressman Bobby Schilling.

Mr. SCHILLING. Thank you, Chairman.

Mr. Capp, I also started out my small company with a C corporation, and for the exact same reasons changed over to an S corp. But, you know, coming from Illinois, we just took the largest tax increase—individual tax increase, state taxes in the history of the state. Corporate tax rates also went up and, you know, I find it very interesting that some folks around believe that higher taxes are going to actually help unemployment and then also help the revenue funds of states or the country per se. But in Illinois, for example, since the largest tax increase in the history of the state happened, we have already lost over 89,000 jobs in Illinois.

So, you know, the thing that is nice about being small business folks is that we get it. And with us starting up our business, one of the fears that I have is that a lot of the small businesses, including myself, had I not been able to put that money back in to my business and invest into it, I do not know if I would have made it.

And my fear is that as we continue to want to tax the job creators, you know, it is going to be a problem for the guy who is sitting in his garage trying to figure out how to get this thing off the ground. You know, and what are we doing to our Steve Jobs guys? I mean, look at Apple Computer. I mean, it is just amazing the process. And one of the things that is very scary to me—I am fresh in. I came straight from the restaurant business to Washington, D.C. And a lot of times in Washington we tend not to look at the unintended consequences. In business we are forced to look at—if I am going to, you know, make an investment into my business I look at 10 years as to how this is going to either adversely—how it is going to affect our business.

So I think that that is something that is very, very important. And I think when we do any type of tax reforms we do have to be careful because we see a difference here between the two businesses. You know, he is buying vehicles and you are buying a lot of equipment for inside, so I think that it is one of those where you come in with the scalpel. You be very careful on how you do it because the write-off of the equipment is pretty imperative. But at the same time I think the key thing that I am hearing here is basically, you know, give us a little leeway here. And I think it is great and I give all of you credit for coming here today because I think that if we were to listen to the small businesses, or as I call them the final 3 feet, the people that are actually putting people to work. Sorry for the rant.

But what I wanted to do is just, Mr. Capp, when you talked about the '01 tax breaks, can you tell me a little bit more specifically how that affected your business?

Mr. CAPP. Specifically, the '01 tax breaks?

Mr. SCHILLING. Yeah. Like what was different from prior to '01? How it helped you?

Mr. CAPP. I think, you know, it allowed us to take a look at equipment and other things and really, you know, gave us more incentive to push, you know, equipment or money back into the business to grow the business and buy the equipment that we needed to create the jobs was the primary thing.

Mr. SCHILLING. Okay. You know, I guess this is kind of a pretty simple question. I think I already know the answer and I am just going to kind of roll right down the line here. Do you believe that more regulation from the federal government and higher taxes is going to help you create more jobs?

Mr. CAPP. The answer to that is absolutely not. We have so many people in our company now. At least part of their job is dealing with regulation and it seems to be getting more and more and more. And when I got people that I am paying to deal with regulation, they are not doing productive things, making the business grow or focusing on customers, things like that. So the answer to that, absolutely.

Mr. SMITH. Well, obviously. I mean, it is a no-brainer answer. We also have—we ended up hiring an OSHA-compliance staff person just to make sure that we are in compliance with OSHA. Now, that is outside of the scope of this process but obviously it hurts. If you think about it, tax accountants are really just—the whole tax code is a full employment act for accountants.

Mr. SCHILLING. That individual that you hired, what is the cost to your company on that, sir?

Mr. SMITH. About $60,000 a year.

Mr. SCHILLING. Sixty thousand, but we created a job. Is that correct?

Mr. SMITH. That is right.

Mr. MAROWSKE. Your question kind of is, hi, I am from the government. I am here to help you?

Mr. SCHILLING. Yeah.

Mr. MAROWSKE. I would definitely—I would not be in favor nor anybody in our industry.

Mr. CARROLL. The only thing I think I would comment on is one could think of a lot of the regulations as in effect are imposing in some form additional taxes, additional expenses, additional time spent by entrepreneurs on complying with those regulations. So that is kind of a way of thinking about holistically the regulatory and tax environment as there are two sides of a similar coin.

Mr. SCHILLING. Very good. Thank you for your time, Chairman.

Chairman WALSH. Thank you, Mr. Schilling. Let me now turn to Congressman Hanna from New York.

Mr. HANNA. Thank you, Chairman.

Mr. Marowske, do you—you mentioned tax credits to homeowners to help them incentivize them. Do you think to improve the insulation of their homes or upgrade their heating systems or air conditioning, do you think that drives the decision to its ultimate conclusion?

Mr. MAROWSKE. Most definitely. Most definitely. You will see in your state you have some great utility incentives for people to—we call it home performance. Insulate windows, duct system, ceiling, many different things. And you have got some huge incentives via your utilities in New York State. But New York State probably is doing the best of any of your 50 states in that. My state of Michigan, it is a mishmash and a mess.

Mr. HANNA. Do any of you gentlemen, Mr. Capp, Mr. Smith, Mr. Marowske know—Mr. Carroll may know in a broader way—what is your effective rate? I mean, we all know the actual rate that you pay or that is listed in the tax code but does anybody have an idea what your effective rate is after all the depreciation, tax credits, accelerated depreciation, et cetera?

Mr. CAPP. I do not think you can hold me to this but the last time I calculated it, it was about 27, 28 percent.

Mr. SMITH. For us, actually, the PMA, our association has created quite a comprehensive tax template for those things. I do not know if you have had a chance to review it or if you have seen this. Our particular company, including local and state taxes, is 35 percent right now. So that is what affects me and our company.

Mr. HANNA. But that is not your—that is not your actual rate that you pay after all the——

Mr. SMITH. No, but again, that is after our base case, where we are right now, is it turns out to be 35 percent of the total dollars that are going into that. The actual federal taxes are approximately 27.7 percent.

Mr. HANNA. Okay. So, Marowske, do you have any idea?

Mr. MAROWSKE. Honestly, I do not know. I would be taking a stab in the dark.

Mr. HANNA. Mr. Carroll, what do you think it is for all the people you handle?

Mr. CARROLL. I do not prepare tax returns. I am an economist and I tend to work on tax policy issues so I have the virtue, I suppose, of not working on actual tax returns. I guess I would observe there are really different ways of thinking about tax rates. One could think of an average tax rate. One could think of an effective tax rate. One could think of a marginal effective tax rate that would take into account different features of the tax code in different ways. A favorite concept that is often used by economists to think about investment decisions, allocation of investment, the amount of investment in the economy is the marginal effective tax rate that would take into account not only the top line individual or corporate tax rate but also take into account the value of accelerated depreciation and investor level taxes on capital gains to indicate the variance of tax rates across different types of economic activities.

Mr. HANNA. Do you think that advantage is given to capital investment for equipment, for example, with Mr. Smith? Do you think that they are pitted against someone who is less capital intensive than, say, Mr. Marowske's business which is mostly labor?

Mr. CARROLL. Yeah, I think there can be a fair amount of unevenness of tax rates across different economic activities, different industries, different sectors, companies that invest in particular assets versus others. There is a fair amount of unevenness and, yeah, that is certainly a consideration

Mr. HANNA. So does that suggest to you that Mr. Marowske may be paying a disproportionate share based on the total volume of dollars he does compared with—

Mr. CARROLL. Yeah. I think one has to come back to, again, the value of the specific tax preferences. If one, for example, were to think that a provision like the R&D credit provided some significant spillover effects to the broader economy or one thought that incentives for some of the renewables—alternative fuels, solar, geothermal and so on—were providing spillover effects to the overall economy, then one might be able to justify the unevenness.

You know, I think it was a couple of years ago that Congress had considered requiring the Joint Committee on Taxation to do a cost benefit analysis of each of the tax expenditures in the Internal Revenue Code with the notion of evaluating on a cost benefit basis whether those provisions were providing sufficient value to the economy to justify their presence in the code.

Mr. HANNA. But then—my time is up. Thank you, Chairman.

You said that, Mr. Capp, you were encouraged to invest in capital equipment because of the accelerated depreciation. Do you think, I mean, this is—do you think that you would not have done it otherwise? I mean, is that what I can infer from that?

Mr. CAPP. I think it is more a question of timing, when we would have done it. With the uncertainty of what the next year's tax code was going to be, we accelerated purchasing equipment that we probably would have pushed out and bought in a more timely manner for us.

Mr. HANNA. Thank you, Chairman.

Chairman WALSH. Thank you, Mr. Hanna. Let me now turn to Congressman Chabot from Ohio.

Mr. CHABOT. Thank you, Mr. Chairman. I apologize for being a little bit late. And if my questions have already been asked, I also apologize for that. I have got three different hearings going on at the same time and I am trying to bounce around and make all of them.

Chairman WALSH. That is no excuse.

Mr. CHABOT. I know. Sorry, Joe.

But in any event, mine are going to be kind of broad. When I first came up here back in the revolution, back in '94, Newt Gingrich's Contract with America, all that, there was some real serious talk about really reforming. We are talking about that now and we have got this super committee and are they going too long? You know, what is going to happen? But there were two competing philosophies. You basically had the Dick Armey philosophy, which was the flat tax and you can basically do your taxes on a postcard and send it in, although nowadays, you know, we do not do anything through the mail so we would probably e-mail it in or something on something even smaller. But that was sort of one philosophy.

And then you had Billy Tauzin and Bill Archer, who was the chairman of the Ways and Means Committee at the time, who wanted to go for a consumption tax or a sales tax and get rid of the IRS altogether and get rid of income taxes altogether.

And then we now have, you know, maybe a hybrid plan that one of the Republican presidential candidates has put forward, the infamous or wonderful or whatever you think about it, the 9–9–9 Plan. And there are various versions. But I would just like to see, and perhaps Mr. Carroll, we could make this, you know, you are with a very large and prestigious accounting firm and if we went to one of those other things it would probably make it less likely that folks like those folks over there and a lot of other folks might need accountants and attorneys and things to figure all this stuff out. Maybe not. But at least in theory.

So I would just like to throw it open for anybody who wants to take this on. And I have got about three minutes, so if you each want to take, you know, a little less than a minute and just go down the line. Maybe we will start with Mr. Capp down there.

Mr. CAPP. I am not entirely clear what you are looking for here.

Mr. CHABOT. Just basically what are the—would you prefer to have a flat tax? Would you prefer to have a national consumption or sales tax? Would you prefer a hybrid where we have both? Both are low right now but could potentially be jacked up down the road somewhere. Or do you think we ought to keep the stupid mess we have right now?

Mr. CAPP. I guess I tend to lean more towards a flatter tax. I know that there are a lot of other ones out there like sales tax and things like that. I think they have to be weighed very carefully when it comes to us as small business people, seeing to it that it does not disrupt the job creation at the small business level. So it could be really any one of those depending on exactly how it is approached and how it is actually executed.

Mr. CHABOT. Mr. Smith.

Mr. SMITH. You know, honestly, I do not care. What I care about is just consistency. And I do not think it is going to matter on a long run basis for a business like ours in any way. Of any approach that is taken I would like a 10-year or a 20-year or a more—change after—for a period of time. That is really all I care about.

Mr. CHABOT. Okay. Thank you. Mr. Marowske.

Mr. MAROWSKE. You know, any one of them, as Mr. Capp mentioned, needs consideration, and whatever you do it needs to be, again, consistent and it needs to be fair. My gut reaction, as I mentioned a little earlier, is I like the national sales tax or consumption tax. If you have more money, earn more money, you are going to spend more money. And you are going to pay a higher level of tax but there are other, you know, drawbacks on that. People that are at minimum wage levels, you know, you have got to come up with something for that. So it needs some thought and some thinking. But it needs to be consistent, fair, and long term.

Mr. CHABOT. Thank you. Mr. Carroll, if you want to——

Mr. CARROLL. Yeah. A couple of thoughts on the choices—the flat tax, the sales tax, a potential hybrid—you know, one thing I would say is I would agree with the sentiments that a tax system that is predictable, provides some certainty, and that is stable would be particularly helpful. We currently have a tax code where 25 percent of the income tax will sunset at the end of 2012, so that creates a lot of uncertainty for people such as those who are sitting at the table with me. That makes it difficult, I think, to make business decisions and other decisions.

Another comment I would make is the flat tax and the sales tax are both—are really very related. They are at least first cousins, if not second cousins. One of the characteristics both of those taxes share is fundamentally they do not tax the return to savings and investment. Both the sales tax and the flat tax are types of consumption taxes. And then I would go on to say that our current tax system is really a hybrid of some of these. We have features in our current tax code that make our tax code a bit more like a consumption tax through accelerated depreciation, through other expensing provisions, through 401(k)s, IRAs, defined benefit plans on the household side. Those provisions all reduce the tax on the return to savings and investment and the idea behind a consumption tax, one of the reasons a lot of economists like consumption taxes, is that by not taxing or taxing less the return to savings and investment, they are conducive to economic growth. But you do need to balance those systems from a distributional perspective. When you do not tax the return to savings and investment, where savings and investment is received primarily or disproportionately by higher income households, one needs to think about the distributional consequences of going in that direction. So those are a few observations I think are worth bringing up.

Mr. CHABOT. Thank you very much. Mr. Chairman, I have been informed I have yet a fourth meeting out in the hallway so I will have to take off. Thank you very much. I yield back.

Chairman WALSH. Thank you. Thank you. Let me turn to Congressman Mulvaney. He is all good. Okay.

Let me close and just revisit one quick question. I am going to ask you each for a yes or no answer. How does that sound? Understand that under the President's Jobs Plan, taxes on capital gains are going to increase. And if we let the '01 and '03 tax rates expire, that will increase your taxes. Will tax increases like those help you purchase more equipment, create jobs, and will it grow the economy? Yes or no.

Mr. CAPP. No.

Mr. SMITH. No.

Chairman WALSH. That was difficult.

Mr. MAROWSKE. No.

Chairman WALSH. Mr. Carroll.

Mr. CARROLL. I guess I would have to say no.

Chairman WALSH. Thank you. And thank you all for participating today. The Subcommittee will continue to closely follow these issues related to tax reform.

Following the hearing we will be sending a letter to the Joint Select Committee on Deficit Reduction, which will have a critical role in determining this tax policy and reducing the deficit. And we will relay the concerns that have been expressed by the witnesses today.

I also ask unanimous consent that the comments of several small business owners regarding the importance of individual tax reform, which were submitted through the Committee's website "Open Mike," be admitted to the record. Without objection, so ordered.

Finally, I ask unanimous consent that members have five legislative days to submit statements and supporting materials for the record. Without objection, so ordered.

Where is my gavel? Let me now bang this. And without objection, the hearing is now adjourned. Thank you very much.

[Whereupon, at 11:10 a.m., the subcommittee was adjourned.]

Testimony before the
Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access
United States House of Representatives

Hearing on
"Pro-Growth Tax Policy: Why Small Businesses Need Individual Tax Reform"

Robert Carroll[1]
November 3, 2011

Chairman Walsh, Ranking Member Schrader, and distinguished members on the Subcommittee, thank you for the opportunity to testify today regarding the taxation of flow-through businesses and tax reform.

Flow-through businesses play an important role in the U.S. economy.[2] The vast majority of businesses in the United States have chosen to organize as flow-through businesses. Today, flow-through businesses comprise more than 90 percent of all business entities, employ more than 50 percent of the private sector work force and report more than one-third of all business receipts. Fifty-four percent of business net income is reported by individual owners of flow-through businesses, and these taxpayers pay 44 percent of business taxes when filing their individual tax returns.

With the prominence of flow-through businesses, it is important to carefully consider how the flow-through form fits into the U.S. tax system and how any particular tax reform might affect flow-through businesses.

There is considerable support for reform of the U.S. corporate income tax, especially by lowering the corporate income tax rate.[3] President Obama has called for a lower corporate income tax rate, combined with the elimination of special interest loopholes, to help restore competitiveness and encourage job creation.[4] Prominent members of Congress have also pointed to the importance of reforming the corporate income tax. House Ways and Means Committee Chairman Dave Camp (R-MI) has advocated lowering the top 35 percent corporate income tax rate to 25 percent. Senate Finance Committee Chairman Max Baucus (D-MT) has

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[1] Principal, Quantitative Economics and Statistics (QUEST) Group and Center for Tax Policy, Ernst & Young LLP. Formerly, Deputy Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, November 2003 through January 2008. The views expressed do not necessarily reflect those of Ernst & Young LLP.
[2] "Flow-through" businesses refer to pass-through entities (S corporations, partnerships, and limited liability companies) and sole proprietorships whose income and expense is reported by the owners along with income received from other sources.
[3] For a discussion of the potential economic benefits of a lower corporate tax rate see Robert Carroll and Thomas Neubig, "The Economic Benefits of Reducing the US Corporate Income Tax Rate," An Ernst & Young LLP report prepared for the Reducing America's Taxes Equitably Coalition, September 2011.
[4] President Obama's State of the Union address, January 25, 2011.

emphasized the need for corporate tax reform, although without specifying a specific target for the corporate income tax rate. Most major tax and entitlement reform proposals have also included significant corporate rate reduction as a key element.[5]

This interest in corporate tax reform stems in large part from the substantial evidence that the U.S. statutory corporate income tax rate is out-of-step internationally and a growing consensus that the U.S. corporate tax rate should be lowered. Over the past several decades most other developed nations have reduced their statutory corporate income tax rates significantly leaving the United States with the second highest statutory corporate income tax rate among developed nations. At the same time, globalization amplifies the importance of differences in corporate tax rates across countries and there is increasing evidence that corporate income taxes adversely affect workers wages.

Elimination of business tax expenditures to finance a lower corporate rate, however, can raise substantial issues for flow-through businesses. Flow-through businesses could potentially lose the benefit of widely used business tax provisions without the benefit of the lower corporate tax rate. Attempts to separately allow provisions, such as accelerated depreciation and the production activities deduction, to flow-through businesses in a corporate-only reform would increase complexity and raise significant administrative issues.

The Internal Revenue Code (the "Code") provides businesses with considerable flexibility in how they organize and structure their business operations. Depending on their ownership and capital needs, businesses can choose between several different organizational forms. The flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment embodied in the income tax system leads to a bias in firms' financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation.

I have had the opportunity to consider the impact of taxation on flow-through businesses from a number of perspectives, inside and outside of government, in the context of broad reform of the Code and more narrow reform of the business tax system. I have analyzed the potential impact of tax reform on the flow-through sector on behalf of the S Corporation Association and have worked with other clients on various other aspects of tax reform. Today I will share my perspectives and experiences with the Subcommittee.

Current tax treatment of flow-through businesses and the double tax on corporate profits

Flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships – are subject to a single level of tax on the income earned. The income and

[5] For example, in December 2010, the President's National Commission on Fiscal Responsibility and Reform proposed lowering the top federal corporate income tax rate to 28 percent. In early 2011, Sens. Ron Wyden (D-OR) and Dan Coats (R-IN) proposed that the corporate income tax rate be lowered to 24 percent and a plan by House Budget Committee Chairman Paul Ryan (R-WI) included a top 25% corporate income tax rate.

expenses of flow-through businesses are reported by an entity's owners – hence the name "flow-through" or "pass-through" entities." An individual owner's flow-through income is combined with income they may receive from other sources and subject to individual income taxes. Losses, rather than accumulating within the business entity level, are also passed through to the owner where, subject to various limitations, they may, subject to various limitations, be used to offset income from other sources. Thus, it is the tax rates faced by individual owners of flow-through businesses that affect decision-making and the economic health of these businesses.

In contrast, the income of C corporations is subject to two levels of tax, first when income is earned at the corporate level, and again when the income is paid out to shareholders in the form of dividends or retained and later realized by shareholders as capital gains. These two levels of tax are often referred to as the double tax on corporate profits.

The differential taxation of business income earned by C corporations and flow-through businesses is an important consideration in a firm's choice of organizational form. The double tax is also economically important and can distort a number of business decisions.[6] One important such distortion arises because the double-tax mainly affects business income generated by activities financed through equity capital within the C corporation form. Interest expenses are generally deductible by businesses, leading to a tax bias in favor of financing with debt rather than equity. The double tax thus raises the cost of equity financed investment by C corporations relative to debt financed investment and provides an incentive for leverage and borrowing rather than for equity-financed investment. Accordingly, the double tax contributes to the tax bias for higher leverage. Greater leverage can make corporations more susceptible to financial distress during times of economic weakness.

The current income tax also leads to a distortion between investment channeled through double-taxed C corporations and single-taxed flow-through businesses.The higher cost of investment in the corporate sector relative to the rest of the economy leads to a misallocation of capital within the economy. This in turn reduces the productive capacity of the capital stock and dampens economic growth. As noted before, the diversity of organizational forms can be seen as a useful choice for businesses to make in organizing themselves, but the impact of differential treatment should be recognized. Finally, the double tax raises the overall cost of capital in the economy, which reduces capital formation and, ultimately, living standards.[7]

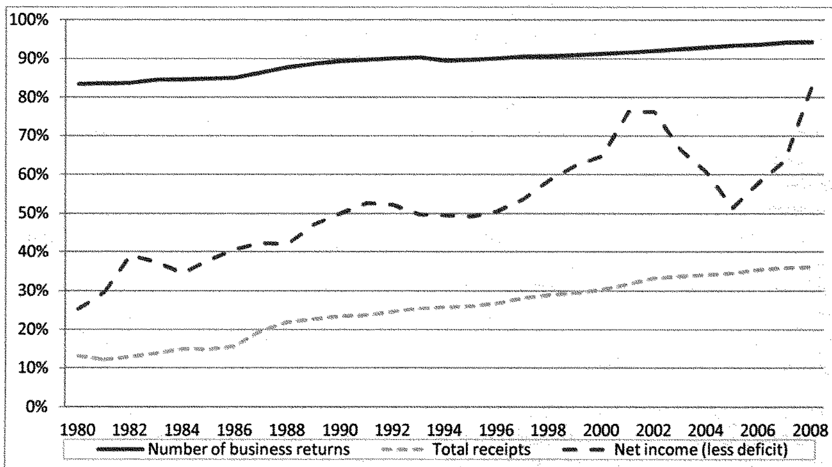
Overall, the flow-through form provides an important benefit to the economy by reducing the economically harmful effects of the double tax.

[6] For a discussion of these issues see Robert Carroll, "The Economic Effects of the Lower Tax Rate on Dividends," Tax Foundation Special Report No. 181, June 2010.
[7] For example, a dynamic analysis of the lower tax rates on dividends and capital gains enacted in 2003 found that they would increase gross domestic product in the long-run by 0.4 percent and the capital stock by 1.2 percent if made permanent. See U.S. Department of the Treasury, *A Dynamic Analysis of Permanent Extension of the President's Tax Relief*, July 25, 2006.

The economic footprint of the flow-through sector

Flow-though businesses have grown steadily over the past several decades. As shown in Chart 1, the percentage of businesses choosing the flow-through form rose from 83 percent in 1980 to 94 percent in 2008.[8] The share of total receipts generated by flow-through businesses has nearly tripled since the early 1980s with the flow-through share of total receipts rising from 13 percent in 1980 to 36 percent by 2008. The flow-through share of net income also rose significantly, 25 percent in 1980 to 82 percent by 2008.[9]

Chart 1. Flow-through shares of all business returns, receipts, and net income, 1980-2008



Note: These data include some flow-through entities, primarily partnerships, which are owned by C corporations. Data focusing on individual owners of flow-through businesses are presented below in Chart 4.
Source: Internal Revenue Service, Statistics of Income, Integrated Business Data.

Two changes contributed to this growth.[10] First, the individual tax rate was lowered significantly relative to the corporate tax rate under the Tax Reform Act of 1986, which had the effect of making the flow-through form more attractive for many businesses. Second, in the late 1980s and 1990s limited liability companies (LLCs) combined flow-through tax treatment with limited

[8] The data presented here (Chart 1) also include RICs and REITs, which effectively are subject to a single layer of tax because of the deductibility of dividends. Note that RICs and REITs are included among C corporations in the Census data on employment, firms and establishments presented below due to data limitations.
[9] As discussed below, it is important to note that the line between business activity that is ultimately subject to the corporate tax or individual tax is blurred because some flow-through businesses, primarily partnerships and limited liability companies, can have corporate owners. Also note that the 82 percent of net income reported by all flow-through entities is for 2008, whereas the 54 percent of net income reported by individual owners of flow-through entities is the average from 2004 through 2008.
[10] Limited partnerships, which offer limited liability to the limited partners, along with flow-through treatment, were available.

liability for their owners[11] and the classification of businesses as LLCs was simplified in 1997 by allowing them to "check the box" on Form 1065-B to elect to be treated as a corporation or partnership (or sole proprietorship) for tax purposes.[12]

As shown in Table 1 below, the flow-through sector now comprises a large fraction of business activity not only based on number of firms and receipts/net income, but also based on the number of workers it employs. In 2008, the flow-through sector employed 54 percent of the private sector work force, with C corporations employing the remaining 46 percent.[13] S corporations employed 25 percent of the private sector work force, while partnerships employed 10 percent and sole proprietorships accounted for 19 percent.[14]

Table 1. Private economic activity of flow-through businesses and C corporations, 2008

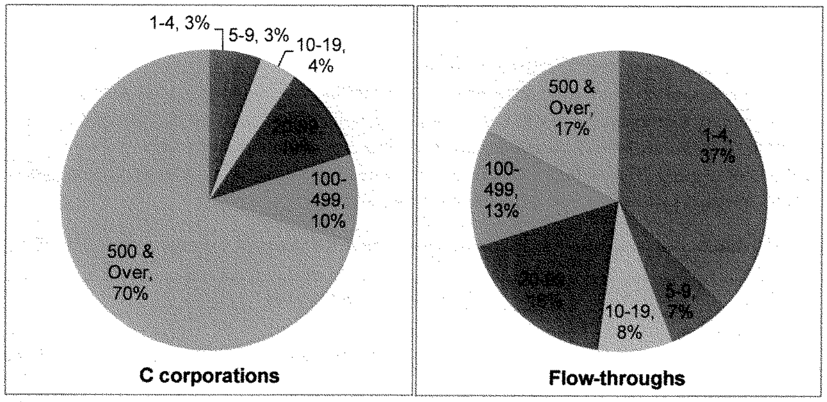
	Total Private Business Sector	Flow-Through Businesses				
		Total	S Corporations	Partnerships	Sole Proprietorships	C corporations
Employment	125.6	68.2	31.0	13.1	24.1	57.4
Firms	26.9	25.1	3.6	1.7	19.8	1.7
Establishments	28.4	25.6	3.9	1.9	19.9	2.8
Receipts	28.7	10.2	5.6	3.1	1.5	18.5
Percent Distribution						
Employment	100%	54%	25%	10%	19%	46%
Firms	100%	94%	13%	6%	74%	6%
Establishments	100%	90%	14%	7%	70%	10%
Receipts	100%	36%	19%	11%	5%	65%

Note: Units in millions, dollars in billions.
Source: U.S. Bureau of the Census, Statistics of U.S. Businesses and Non-employer Statistics; receipts are from Statistics of Income Division, selected sources.

Private sector employment within the flow-through sector is sizable and more concentrated among smaller firms than C corporations (see Chart 2). About 37 percent of workers within the flow-through sector were with firms with four or fewer employees. About 52 percent of workers in the flow-through sector held jobs in firms with fewer than 20 employees. In contrast, among C corporations 70 percent of workers held jobs in firms with more than 500 employees and 90 percent of workers held jobs in firms with more than 20 employees.

[11] In 1988 the IRS issued a revenue ruling indicating that it would treat LLCs established under Wyoming state law as partnerships for tax purposes. Other states subsequently enacted similar LLCs statutes.
[12] In 1995, there were 118,559 LLCs in the United States. By 2008 the number had grown to 1,898,178. Internal Revenue Service, *Partnership Returns, 2008*, Statistics of Income Bulletin, Fall 2010.
[13] These tabulations exclude the non-profit and government sectors. RICs/REITs are included among C corporations due to data limitations. U.S. Bureau of the Census, Center for Economic Studies, 2008.
[14] Sole proprietors are counted as one "employee." A summary of the data and methodology used for these tabulations is provided in Appendix A.

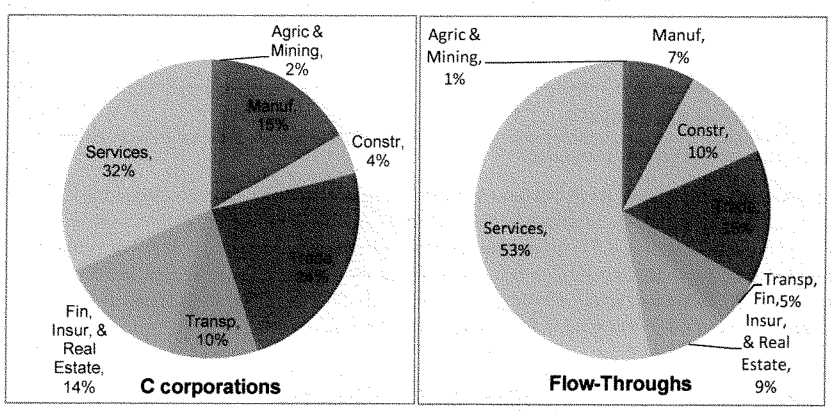
Chart 2. Employment by size of firm, C corporation and flow-through sectors, 2008



Source: U.S. Bureau of the Census, Statistics of U.S. Businesses and Non-employer Statistics.

There are also considerable differences in the employment within various industies for these two sectors, with significantly greater respresentation of flow-through employment in the services and construction industries (see Chart 3). In contrast, C corporation employment is more dominant in the manufacturing, wholesale and retail trade, and transportation industies.

Chart 3. Employment by industry, C corporation and flow-through sectors, 2008



Source: U.S. Bureau of the Census, Statistics of U.S. Businesses and Non-employer Statistics.

It is important to point out that these employment estimates are influenced by the presence of large employers, particularly among C corporations. For example, while only 7 percent of flow-through employment is within the manufacturing sector, more than 81 percent of all manufacturers are organized as flow-through businesses.

Flow-through businesses are well represented in all areas of the country, representing more than one-half of the private sector work force in every state except for Delaware (49 percent) and Hawaii (48 percent) (state-by-state data is presented in Appendix B). Flow-through employment exceeds 60 percent of the private sector work force in six states: Idaho (65 percent), Maine (62 percent), Montana (69 percent), South Dakota (63 percent), Vermont (63 percent) and Wyoming (62 percent).

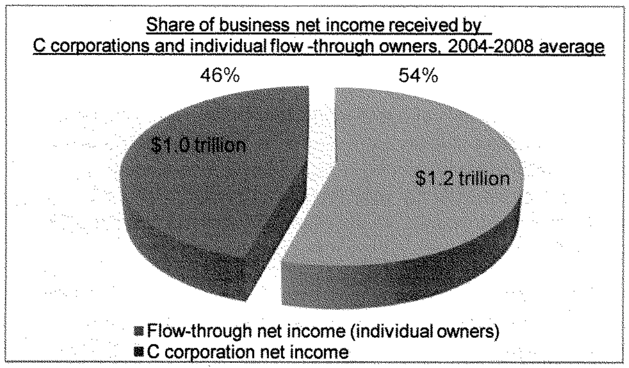
While the foregoing data provides a picture of the economic footprint of flow-through business entities, the owners of some flow-through businesses (primarily some partnerships[15]) are corporations, not individuals. This distinction is important because individual owners of flow-through businesses are taxed under the individual income tax. A significant amount of partnership income flows through to corporate owners.[16] This income is often associated with various types of joint ventures between corporations.

Another important factor that makes comparisons of business entities and the flow-through income received by individual owners difficult is that a considerable share of flow-through income takes forms other than allocated net income reported on an owner's Schedule C or Schedule E. For example, individual owners of flow-through businesses can also receive allocated income in the form of capital gains, rents and royalties. This income is reported separately from allocated net income reported on the Schedule C or Schedule E in order for it to maintain its character and receive special tax treatment under the Code (e.g., the special lower tax rate on long-term capital gains and the limitations on passive activity losses).

As shown in Chart 4, after accounting for all of the income allocated to individual owners of flow-through businesses, individual owners received 54 percent of total business income from 2004 through 2008.[17] The taxes paid on this income by individual owners of flow-through businesses averaged $232 billion annually (44 percent) from 2004 through 2008, as compared to an average of $290 billion for C corporations over this period.[18]

[15] Sole proprietorships are, by definition, owned by individuals and the ownership of S corporations is generally restricted to individual shareholders.
[16] In 2007, about 30 percent of partnership income was allocated to corporate partners. Wheeler and Nina Shumofsky, *Partnership Returns, 2008,* Statistics of Income Bulletin, Fall 2010.
[17] The net income and taxes paid by individual owners of flow-through businesses and C corporations are not directly comparable because the labor compensation of owners of C corporations are generally paid as wages and deductible to the business, while the labor compensation paid to owners of partnerships and sole proprietorships is generally included as part of business entities' allocable net income. S corporations, in contrast, are generally required to pay owners actively involved in a business a reasonable level of compensation, which, similar to C corporations, is a deductible expense by the business. Taking into account the amount of labor compensation paid to owners of partnerships and sole proprietorships as allocable net income could have a significant effect on these calculations.
[18] This comparison only takes into account the taxes related to the net income of flow-through businesses and C corporations. Investor level taxes on corporate earnings are not taken into account.

Chart 4. Individual owners of flow-through entities receive 54% of business net income, 2004-2008 average



Source: Internal Revenue Service, Statistics of Income, Corporate Source Book and Individual Tax Returns (publication 1304), selected years; computations by Ernst & Young LLP.

Economic decisions of flow-through businesses affected by the tax system

Research has found that individual income tax rates affect various economic decisions of flow-through business owners. For example, tax rates have been found to affect the entry and exit from flow-through form as individuals decide whether to open up their own business or work for another firm.[19] Tax rates have also been found to deter these businesses from hiring workers and investing and affect the rate at which flow-through businesses grow.[20] The effect of the individual tax rates on these types of economic decisions is one reason the tax treatment of flow-through businesses has figured prominently in recent discussions of changes to these tax rates.

Increases in the cost of capital resulting from higher individual income tax rates was found to reduce the investment spending of entrepreneurs and the probability that they invested at all.[21] A 5-percentage point increase in the individual marginal tax rate was found to reduce the

[19] Donald Bruce and Tami Gurley-Calvez, "Federal Tax Policy and Small Business," In Overcoming Barriers to Entrepreneurship, Rowan and Littlefield Publishers, forthcoming; William M. Gentry and R. Glenn Hubbard, "'Success Taxes, Entrepreneurial Entry, and Innovation," Working Paper No. 10551, National Bureau of Economic Research, June 2004.

[20] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics*, April 2000, 18(2), pp. 324-351; Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147; and Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.

[21] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.

percentage of entrepreneurs who made new capital investments by 10.4 percent and the mean amount of investment by 9.9 percent.

Lower individual tax rates were found to increase the probability that entrepreneurs hired workers and, for those with employees, the total amount of a firm's wages.[22] A 10-percent increase in the net-of-tax share (i.e., 1 minus the marginal tax rate) was found to increase the mean probability of hiring workers by 12 percent, and for those firms with employees, increase the median wage bill by 3.7 percent. Finally, a 10-percent increase in the net-of-tax share was found to increase business receipts by 8.4 percent.[23]

The concern over higher individual tax rates has, in part, been the result of the fact that the flow-through sector plays an important role in the U.S. economy and the recognition that higher tax rates on these firms' owners may result in less hiring and capital investment of businesses within the flow-through sector. These issues will arise again in 2013 due to the scheduled increase under current law in the top tax rate imposed on flow through businesses through the individual income tax income from 35 percent to 39.6 percent and the Medicare tax from 2.9 percent to 3.8 percent.

Tax reform can have significant consequences for flow-through businesses

Some have suggested that tax reform focus first on reform of the corporate income tax before focusing on reform of the individual income tax. With the flow-through sector representing more than half of all business activity, as measured by employment (in 2008), and paying 44 percent of total federal business income taxes (between 2004 through 2008), tax reform could have significant consequences for flow-through businesses.

One approach to tax reform that has been suggested, for example, is lowering the corporate tax rate and paying for this change by eliminating or limiting business tax expenditures. Many of these expenditures are long-standing provisions that are available to and widely used by both C corporations and flow-through businesses.

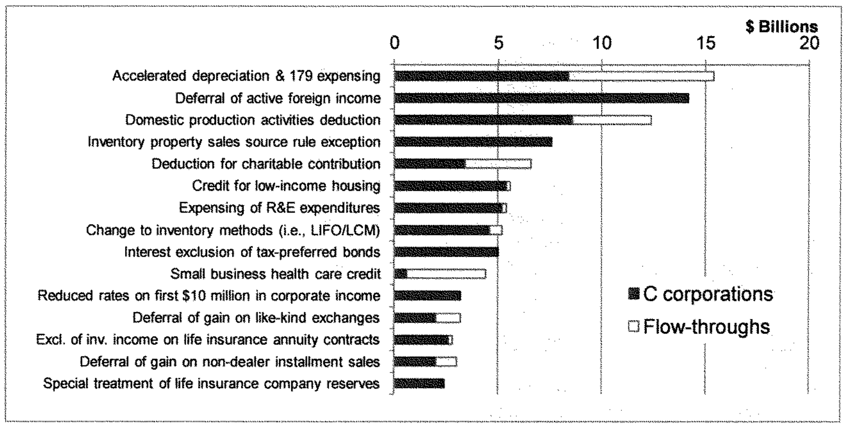
Curtailing business tax expenditures would raise the taxes paid by owners of flow-through businesses, even though these businesses would receive no tax benefit from the lower corporate tax rate and could even face a higher tax rate if individual income tax rates increase after 2012.[24] For example, if accelerated depreciation was eliminated to help finance a lower corporate tax rate, flow-through businesses would lose the benefit of this tax provision without receiving the benefit of a corresponding reduction in the corporate tax rate.

As shown in Chart 5, flow-through businesses make extensive use of a number of broadly available business tax expenditures such as accelerated depreciation, the deduction for

[22] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351.
[23] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy,* NBER, Vol. 15, 2001, pp. 121-147.
[24] For a similar analysis that considers the effects of revenue neutral business tax rate reduction financed by repeal of all business tax expenditures see Gerald Prante, Robert Carroll, and Thomas Neubig, "Lowering Business Tax Rates by Repealing Tax Expenditures: An Industry Analysis," *Bureau of National Affairs Daily Tax Report,* Vol. 2011, No. 34, February 18, 2011.

domestic production activities, and the deduction for charitable giving. In total, flow-through businesses benefited from 23 percent of the approximately $116 billion in annual business tax expenditures between 2010 and 2014.[25]

Chart 5. Largest business tax expenditures in US, Annual average, 2010-2014*



*The value of the tax expenditure for tax-exempt bonds includes only the benefit to the corporate investors, not the benefit of lower interest rates to the issuers.
Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), December 15, 2010, and Ernst & Young LLP calculations.

Repeal of these provisions could entail substantial tax increases for flow-through businesses that could negatively impact employment and growth in the flow-through sector. To gauge the potential impact on flow-through businesses of a "corporate only reform," the percentage change in income tax liability associated with elimination of all business tax expenditures was calculated for flow-through businesses. The analysis takes into account all business tax expenditures permanently in effect from 2010 through 2014 and as estimated by the Joint Committee on Taxation.[26]

The starting point for this estimate is computing the income taxes paid on flow-through income earned and allocated to individual owners of flow-through businesses. As shown in Table 2, based on simulations using the Ernst & Young LLP Individual Tax Simulation Model, individual income taxes on flow-through business income received by individual owners will average $346 billion during 2010 through 2014 period.[27] About 38 percent of these taxes are paid by flow-

[25] Includes only permanent, positive tax expenditures.
[26] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014," (JCS-3-10), December 15, 2010.
[27] The procedure for estimating the income tax paid on flow-through business income estimated the income tax liability of owners of flow-through businesses with and without their flow-through business income. This approach, described in greater detail in Appendix A: Data sources/simulations, assumes flow-through business income is a taxpayer's last dollar of income earned. The income and associated taxes for RICs/REITs are excluded for purposes of this calculation.

through businesses in the finance, insurance, and real estate industry, followed by services (25 percent) and manufacturing (11 percent).

Table 2. Average annual tax increase on flow-through businesses from elimination of business tax expenditures, by industry, 2010-2014

Industry	Current Tax ($billions)	Share of Taxes (current law)	Tax increase ($billions)	Percent change in tax
Agriculture and mining	14	4%	3.0	22%
Utilities	2	1%	0.2	8%
Construction	26	8%	2.3	9%
Manufacturing	37	11%	3.0	8%
Wholesale trade	21	6%	1.0	5%
Retail trade	12	3%	1.1	9%
Transportation	8	2%	0.5	6%
Information	10	3%	0.4	4%
Finance, insurance, and real estate	130	38%	9.9	8%
Services	86	25%	5.6	7%
All industries	346	100%	27.0	8%

Source: Ernst & Young LLP calculations based upon multiple data sources, primarily JCT and IRS.

Based on Ernst & Young LLP estimates, eliminating all businesses tax expenditures would increase the income taxes paid by individual owners of flow-through businesses, on average, by 8 percent or $27 billion annually from 2010 through 2014.[28] Flow-through businesses in the agriculture and mining industry would experience the largest increase in individual income taxes (22 percent) primarily due to the elimination of timber-related provisions. Flow-through businesses in the finance, insurance, and real estate industry would face an 8 percent increase in taxes due to the loss of the benefit of the tax expenditures for the deferral of gains on non-dealer installment sales, amortization of business start-up expenditures, the charitable giving deduction, as well as accelerated depreciation for certain rental property and the low income housing tax credit. In contrast, flow-through businesses in the information industry would only have a 4 percent increase in taxes, below the 8 percent average across all industries because flow-through businesses within this industry tend not to receive much benefit from business tax expenditures.

A corporate tax reform that lowered the corporate tax rate paid for by eliminating or limiting business tax expenditures only for C corporations would, in effect, hold flow-through businesses harmless from the reform, but would add substantial complexity to the Code. New tax rules would be needed to, in effect, partition provisions off for just flow-through businesses. Moreover, it is unclear how these rules would operate in a number of circumstances. For example, in the case of a joint venture between a C corporation and a pass-through business, it is unclear how

[28] This estimate includes the higher taxes on ordinary income reported by flow-through businesses, as well as taxes paid on other flow-through income reported on individual tax returns, such as capital gains, rental income, and royalty income.

tax expenditures available to one business form, but not the other would be allocated. The creation of additional differences in the tax treatment of C corporations and flow-through businesses might also cause additional shifting between these business forms. Differences in tax treatment have caused shifting between the C corporation and flow-through business forms in the past,[29] but in this case the shift between organizational forms would result from the various tax expenditures being available only to businesses in the flow-through sector.

This type of complexity, which could arise in a number of circumstances across many business tax provisions, would not be in the spirit of tax reform. Rather than a simpler tax system, such a reform would have the potential to add considerable complexity to the Code.

Summary

The current focus on reform of the tax system has also drawn attention to how flow-through businesses might be affected by tax reform. Corporate tax reform is clearly an important component of an overall approach to improving the current tax system. The high US corporate income tax rate relative to most other developed nations may adversely affect the competitiveness of the United States. Difficult choices also arise in reforming the US corporate income tax in an increasingly global economy where most other developed nations have shifted to territorial tax systems.

As with any such endeavor, however, policy makers should keep in mind the potential for undesirable side effects. Corporate reform that eliminates business tax expenditures could have the unintended impact of raising the cost of capital for businesses organized using the flow-through form. Such firms are a large part of the U.S. business sector and important contributors to the vitality of the US economy.

This sector has grown rapidly over the past several decades to the point where flow-through businesses now employ 54 percent of all private sector workers and pay 44 percent of all business taxes. The expansion of the flow-through sector provides the important benefit of reducing the scope of the double tax on corporate profits, as well as providing additional flexibility in the ownership structure of businesses that may provide a better match to their management needs and capital requirements.

The path towards tax reform will need to take into account many features of our tax system and strike a balance between a number of sometimes conflicting and competing objectives.

Thank you and I would be pleased to address any questions you may have.

[29] See, for example, Robert Carroll and David Joulfaian, "Do Taxes Affect Corporate Financial Decisions? -- The Choice of Organizational Form," U.S. Treasury Department, Office of Tax Analysis, Working Paper 73, October 1997; and Austan Goolsbee, "Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax," *Journal of Public Economics,* 69(1), 1998, pp. 143-152.

Testimony of

Gary Marowske

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Warren, Michigan

On Behalf of the

Air Conditioning Contractors of America (ACCA)

Submitted to the
Subcommittee on Economic Growth, Tax and Capital Access

Hearing on

Pro-Growth Tax Policy: Why Small Businesses Need Individual Tax Reform

2360 Rayburn House Office Building

November 3, 2011

Chairman Walsh, Ranking Member Schrader, and members of the Subcommittee on Economic Growth, Tax and Capital Access, thank you for allowing me this opportunity to provide testimony on behalf of the small business contractors of the heating, ventilation, air conditioning, and refrigeration (HVACR) industry.

My name is Gary Marowske, and I am the President of Flame Heating, Cooling, Plumbing & Electrical in Warren, Michigan. Our company offers maintenance, repair, and installation services for heating, cooling, plumbing, electrical, and indoor air quality equipment to residential and commercial clients throughout Metro Detroit. Like a lot of small businesses in the HVACR industry, ours is a family owned company, started in 1949 by my father, Robert Marowske. From a humble beginning, we have grown steadily and today employ 70 workers, own a fleet of more than 60 vehicles, and have installed more than 75,000 home comfort systems.

I come before you this afternoon as a proud member of the Air Conditioning Contractors of America (ACCA) where I serve as Chairman of the Government Relations Committee.

Every day, more than 4,000 ACCA member companies across the nation help homeowners, small business owners, and building managers realize the comfort, convenience, and cost benefits of highly efficient HVACR equipment. Nearly three fourths of ACCA's member companies have fewer than 25 employees, and 92% have fewer than 100 employees.

It's an honor to present testimony before you today and I want to commend the Committee for its leadership and its efforts to give voice to America's small businesses in the current tax reform debate. I hope that my testimony today will be helpful to this subcommittee and to the rest of Congress as we all work to improve the economic recovery.

As Congress considers an overdue and much needed reform to the tax code, the interests of the great economic engine, America's small businesses, cannot be overlooked. Small businesses like mine employ 70 percent of the workforce and are the chief source of new jobs in an economic recovery.

Tax reform must be comprehensive

I wholeheartedly agree that tax reform must address individual rates because of their impact on small businesses. Not everyone understands that sole proprietors, partners, and S Corporation shareholders pay taxes on business income through the individual income rate schedules. These are generally referred to as "pass-through" entities and they make up the bulk of the small businesses in the United States. It is estimated that more than 90% of all US businesses are pass-through entities.

Flame Furnace is organized as an S Corp, as are most of the small businesses in the specialty construction trades. Organizing as a pass-through protects the owners and shareholders from business liabilities and debts, and allows small firms to take advantage of business deductions, and facilitates the transfer of ownership through stock.

Because S corporations pay taxes on business income at the individual rates, Congress should be very careful before enacting any tax reform proposals that tinker with the individual tax rates.

In 2009, 7% of federal tax revenue came from the income taxes paid directly by C Corporations, what most people assume a corporation to be. Individual income tax revenue, *including that from all the pass-through businesses*, was 44 percent of total federal tax revenue in 2009. Unfortunately, it's nearly impossible to say exactly how much came from taxing the net income passed through. Rounding out the breakdown were payroll taxes (employer and employee) at 42 percent, excise taxes at three percent, and "other taxes" which includes estate and gift taxes, customs duties, Federal Reserve earnings/losses, and miscellaneous receipts, at four percent.

While I understand the purpose of today's hearing is to look at the impact of changes to individual rates on small businesses, I must take this opportunity to say that it is encouraging to see Congress take a comprehensive approach to tax reform by looking at the individual, corporate, and international tax codes.

America's small businesses are looking for a simple, rational, and permanent tax code that will encourage prosperity and foster job creation.

The tax code should be simple and rational

The tax code is a powerful tool that can affect individual and corporate behaviors in ways that advance beneficial public policies. Use of the tax code to create incentives for individuals and small businesses can have positive effects on the economy. For example, allowing homeowners to utilize the mortgage interest deduction makes homeownership more attractive and affordable and helps drive the construction industry.

Our industry has seen tremendous positive benefits from the residential energy tax credits found in Section 25C of the tax code. Section 25C allows eligible taxpayers who install qualified new furnaces, boilers, central air conditioners, heat pumps, hot water heaters, and other improvements in their primary residences to claim a non-refundable tax credit. All an eligible taxpayer has to do is install a qualified appliance and they can take advantage of the credit.

In 2006 and 2007, homeowners were able to claim 10% of the installed costs (up to $500) in tax credits, depending on the type of qualified improvements they made. In 2009 and 2010, the value of the tax credit was boosted to 30% of the installed costs up to $1,500. When the tax credits were extended for 2011, the values were reduced back to 10% of the installed costs up to $500.

Retrofitting HVACR and hot water appliances can be an expensive investment in a home. Despite the higher first costs, ACCA members saw an increase in sales because the tax credits reduced initial investment and shortened the payback period for qualified HVACR retrofits. The policy to grant the tax credit meant homeowners paid less in their utility bills to heat and cool their homes, experienced better indoor air quality and comfort, and the resulting reduction in energy use meant fewer greenhouse gases were released into the environment. But even more importantly, even though these tax credits are aimed at individual taxpayers, these valuable incentives helped the small businesses of the HVACR industry.

Based on our own surveys, a clear majority of ACCA's member companies saw positive benefits from these tax credits in 2009 and 2010. In a survey conducted last year, 46% of ACCA's contractor members saw a "significant" increase in the sale of qualifying HVAC equipment after the increase in the tax credit value. Another 32% saw a small increase in the sale of qualifying HVAC equipment. When taken in tandem, more than 75% of ACCA's contractor members saw an increase in the sale of qualifying higher efficiency equipment.

When the tax credit values were reduced for 2011, consumer interest waned. At the lower value level, the most a taxpayer can claim for a high efficiency furnace is $150, not enough to justify reaching higher than the base model furnace in the short term.

The 25C tax credits do not favor the wealthy. According to IRS statistics, fully 93% of tax credit claims under 25C and 25D (for solar, geothermal, wind, and photovoltaic properties) were made by taxpayers who have an adjusted gross income of no more than $200,000, which is indicative of a middle class tax program.

Examining the 2009 Estimated Data Line Counts for Individual Tax Returns gives a clear picture of how homeowners used $1,500 residential energy tax credits in 2009.

Taxpayers use the Form 5695 worksheet to claim one of several available residential energy credits. The taxpayer first calculates the total cost of qualified expenditures, then reduces that amount by 30%, and compares that value with $1,500. The taxpayer is eligible for tax credits equal to the lesser amount.

Data from the tax forms filed in 2009 tells us how many taxpayers claimed the residential energy tax credits; how many claimed a credit for the purchase of a qualified central air conditioner, heat pump, or hot water heater; a qualified furnace or hot water boiler, or an advanced main air circulating fan; and the total expenditures on these improvements.

In 2009, 6,753,885 households filed Form 5695 to claim a credit against their tax liability for installing some type of energy efficient appliance or retrofit measure in their primary home.

Of that total amount, 976,380 households claimed for purchasing and installing "energy efficient building property," otherwise known as a qualified central air conditioner, heat pump, or hot water heater totaling $3,968,715,000 in expenditures.

In 2009, 1,290,640 taxpayers claimed tax credits for "qualified natural gas, propane, or oil furnaces or hot water boilers" and reported total expenditures of $4,310,456,000.

And 221,274 taxpayers claimed some credit for an advanced main air circulating fan, with an aggregate expenditure amount of $694,422,000.

For all retrofit measures and appliances that qualified for the tax credit, including energy efficient windows and door, insulation, and roofing materials, American taxpayers claimed $5.17 billion in tax credits on $25.1 billion worth of work. This is a significant number, especially when you consider that it only represents what was filed. What's missing is the work performed for a taxpayer who ended up not being able to use the tax credit because it turned out they weren't eligible.

The National Association of Home Builders estimates every $100,000 in remodeling expenditures generates 1.11 full-time jobs.

The 25C tax credits highlight how a simple tax incentive can help individuals and small businesses and the create an economic benefit. Congress needs to extend the 25C tax credits beyond their expiration at the end of this year, and restore the tax credit to $1,500.

Regrettably there are few federal incentives that make sense for commercial building or rental property owners who want to make energy efficient improvements. Every building is unique and Congress should provide ways to encourage more energy efficient improvements to the variety of commercial buildings.

As Congress considers tax reform, it should look at changes to the depreciation schedules that require most commercial HVACR equipment to be recovered over a 39 year period. When you realize that properly installed and maintained HVACR equipment has an expected lifespan of fifteen to twenty years, there is almost no incentive to replace at all.

Without any incentive to replace aging HVACR equipment, small businesses will continue to maintain and repair old, inefficient furnaces, air conditioners, chillers, and boilers. According to the Department of Energy's 2005 Buildings Energy Databook and the Energy Information Administration, commercial buildings account for 18% of total US energy consumption. Within those buildings, 14.2% of the energy consumed goes toward space heating, 13.1% goes toward space cooling, and 6% goes toward ventilation. All told, nearly $142 billion was spent nationally in 2005 on space heating and cooling for residential and commercial buildings combined. According to the 2005 Residential Energy Consumption Survey, since 1990 only 30% of commercial buildings have had their main heating equipment replaced, and only 37% have had their main cooling equipment replaced.

A change in the tax code to bring the depreciation schedules more in line with reality would reduce energy use and help many small firms located in commercial properties like professional townhouse suites, doctor's offices, and strip malls that use smaller and less expensive commercial HVAC equipment. Changing the rules regarding depreciation would stimulate domestic job creation at the manufacturing, distribution, and contractor segments in an emerging green market economy. In the past 15 years there have been dramatic advancements in HVACR technology, making the equipment manufactured today extremely energy efficient, which means lower utility bills and less energy use. Providing a financial incentive to building owners now would encourage them to upgrade to more energy efficient equipment instead of waiting until their outdated equipment breaks down beyond repair, which is the current practice today.

Tax reform must be long term, not piecemeal or through short term fixes
All of America's small businesses applauded the passage of H.R. 4, the Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011 that repealed the Form 1099 filing provision. And we are hopeful that the Senate can pass and the President will sign H.R. 674 to repeal the 3% withholding tax on government contracts. But the effort to pass these two small business priorities highlights the piecemeal and short term approach Congress has taken with regard to the tax code.

Last year, Congress passed The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 that extended more than 60 tax provisions benefited individuals and small businesses just two weeks before they were set to expire. Included in the bill were a temporary extension of the Bush Tax Cuts, a short term estate tax reduction, a short term extension of bonus depreciation and modification to Section 179 expensing rules, a one year extension of the Alternative Minimum Tax "patch", and a temporary extension of the residential energy tax credits described above.

While the extension of these tax incentives is greatly appreciated, the timing and nature of their extension make it very difficult for businesses to make business decisions.

America's small business owners are crippled by fear - fear of the unknown of what may or may not happen next year. By sending the right signals to America's small businesses, Congress can eliminate the fear of the unknown in the future. We all need clear communication of what is coming next and what needs to be done and I assure you American small businesses will rise up and create new jobs.

With that I will conclude my comments and would be happy to answer any questions you may have. Thank you again for this opportunity to testify before you today.

Written Testimony before the
House Committee on Small Business
Subcommittee on Economic Growth, Tax, and Capital Access
Delivered by
Mr. William R. Smith, President and CEO
Termax Corporation
On behalf of the
Precision Metalforming Association

November 3, 2011

Chairman Walsh, Ranking Member Schrader, members of the committee, thank you for the opportunity to testify today. My name is William Smith, President and CEO of Termax Corporation based in Lake Zurich, Illinois. We are members of the Precision Metalforming Association (PMA), which has roughly 1,000 member companies like ours throughout the country representing the $113 billion precision metal products industry using stamping, fabricating, and other technologies. Roughly two-thirds of our member companies are structured as Sub Chapter S Corporations or similar pass-throughs, as is Termax Corporation. The industry averages about 50 employees per business, most of which are family owned like ours.

My father founded the company in 1971, and in 1998, my brother and I took over operations where we have seen the company grow to 250 employees and holding over 60 patents. While primarily servicing the automotive industry, Termax products and services are used by many organizations that require quality engineered clips and fasteners including appliances, lighting, toys, construction, and automotive aftermarket providers. Before taking over the family business in 1998, I worked as a Certified Public Accountant (CPA) for roughly twenty years, giving me a unique perspective to understand both the production and finance sides of manufacturing in America.

In my experience as a CPA, the vast majority of manufacturers are structured as an S Corporation, Limited Liability Corporation (LLC), partnership or other form of pass-through. Recent statistics show that 54% of all private employers are structured this way and among PMA member companies, 64% of manufacturers are a pass-through entity.

Many companies like ours are structured this way because we are family owned businesses with a limited number of shareholders and owners who are often our siblings and increasingly our children and grandchildren. We initially became an S Corporation to avoid the double-taxation that a C Corporation faces.

First, I would like to provide a quick analysis from the standpoint of a CPA and then show the impact of the current tax code on a manufacturer in Illinois. Small and medium sized manufacturing business owners (such as my brother and me) pay our income taxes at the individual rate, and claim all deductions and credits at the personal level as well as the company level when appropriate. This means that the financial and manufacturing success of our employees and business are directly tied to that of the business owners – the Smith Family.

The vast majority of company owners like us leave most of the money in the business, directly reinvesting in our employees, facilities, and equipment. This is an important point. Due to our current U.S. tax code, we are taxed on income we do not take out of the company but leave in the business to reinvest. This means we have fewer resources to put towards hiring, training, and buying new machines. In speaking to a few companies in our industry from Illinois, Wisconsin, and Ohio, small and medium sized manufacturers, based on wage and K-1 income, pay 36% in taxes, distribute 18% to owners, and reinvest 46% in the business.

In addition, those funds are taxed at the individual rate which for most of us is at the current 35% level set to increase to 39.6% on January 1, 2013 without Congressional action. If statutory rates increase by nearly 5%, as business owners we have to take it out of the pie somewhere, either from the owner's families or from reinvestment in the employees and company – usually both.

Tax increases resulting in reduced cash flow in the business causes a major unintended ripple effect on a small business – access to capital. Banking and other lending requirements have toughened forcing more owners to leave retained earnings in the business for capitalization purposes. Therefore, increased tax liability means less money in the business which will restrict the ability of a small business to access timely and sufficient credit to purchase machines, expand their facility, and hire new employees. This is particularly true for a passthrough entity like ours who is taxed regardless of the actual distribution made to the owner.

Tax rates are is clearly a politically charged issue but from the standpoint of the small business owner, we must take whatever steps we can to reduce our effective tax rate in order to free up funds to reinvest in new technologies and people to remain globally competitive. Over the last few years, Termax Corporation has seen our American competitors decrease to just two (2) from approximately eight (8); while our foreign competitors have increased dramatically. This is where tax deductions and credits come in as the only tool we have to reduce our effective tax rate and incentivize us to take actions we might otherwise not take at that time.

Companies of all structures and sizes claim deductions and credits for certain activities or property, from the Research and Development Tax Credit to Bonus Depreciation. As I mentioned, our company holds over 60 patents and in 2011 we expect to spend $1,500,000 on R&D to develop new technologies for the automotive and construction industries among others.

Another good example is the Section 199 Domestic Production Activity Deduction, where manufacturing businesses and other qualified production activities are eligible for a 9% deduction. This amounts to an *effective* rate reduction of 3.19%, lowering the tax burden on the manufacturer and freeing funds for reinvestment.

This is why removing deductions and credits such as the Section 199 for all businesses to reduce the rate for traditional C Corporations will *increase* the effective tax rate and burden on all S Corporations and other pass-throughs like our business. We need a comprehensive approach to tax reform that addresses corporate, pass-through business, and individual tax rates, deductions, and credits. Due to the complicated and interwoven nature of the tax code, a piecemeal approach to reform will not work and will inevitably disadvantage the smaller businesses.

Some have asked why we S Corporations and LLCs simply do not convert to becoming a traditional C Corporation. First the costs associated with the conversion are astronomical and it is extremely time consuming, especially for a company of smaller resources. Another reason is due to the family owned structure of the business, when a business owner passes a company down to the next generation, there is a greater tax liability for a C Corporation. This is akin to the family farm being sold to pay taxes.

Tax reform is possibly the single most important barrier to improving manufacturing growth in the U.S. but it is about so much more than just statutory rates. If you ask them, most manufacturers want stability, simplification, and globally competitive effective rates. We each need to pay our fair share and there is no question the tax code is filled with outdated provisions and loopholes that have long outlived their effectiveness. A prime example of this is the Alternative Minimum Tax, the forerunner of the current Millionaires' Tax.

As a business owner, the most important questions are: what is my total federal, state, and local tax liability, what is my effective rate, and what is left over for me to invest and grow my business? On behalf of small and medium sized businesses manufacturing in America, we ask that Washington move on comprehensive tax reform to help us all grow our businesses and create jobs in the U.S.

Thank you for the opportunity to present testimony today. I look forward to continuing to work with this Committee.

TaxTemplate-medium 25% 111101, "Medium S Corp 25%" - 11/2/2011

	Base Case Assumptions	#NAME? Assumptions
Sales	$ 25,000,000	$ 25,000,000
PreTax Profit %	6.0%	6.0%
Wages (Salaries + Bonus)	$ 200,000	$ 200,000
Self Employed Health	$ 10,500	$ 10,500
Section 199 %	9.0%	9.0%
LIFO to FIFO	$ -	$ -
Federal Tax Rate	35.0%	25.0%
Local Tax Rate	2.0%	2.0%
State tax Rate	5.93%	5.93%
S Corp Medicare Tax Rate	2.90%	2.90%
LLC Medicare Tax Rate	2.90%	2.90%
Donations ($)	$ 25,000	$ 25,000
Other ($)	$ 15,000	$ 15,000
Social security tax	12.40%	12.40%
Itemized Deduction Phaseout $	$ 166,000	$ 166,000
Itemized Deduction Phaseout %	3.0%	3.0%
R&D Tax Credit	$ 50,000	$ 50,000
Millionaires Tax Threshold	$ 1,000,000	$ 1,000,000
Millionares Tax Rate %	0.00%	0.00%
S Corp Medi. Tax Increase 2014	0.00%	0.00%
LLC Medi. Tax Increase 2014	0.00%	0.00%
Investment Tax Credit		
Social Security max income	$ 106,800	
S Corp or LLC?	S Corp	S Corp

Base Case

#NAME?

	Base Case P&L View	Base Case Taxes	#NAME? P&L View	#NAME? Taxes	Taxes
Sales	$ 25,000,000		$ 25,000,000		
S Corp and LLC K1 Income	$ 1,500,000		$ 1,500,000		
Wages + K1 Income	$ 1,700,000		$ 1,700,000		
Adjustments					
Self Employed Health	$ 10,500		$ 10,500		
Section 199	$ (135,000)		$ (135,000)		
LIFO to FIFO	$ -		$ -		
Total Adjustments	$ (124,500)		$ (124,500)		
Adjusted Gross Income	$ 1,575,500		$ 1,575,500		
Deductions					
Local Tax	$ 31,510		$ 31,510		$ -
State Tax	$ 93,427		$ 93,427		$ -
Social Security tax	$ 13,243	$ 13,243	$ -	$ 13,243	
Medicare Tax	$ 5,800	$ 5,800	$ 5,800	$ 5,800	$ -
Donations	$ 25,000		$ 25,000		
Other	$ 15,000		$ 15,000		
Subtotal Deductions	$ 183,980		$ 170,737		
Itemized Deduction Phaseout	$ 42,285		$ 42,285		
Total Deductions	$ 141,695		$ 128,452		
Taxable Income	$ 1,433,805	$ 501,832	$ 1,447,048	$ 361,762	$ (140,070)
Credits					
R&D Tax Credit	$ 50,000	$ (50,000)	$ 50,000	$ (50,000)	$ -
Investment Tax Credit	$ -	$ -		$ -	$ -
Total Taxes		$ 470,875		$ 330,805	$ (140,070)
Potential Changes					
S Corp Medi. Tax Increase	$ -	$ -	$ -	$ -	$ -
LLC Medicare Tax Increase	$ -	$ -	$ -	$ -	$ -
Millionaires Tax	$ -	$ -	$ -	$ -	$ -
Total Changes	$ -	$ -	$ -	$ -	$ -
Total Federal Taxes After Changes		**$ 470,875 27.7%**		**$ 330,805 19.5%**	**$ (140,070)**
State and local taxes		$ 124,937		$ 124,937	
TOTAL TAXES		**$ 595,812 35.0%**		**$ 455,742 26.8%**	

Comments

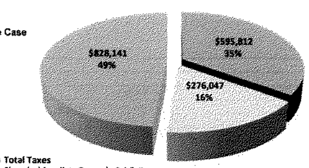
Example based on a metalworking company in Ohio with a 25% statutory rate assumption removing most deductions.

This tax template is a representation of the potential effects of tax reform. It is not intended to be an exact calculation of a business's tax liability.

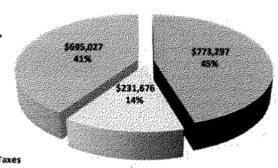
TaxTemplate-medium 25% 111101, "Medium S Corp 39% 2013 changes" - 11/2/2011

	Base Case		#NAME?	
	Assumptions		Assumptions	
Sales	$	25,000,000	$	25,000,000
PreTax Profit %		6.0%		6.0%
Wages (Salaries + Bonus)	$	200,000	$	200,000
Self Employed Health	$	10,500	$	10,500
Section 199 %		9.0%		0.0%
LIFO to FIFO	$	-	$	-
Federal Tax Rate		35.0%		39.6%
Local Tax Rate		2.0%		2.0%
State tax Rate		5.93%		5.93%
S Corp Medicare Tax Rate		2.90%		2.90%
LLC Medicare Tax Rate		2.90%		2.90%
Donations ($)	$	25,000	$	25,000
Other ($)	$	15,000	$	15,000
Social security tax		12.40%		12.40%
Itemized Deduction Phaseout $	$	166,000	$	166,000
Itemized Deduction Phaseout %		3.0%		3.0%
R&D Tax Credit	$	50,000	$	-
Millionaires Tax Threshold	$	1,000,000	$	1,000,000
Millionares Tax Rate %		0.00%		0.00%
S Corp Medi. Tax Increase 2014		0.00%		0.00%
LLC Medi. Tax Increase 2014		0.00%		0.00%
Investment Tax Credit				
Social Security max income	$	106,800	$	106,800
S Corp or LLC?	S Corp		S Corp	

Base Case



#NAME?



	Base Case					#NAME?						
	P&L View		Taxes			P&L View		Taxes				Taxes
Sales	$	25,000,000				$	25,000,000					
S Corp and LLC K1 Income	$	1,500,000				$	1,500,000					
Wages + K1 Income	$	**1,700,000**				$	**1,700,000**					
Adjustments												
Self Employed Health	$	10,500				$	10,500					
Section 199	$	(135,000)				$	-					
LIFO to FIFO	$	-				$	-					
Total Adjustments	$	(124,500)				$	10,500					
Adjusted Gross Income	$	**1,575,500**				$	**1,710,500**					
Deductions												
Local Tax	$	31,510				$	34,210				$	-
State Tax	$	93,427				$	101,433				$	-
Social Security tax	$	13,243	$	13,243		$	13,243	$	13,243			
Medicare Tax	$	5,800	$	5,800		$	5,800	$	5,800		$	-
Donations	$	25,000				$	25,000					
Other	$	15,000				$	15,000					
Subtotal Deductions	$	183,980				$	194,686					
Itemized Deduction Phaseout	$	42,285				$	46,335					
Total Deductions	$	141,695				$	148,351					
Taxable Income	$	**1,433,805**	$	501,832		$	**1,562,149**	$	618,611		$	116,779
Credits												
R&D Tax Credit	$	50,000	$	(50,000)		$	-	$	-		$	50,000
Investment Tax Credit	$	-	$	-				$	-		$	-
Total Taxes			$	470,875				$	637,654		$	166,779
Potential Changes												
S Corp Medi. Tax Increase	$	-	$	-		$	-	$	-		$	-
LLC Medicare Tax Increase	$	-	$	-		$	-	$	-		$	-
Millionaires Tax	$	-	$	-		$	-	$	-		$	-
Total Changes	$	-	$	-		$	-	$	-		$	-
Total Federal Taxes After Changes			**$**	**470,875**	**27.7%**			**$**	**637,654**	**37.5%**	**$**	**166,779**
State and local taxes			$	124,937				$	135,643			
TOTAL TAXES			**$**	**595,812**	**35.0%**			**$**	**773,297**	**45.5%**		

Comments

Example based on metalworking manufacturing company in Ohio with a 39.6% statutory rate assumption

This tax template is a representation of the potential effects of tax reform. It is not intended to be an exact calculation of a business's tax liability.

TaxTemplate-medium 25% 111101, "EXPLANATION" - 11/2/2011

	Assumptions	Assumptions	
Sales			PMA average rate for 2008
PreTax Profit %			Can be multiple owner operators - represents total salaries and bonus
Wages (Salaries + Bonus)			W2 earnings from businesses
Self Employed Health			This represents value for self employed health care - will be an arbitrary number selected by
Section 199 %			Domestic production activities deduction
LIFO to FIFO			A fixed number based on 10 year phase in - to start by 2013
Federal Tax Rate			federal - returns to Pre Bush tax cuts
Local Tax Rate			City
State tax Rate			State
S Corp Medicare Tax Rate			Medicare tax paid by employee and employer - W2 only for S Corp
LLC Medicare Tax Rate			Medicare tax paid by employee and employer - unlimited in LLC
Donations ($)			Total donations within K! plus personal donations of filer
Other ($)			Investment fees, tax preparation fees, non-covered expenses, real estate taxes above thres
Social security tax			**12.4% up to $ 106,800 - doesn't change in 2013**
Itemized Deduction Phaseout $			Phaseout threshold
Itemized Deduction Phaseout %			Reimposed in 2013
R&D Tax Credit			Amount calculated annually - goes away in 2013
Millionaires Tax Threshold			Not scheduled for 2013
Millionares Tax Rate %			Charged to LLC and K1 earnings ???
S Corp Medi. Tax Increase 2014			Additional tax set at .9% on W2 but not K1 for S Corps
LLC Medi. Tax Increase 2014			Additional tax set at .9% on wages and bonus including K1
Investment Tax Credit			10% tax credit on machinery purchased (not presently used)
Social Security max income			Maximum income that social security is paid on (remains unchanged in 2013)
S Corp or LLC?			Place Cursor in cell and select S Corp or LLC from dropdown list

General Notes:
- Enable Macros
- to create a new sheet, ONLY press "New Case" in upper left corner of sheet. Do not copy sheet because pie chart will be invalid.
- renaming the sheet title will automatically rename titles on the active sheet
-"Resize this Row" will accommodate longer case names
- password to unprotect all sheets is "mcgregor"

This tax template is a representation of the potential effects of tax reform. It is not intended to be an exact calculation of a business's tax liability.

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

NFIB
The Voice of Small Business.®

Testimony of Stephen Capp, Laserage Technology Corp.

U.S. House Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access

"Pro-Growth Tax Policy: Why Small Businesses Need Individual Tax Reform"

November 3, 2011

Good morning, Chairman Walsh, Ranking Member Schrader, and members of the Subcommittee.

My name is Steve Capp, President and CEO of Laserage Technology Corp. (Laserage), and I am pleased to be here as a small business owner and member of the National Federation of Independent Business (NFIB) – the nation's leading small-business advocacy organization – to discuss the impact federal income taxation has on my company.

My father and I founded Laserage in 1979, which is now based in Waukegan, Illinois. When we started Laserage, we were just a tiny contract manufacturer with one laser, primarily working on ceramic components for the electronics industry. Over 32 years, we now have 135 employees and 65 lasers in 38 work centers processing many different types of materials. We specialize in laser processing of material for the medical device industry, but we also work with the electronics, LED, aerospace, and other industries. We also perform secondary operations such as finishing, testing, and packaging. Currently we export about 50 percent of the products we manufacture.

Like many small business owners, taxes are a major concern for us. The most recent NFIB Research Foundation's Small Business Problems and Priorities survey shows the challenges the tax code presents for small businesses. Four of the top ten issues identified in the survey are tax-related. Specifically, federal tax rates ranked third and tax complexity ranked fifth.[1]

I can assure you that small business owners are encouraged that Congress is considering tax reform. But, I am here to tell you that small businesses face unique tax challenges and need to be part of the tax reform debate. Like Laserage, which operates as an S Corp, the majority of small businesses – about 75 percent – are organized as pass-through businesses.[2] The pass-through business structure works to make small businesses competitive, and should continue to be supported by Congress, including recognition of the unique issues that impact pass-through businesses.

Choosing a Pass-Through Business Structure

An owner chooses a business structure for a variety of reasons. Avoidance of organization costs, liability protection and tax planning are generally the most common reasons to choose a pass-through structure. But, according to an NFIB Small Business Poll, of the small businesses that changed their business structure, 39 percent of them changed to avoid liability and 27 percent for tax planning reasons.[3]

[1] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.

[2] Firms of all size responded that 20.9-percent organized as sole proprietors, 5.8-percent as partnerships, 25.6-percent as C-Corps, 30.9-percent as S-Corps, 12.4-percent as LLCs, and 4.2-percent as other/DNK. *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

[3] *Ibid.*

While a business structure like a sole proprietor or a partnership will protect the business from double taxation, the liability protection that a C Corp offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. Several changes made to the S Corps rule have increased the attractiveness of choosing the S Corp structure. This has led to a substantial increase in the number of S Corps. In 1985, 22 percent of all corporations were S Corps; by 1990, the figure has risen to 43 percent; and today, the majority of U.S. corporations are S Corps.[4]

Laserage is not unlike a lot of closely-held businesses in that we were originally organized as a C Corp, but changed to an S Corp. Ending the double taxation of profits and gains -- leaving us more after-tax profits to re-invest in our business -- was our primary reason for converting from a C Corp to an S Corp.

Ours is a capital intensive business, and historically, we have re-invested back into our business all of our after-tax profits (though we have occasionally bought back the stock of some shareholders when they asked us to and we could afford to). We made the decision to switch to an S Corp based on our need to retain as much of our profits for reinvestment as possible and for the benefit of our shareholders.

We have 34 shareholders -- double taxation as a C Corp made their investment in our company less attractive. As an S Corp, the distributions to shareholders have to be made to them pro rata to the percentage of the company they own. Our growth strategy is to distribute to our shareholders only that portion of our pre-tax profits that is required to furnish our shareholders with the taxes they will owe on the share of our profits they must each report on their personal income tax returns (we use the sum of the highest federal marginal tax percentage, plus the highest marginal state rate to make these calculations). We retain the rest our income almost entirely to fund modernization, growth and new investments (and only occasionally, to redeem shares of stock of a shareholder on his or her request).

But, avoiding double taxation of gains is another factor that greatly influenced Laserage's decision to be an S Corp. For many of our shareholders, their ownership is a significant part of their savings, and they look to the appreciation in Laserage's value culminating in its eventual sale.

Frequently business sales of closely-held businesses are structured as "asset sales" (unlike sales of public companies, which are usually "stock sales"); by being an S Corp, if Laserage is sold in an "asset sale," our shareholders' gain will only be taxed once. As a C Corp, an "asset sale" sale would first be taxed at the corporate level, and then a second time when the after-tax proceeds were distributed to the shareholders. As an S Corp, in an "asset sale" the sale only faces one layer of tax at the shareholder level. Obviously, this single layer of tax makes the investment in our company more attractive.

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[4] *SOI Bulletin*, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data - table 13, Winter 1999-2000.

While the conversion from a C Corp to an S Corp added complexity to our accounting and tax preparation, both Laserage and its shareholders have benefited from this decision -- allowing us to maximize our re-investment of our after-tax profits in our business without penalizing our shareholders. The choice to become an S Corps has allowed us to make the right decisions to grow and strengthen our business. Congress should continue to support pass-through business structures and they must be part of any tax reform debate.

Individual Rates and Small Business

Switching from a C Corp to an S Corp means that the individual tax rates are the rate at which we and our shareholders now pay tax on our business income. Keeping these tax rates low is important to our business and important to small businesses in general.

Small businesses fall into all of the current six individual income tax brackets. In 2001, the individual rates were lowered across the board providing all small business taxpayers with some tax relief. Since those tax rates became law, many agree that keeping rates low for some taxpayers is important. That is a step in the right direction to promoting a pro-growth tax policy and ensuring that many business owners will not see a tax increase. I encourage Congress to keep tax rates low for all small business owners. This is especially important as we continue to recover from the most recent recession.

Laserage's business would be impacted by higher tax rates and add to the economic challenges we are confronting. As I noted, we now export about half of the products we manufacture and this increase is driven by many of our customers. As our exporting has increased, Laserage has received ever-increasing pressure from some of our largest customers to begin production in a low-cost country.

To this point Laserage has successfully avoided taking this step, primarily by adopting what are known as "lean" manufacturing techniques and achieving productivity increases through improvements to our production methods. But, there is only so much that can be accomplished through those efforts, and at some point, if Laserage is to continue to be competitive and stay in business, it will either have to see its operating costs (including taxes) go down, or it will have to take additional steps such as relocating manufacturing overseas in order to avoid losing major customers.

Over the last few years, Laserage's operating costs have steadily increased. Illinois taxes were increased massively this past year. Last year, health insurance costs rose 21 percent. Materials and energy costs continue to increase. If federal income taxes increase, as well, it could well be the "straw that breaks the camel's back" and forces us to manufacture in an offshore business.

In candor, Laserage has already started looking into starting up manufacturing operations as a matter of self-preservation, and in doing so, we are certainly well aware that the corporate tax rate even in a well-developed county like Singapore is only 17 percent. A lower U.S. tax rate would make a difference in Laserage's product pricing thereby making it more competitive.

Raising the federal tax rate only makes the situation worse for Laserage and places greater pressure on its bottom line. I will continue to work to build Laserage's business here in the U.S. But, I must report to you that if the cost pressures become too great, given the rising demands of our customers for an overseas cost solution, Laserage will have no choice but to consider overseas options in order to survive and grow.

Tax Reform and Small Business

Because taxes are such a concern for small business owners, we support reforming the tax code. Any tax reform must consider the unique issues facing small businesses, including choosing a pass-through business structure. Tax changes that only focus on part of the tax code is not reform and may make the tax situation worse for small businesses.

Pass-through businesses, and the many small businesses that choose a pass-through structure, must be included in any reform of the tax code. Much of the debate surrounding tax reform has focused on eliminating deductions and closing loopholes to reduce rates. If that is the path for tax reform, the rate reductions must also include pass-through businesses or businesses like mine will be placed at a competitive disadvantage.

The current tax rates for pass-throughs are similar to a C Corp. If the rates were to go down for C Corps but remain unchanged for my S Corp, or stay at current rates for my C Corp competitors but increase for me and my fellow Laserage shareholders, it would put Laserage at a distinct disadvantage. At the very least, the tax rate paid by pass-through businesses should be the same rate that applies to C Corps. Reducing the taxes for both S Corp and C Corp manufacturers would make us both more competitive relative to goods made elsewhere in the world.

In addition, losing deductions without corresponding relief by lowering tax rates would similarly place Laserage at a competitive disadvantage. As a manufacturer, Laserage operates a capital intensive business, and therefor relies on the deductions it was entitled to take for its capital expenditures to help fund its modernization, growth and competitiveness. Last year, we purchased $1.1 million in capital equipment, though I should tell you that this included an additional $350,000 in investments, because of the uncertainty over whether the same expensing of capital expenditures would be extended to 2011. This year, we will purchase about another $850,000 of equipment, which we will also deduct as an expense. In addition, as a manufacturer we rely on the Section 199 domestic production deduction.

Losing the benefit of these deductions without corresponding relief in the form of rate reductions would be harmful to Laserage. On top of the inordinately large price increases Laserage has endured in state taxation, health insurance, commodities and other areas, any tax increase will make it even more difficult for Laserage to compete.

Tax reform must also include simplifying the tax code. The current code is cumbersome and requires us to spend too much time and money to ensure we comply. The tax return Laserage filed with the IRS last year was 416 pages long. This is simply an information return, since as a pass-through, Laserage is not a taxable entity. Yet, even with the massive internal accounting personnel costs Laserage incurred to generate all of the necessary information required to be included in the return, the return itself was so complex we had to pay more than $9,000 to have our independent auditors simply prepare it for filing. Last year, my personal tax return, which includes my share of Laserage's taxable income, was 28 pages and cost me about $2,500 to have my personal accountant prepare.

Any changes to the tax code must make it simpler and less expensive for businesses to comply with the code.

One simple step that Congress can take is to end the many expiring and short-term tax provisions. A simple example is the current individual rates. With those rates set to expire at the end of 2012, pass-through business owners like mine are left wondering what the following year's tax rates will be.

In addition, the short-term and one-time provisions promoted as tax incentives also provide little certainty for small business owners. We simply cannot plan and make business decisions with constantly changing tax laws "hanging over our heads." Business owners need certainty and clarity about the tax rules and to be freed of fear of constant and\or harmful changes.

Conclusion

Tax reform can be an effective tool for economic growth. This is particularly true for pass-through and small businesses. The tax code is an impediment to growth, and reforming the tax code so that we can make business decisions, rather than tax decisions must be part of any tax reform.

The majority of private sector employees – 54 percent – work for pass-through businesses.[5] Small businesses, in particular, account for the vast majority of new jobs. But the current economic conditions have kept small businesses from growing and creating new jobs. The trends in the most recent NFIB Small Business Economic Trends (SBET) survey demonstrate this. While this month saw a slight increase in small business optimism, the survey had been negative for the previous six months.[6]

Two of the biggest concerns in the SBET are taxes and government regulations. Congress has the opportunity to address those concerns, but I urge Congress to focus on

[5] Carroll, Robert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform*, April 2011.
[6] Dunkelberg, William C. and Holly Wade, *NFIB Small Business Economic Trends*, October 2011.

long-term solutions, so that businesses are able to plan and make sound investments in their future.

Tax reform and more certainty can be an effective tool for economic growth and job creation. Businesses like mine struggle every year with complicated and expiring tax provisions. The Congress has the opportunity to reform our complicated tax code, but you must make sure to do it right. Tax reform must address the concerns of both pass-through and corporate businesses.

Thank you for the opportunity to appear before the committee on this important issue.

NATIONAL
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The Cornerstone of the Economy, Career Opportunities and Community Involvement

Statement for the Record

Of

**Dave Koenig, Vice President, Tax and Profitability,
National Restaurant Association**

For The Hearing On

"Pro-Growth Tax Policy: Why Small Businesses Need Individual Tax Reform"

Before

**The U.S. House of Representatives
Committee On Small Business
Subcommittee on Economic Growth, Tax and Capital Access**

Thursday, November 3, 2011

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Chairman Walsh, Ranking Member Schrader, and members of the House Small Business Subcommittee on Economic Growth, Tax and Capital Access, thank you for the opportunity to submit this statement for the record on behalf of the National Restaurant Association. We applaud the Subcommittee for convening this hearing to examine the need for tax reform to comprehensively address pass-through and individual tax issues.

Currently, the tax law presents taxpayers with a great deal of complexity and uncertainty. Tax reform provides an opportunity to address these issues. Done properly, a comprehensive and nuanced review of the tax system could result in predictability, simplicity, and fairness, while encouraging economic growth and job creation.

This statement discusses the importance of comprehensive tax reform that addresses both the corporate and individual tax code. Additionally, we wanted to bring to your attention several tax policies that are important to the restaurant industry and could benefit from reform efforts, including: (1) the 15-year depreciation schedule for leasehold improvements, restaurant improvements and new construction, and retail improvements; (2) the Work Opportunity Tax Credit ("WOTC"); (3) the deduction for donations of food inventory; and (4) the deduction for business meals.

Restaurants: Small Businesses with a Large Impact on our Nation's Economy

The restaurant industry plays a significant role in our nation's economy. This year alone, the restaurant industry will generate an estimated $604 billion in sales, with an overall economic impact of more than $1.7 trillion. Every dollar spent in restaurants generates an additional $2.05 spent in our nation's economy. The restaurant industry is one of the nation's largest private job creators, employing approximately 12.8 million people, representing nearly ten percent of the U.S. workforce.

Moreover, it is important to stress that the restaurant industry is an industry of small businesses. There are 960,000 restaurant and foodservice outlets in this country. Seven out of ten restaurants are single-unit operators. Most eating and drinking establishments, 93 percent of the industry, have fewer than 50 employees. Restaurants also serve as the conference rooms for many of the self-employed and other small businesses.

Tax Reform and Pass-Through Entities

As Congress confronts the challenge of reforming the tax code, it is critical that the effort comprehensively considers tax issues impacting pass-through entities and individuals.

Pass-through entities constitute an increasing part of the U.S. economy and are responsible for a substantial share of economic activity and employment. A 2011 study by Robert Carroll and Gerald Prante of Ernst & Young LLP found that, in 2008, pass-through entities accounted for nearly 95 percent of all business entities, employed 54 percent of the private sector work force, and reported 36 percent of all business receipts.

Because the restaurant industry is largely comprised of small businesses, many restaurant operators are organized as pass-through entities. A 2009 survey of National Restaurant Association members revealed that 77% were organized as flow-through entities or as sole proprietors.

With the large size of this sector of the economy, tax reform could have significant consequences for pass-through businesses, jobs in the pass-through sector and therefore the broader economy. Based on the Ernst & Young LLP study, pursuing corporate-only reform that eliminates some or all business tax expenditures would increase the income taxes paid by individual owners of pass-through businesses, on average, by eight percent or $27 billion annually from 2010 through 2014.

In light of this, tax reform needs to be comprehensive, simultaneously addressing both the individual tax code and the corporate tax code, in order to ensure that pass-through entities, which largely constitute our nation's small businesses, are not disproportionately harmed. Additionally, individual and corporate tax rates should be kept at similar, low levels. Different individual and corporate tax rates would encourage planning to circumvent the higher rates, ultimately resulting in wasted resources and lower growth. To ensure that tax reform results in a more simple and competitive tax code, Congress needs to keep top tax rates low, and it needs to keep them at similar levels. Furthermore, it should be noted that the prevalence of pass-through taxation is the result of purposeful and explicit reforms enacted by Congress over the past half-century. A key goal of tax reform should be to continue this progress to tax business income only once.

Tax reform that embraces these broad concepts will help establish a tax system that ensures that all employers, regardless of how they are organized, continue to invest and create jobs in the United States.

Other Important Tax Issues in the Context of Tax Reform

In addition to the pass-through entity issues discussed above, tax reform presents an opportunity to provide taxpayers with predictability and fairness, while encouraging economic growth and job creation. The 15-year depreciation schedule for leasehold improvements, restaurant improvements and new restaurant construction, and retail improvements, the WOTC, the enhanced deduction for the contribution of food inventory, and the deduction of 80 or 100 percent of the cost of business meals and entertainment are consistent with all of these goals and should be considered as tax reform progresses.

15-year Depreciation Schedule for Leasehold Improvements, Restaurant Improvements and New Construction, and Retail Improvements

One principle of the tax code is that costs of assets are allocated over the period in which they are used. Assets with longer expected lives are depreciated over a longer period of time, while assets with shorter lives are depreciated over a shorter period of time. As a reflection of this principle, the tax code contains a provision under which leasehold improvements, restaurant improvements and new restaurant construction, and retail improvements can be depreciated over

15 years rather than a 39-year recovery period that would otherwise apply to nonresidential real property.

With more than 130 million Americans patronizing restaurants each day, restaurant building structures experience daily structural and cosmetic wear and tear caused by customers and employees. National Restaurant Association research shows that, as a result, most restaurants remodel and update their building structures every six to eight years. Consequently, 15 years is a more accurate timeframe for recovering the cost of investments in restaurant buildings and improvements.

Moreover, a 15-year depreciation schedule reduces the cost of capital expenditures and increases cash flow. As demonstrated in Figure 1 below, the annual tax savings and corresponding additional cash flow realized by restaurateurs from a 15-year, rather than a 39-year, depreciation schedule are considerable. For example, a restaurateur's annual tax liability would increase by nearly $10,000 if the recovery period for a $1 million investment were increased from 15 years to 39 years. A more accurate recovery period frees resources to expand business either through new hires or further capital expenditures.

Figure 1.

Sample Calculations for 15-Year versus 39-Year Depreciation

Total Capital Expenditure on Eligible Property	Annual Depreciation Based on 39-year Schedule	Annual Tax Savings from Depreciation	Annual Depreciation Based on 15-year Schedule	Annual Tax Savings from Depreciation	Annual Difference in Tax Savings Between 15- & 39-year Schedules
$100,000	$2,532	$608	$6,667	$1,600	$992
$250,000	$6,329	$1,519	$16,667	$4,000	$2,481
$500,000	$12,658	$3,038	$33,333	$8,000	$4,962
$700,000	$17,722	$4,253	$46,667	$11,200	$6,947
$1,000,000	$25,316	$6,076	$66,667	$16,000	$9,924
$1,500,000	$37,975	$9,114	$100,000	$24,000	$14,886
$2,000,000	$50,633	$12,152	$133,333	$32,000	$19,848

Expenditure Scenarios

Rebuild Costs:	Renovate Costs:
Quickservice - $700,000	Quickservice - $250,000
Fullservice - $1,500,000	Fullservice - $500,000

Note: Figures are based on a 24 percent effective marginal tax rate

Moreover, the 15-year depreciation schedule is an important driver of economic activity, fueling investment and job growth. According to the Bureau of Economic Analysis, every dollar spent in the construction industry generates an additional $2.39 in spending in the rest of the economy and every $1 million spent in the construction industry creates more than 28 jobs in the overall economy. In 2008 and 2009, at a time when the overall economy was contracting, restaurant industry construction spending of $13.8 billion created 388,000 jobs (see Figure 2 on the next page).

Figure 2.
Restaurant Spending on Construction

Year	Billions ($)	Jobs Created In Overall Economy
2004	5.2	145,000
2005	7.4	208,000
2006	6.6	185,000
2007	10.4	292,000
2008	7.6	214,000
2009	6.2	174,000

Source: U.S. Census Bureau and National Restaurant Association

However, the 15-year depreciation schedule is temporary and must be extended annually. Most recently, it was extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Act") retroactive to the beginning of 2010 and through the end of 2011, which means the provision will expire again at the end of the year. The piecemeal and temporary approach to the 15-year depreciation schedule, requiring extension every couple of years, presents taxpayers with unnecessary uncertainty and complexity.

Making permanent the 15-year depreciation schedule for leasehold improvements, restaurant improvements and new construction, and retail improvements would address this issue, providing taxpayers with predictability, simplicity, and fairness. Our nation's businesses are looking forward by planning capital expenditures to improve and expand their businesses. The ability to plan for these expenditures and know what the tax treatment will be in the future is important to those who are making such decisions right now.

Work Opportunity Tax Credit

Another important, but temporary, aspect of the tax code is WOTC, a tax credit provided to employers who hire individuals from several targeted groups who face significant barriers to employment. Examples of WOTC-targeted employee groups include veterans who either are food stamp recipients or are unemployed and suffering a service-connected disability, former felons, disconnected youth, and members of families receiving benefits under the Temporary Assistance for Needy Families Program ("TANF").

The restaurant industry employs close to 13 million people, many of whom may not have been hired had WOTC not been in place. WOTC encourages employers to hire certain categories of individuals with low work skills and other barriers to employment, enabling these workers to move into self-sufficiency as they earn a steady income and become contributing taxpayers. A 2011 study by Peter Cappelli of the Wharton Business School at the University of Pennsylvania found that individuals hired under WOTC go on to become productive employees who are no longer dependent on public assistance.

Further, WOTC works. According to the Department of Labor, during fiscal year 2008, over 691,000 WOTC certificates were issued. The Cappelli study found that WOTC is one of the most successful and cost effective federal employment programs.

Congress should make WOTC permanent, since it has proven to be an efficient incentive for business to provide jobs for workers who might otherwise fall through the cracks. Doing so would further the objectives of providing taxpayers with predictability and certainty in the Code.

Deduction for Charitable Donation of Food Inventory for Small Businesses

Each day, 35 million Americans are at risk of hunger. At the same time, billions of pounds of food are wasted each year. America's restaurants give back to their communities in major ways, the most significant of which is through food donation. According to National Restaurant Association research, 73 percent of restaurants donate food to individuals or charities.

The deduction for charitable donation of food inventory is a critical tool in alleviating hunger. Without the provision, taxpayers receive the same tax treatment for throwing out surplus food as they do for giving it to charity. The enhanced deduction encourages donating the food to charity instead, by helping to offset the costs associated with storing and transporting the extra food. Absent the enhanced deduction for the charitable donation of food inventory, these charities would be hard-pressed to meet critical demands, putting our nation's most vulnerable families at risk for hunger.

However, the impact of the deduction could be improved. Since its inception in 1976, the tax deduction for contributions of food inventory was limited to C corporations. In 2005, the provision was temporarily expanded to include pass-through entities (i.e., Subchapter S corporations, limited liability companies) and has subsequently been extended a number of times. Making permanent the now-temporary component of the deduction would make it more effective and fair, while advancing the objectives of providing taxpayers with simplicity and predictability.

Increase the Business Meal Deduction to Stimulate the Economy

A general principle of the tax code is that ordinary and necessary business expenses, as well as expenses incurred for the production of income, are generally deductible. However, under current law, the business meal deduction is limited to only 50 percent of costs incurred. By way of background, business meals previously were fully deductible. In 1986, the deduction was reduced to 80 percent and, in 1993, the deduction was further reduced to its current level of 50 percent.

The business meal deduction should be reformed to better reflect the basic principle that business expenses should be fully deductible. Full deductibility would appropriately bring the business meal deduction in line with other ordinary and necessary business expenses, but even increasing the limitation to 80 percent would better align the provision with these objectives. Such reform efforts would also increase the Code's simplicity and predictability.

According to National Restaurant Association research, increasing the business meal deduction to 80 percent would increase business meal sales by over $7 billion and provide an additional 200,000 jobs. Moreover, the impact of the restaurant industry on the nation's economy is considerable and felt in every state (Figure 3 on page 8 provides the state-level economic and jobs data for an increase in the deduction limitation from 50 percent to 80 percent; Figure 4 on page 9 provides the same information for full deductibility). We service more than 130 million guests every day. Each dollar spent dining out generates $2.05 in business to other industries, totaling more than $1.7 trillion in overall economic impact.

Increasing the business meal deduction would also benefit small businesses. America's restaurants are small businesses' conference rooms, and the restaurant table is often where business is conducted. Increasing the deduction is a benefit not only to restaurateurs and their employees, but to their guests and the many small business owners across the country. For many small companies, the ability to conduct business over a meal is their only means of advertising and marketing their business.

Conclusion

We greatly appreciate the opportunity to submit this testimony on behalf of the restaurant industry. Tax reform presents an opportunity to provide taxpayers with predictability and fairness, while encouraging economic growth and job creation. As Congress considers the important issue of tax reform, we are happy to be a resource to Congress, the Committee, and the Subcommittee and we look forward to our continued work together on these issues.

Figure 3.

Estimated Impact of Increasing Business Meal Deductibility from 50% to 80%

State	Increase in Business Meal Spending 50% to 80% Deductibility (in millions)	Total Economic Impact In the State (in millions)	Total Employment Impact In the State (number of jobs created)
Alabama	$92	$186	2,952
Alaska	$19	$33	452
Arizona	$151	$300	3,984
Arkansas	$50	$101	1,689
California	$967	$2,267	26,315
Colorado	$136	$313	3,943
Connecticut	$88	$165	2,019
Delaware	$24	$43	499
District of Columbia	$39	$53	313
Florida	$472	$957	12,522
Georgia	$230	$532	6,732
Hawaii	$54	$104	1,402
Idaho	$28	$55	933
Illinois	$313	$744	8,786
Indiana	$135	$278	4,272
Iowa	$51	$102	1,669
Kansas	$56	$112	1,606
Kentucky	$90	$183	2,618
Louisiana	$98	$193	2,888
Maine	$29	$55	848
Maryland	$148	$307	3,594
Massachusetts	$193	$388	4,649
Michigan	$191	$380	5,872
Minnesota	$119	$272	3,714
Mississippi	$50	$95	1,630
Missouri	$134	$298	4,084
Montana	$21	$40	710
Nebraska	$35	$73	1,190
Nevada	$83	$147	1,974
New Hampshire	$34	$63	784
New Jersey	$205	$442	4,993
New Mexico	$45	$82	1,331
New York	$482	$954	11,251
North Carolina	$222	$467	6,849
North Dakota	$12	$22	373
Ohio	$252	$540	8,081
Oklahoma	$74	$157	2,491
Oregon	$94	$194	2,611
Pennsylvania	$258	$582	7,688
Rhode Island	$29	$53	706
South Carolina	$108	$221	3,329
South Dakota	$15	$30	509
Tennessee	$143	$322	4,191
Texas	$576	$1,405	17,036
Utah	$50	$113	1,682
Vermont	$13	$22	335
Virginia	$200	$423	5,312
Washington	$157	$340	4,160
West Virginia	$32	$54	950
Wisconsin	$107	$224	3,629
Wyoming	$12	$19	346

Source: National Restaurant Association estimates, 2011

Figure 4.

Estimated Impact of Increasing Business Meal Deductibility from 50% to 100%

State	Increase in Business Meal Spending 50% to 100% Deductibility (in millions)	Total Economic Impact In the State (in millions)	Total Employment Impact In the State (number of jobs created)
Alabama	$167	$336	5,334
Alaska	$34	$59	817
Arizona	$273	$542	7,198
Arkansas	$91	$182	3,052
California	$1,748	$4,095	47,543
Colorado	$245	$565	7,124
Connecticut	$160	$298	3,648
Delaware	$43	$77	901
District of Columbia	$70	$96	565
Florida	$854	$1,729	22,623
Georgia	$416	$961	12,162
Hawaii	$97	$188	2,533
Idaho	$50	$99	1,685
Illinois	$565	$1,344	15,874
Indiana	$243	$501	7,718
Iowa	$92	$185	3,015
Kansas	$101	$202	2,902
Kentucky	$163	$331	4,730
Louisiana	$177	$348	5,219
Maine	$53	$100	1,533
Maryland	$267	$554	6,493
Massachusetts	$348	$701	8,399
Michigan	$345	$686	10,610
Minnesota	$216	$492	6,710
Mississippi	$90	$171	2,944
Missouri	$241	$539	7,379
Montana	$38	$72	1,282
Nebraska	$64	$132	2,149
Nevada	$150	$266	3,566
New Hampshire	$62	$114	1,416
New Jersey	$370	$799	9,022
New Mexico	$81	$148	2,405
New York	$871	$1,724	20,328
North Carolina	$401	$844	12,374
North Dakota	$22	$40	673
Ohio	$455	$976	14,601
Oklahoma	$133	$284	4,500
Oregon	$170	$350	4,717
Pennsylvania	$467	$1,052	13,890
Rhode Island	$52	$95	1,276
South Carolina	$195	$400	6,014
South Dakota	$28	$54	920
Tennessee	$258	$582	7,571
Texas	$1,041	$2,539	30,778
Utah	$91	$204	3,039
Vermont	$23	$40	606
Virginia	$362	$764	9,598
Washington	$284	$614	7,516
West Virginia	$57	$98	1,717
Wisconsin	$193	$405	6,556
Wyoming	$22	$35	626

Source: National Restaurant Association estimates, 2011

Open Mic Statements for the Record

We are organized as a "Type S" Corporation. The majority of lawmakers in Washington, DC don't understand the differences between "Type S" and "Type C" corporations. As a result, many of the proposed tax policy changes negatively impact S Corps due to their lack of knowledge. Lawmakers need to treat S Corps fairly when proposing changes. Most small business corporations are organized as S Corps. Remember, profit does not equal distributions! Most businesses retain most of their profit for reinvestment directly in the business.

Frank Burch (Duncan, OK)
Southern Machine Works Inc.

I would be interested in hiring an employee and growing my business if it weren't for all the regulations and tax complications. Instead, I will remain a sole proprietor and not worry about it. Maybe if the tax code is ever fixed I will reconsider the risks/rewards.

Albert Wiersch (Dallas, TX)
Al Internet Solutions

The greatest hurdle our business faces is uncertainty of undefined business, tax, and entitlement policies such as Obama's healthcare bill. As a small business generating around 2 million with 30 employees, we must seriously think about it before hiring more people, in fear that we might have to fully take the health care expenses when those take effect. Also, as an S-Corp, the business income will flow through my personal income tax return making me "mega rich" this may cause me to be taxed even more. Not every household "making millions" is rich. I certainly am not. Thankfully our industry is not unionized here, which would make us even less competitive. If there is such thing as a privileged class in this country, it is the Unionized. It is unfair that people would get paid many times over for performing the same work what non-union people do. How do you compete with the rest of the world when the majority of the people are taken care of from cradle to grave? Developing countries the US has to compete with don't have these added expenses. We must as a Nation change our paradigm from "I deserve..." to "I can create..." Roll up our sleeves and get study, learn, work ... Create a family, a business, an industry... whatever... where I do it, not have someone else do it for me or getting in the way of me doing it. The American dream is "life, liberty, and the pursuit of happiness" not a house, a car, and the pursuit of entitlements.

Jorge O. (El Paso, TX)
Hawk Construction

Having been in business for 10 years, my company is not affected by regulations. As an S-Corp, I'm taxed at the usual income tax rates. Ever increasing health insurance premiums represent the largest uncontrollable expense to my business. My key struggles have been finding the time to work on my business rather than being trapped in it. The

Feds should take a lesson from the 10,000 Small Businesses program that is sponsored by the Goldman Sachs Foundation. I am currently a scholar in the program, and this basic entrepreneurial education has been fantastic. If the Feds claim to value small businesses, give us the knowledge to succeed as entrepreneurs. The SBA should be providing the same type of instruction that 10KSB is for anyone who wants it.

Darren Carter (Bismarck, ND)
Provistas Incorporated

I can only ditto the majority of the comments listed already. We are in protection mode, not growth mode as a small business. The uncertainty surrounding healthcare, estate tax, S- Corp tax liability, and overreaching local and federal government regulation has stifled most of us in business. I really don't see how anyone with enough capital to start a new business would even try in the country any longer. Many programs may have started with good intentions but as is always going to be the case get taken to unhealthy extremes when administered by any government. I often use the analogy that if your Daddy owned the farm (or small business) you can probably make a living but if you have to buy the farm there is no way you can make it today. I genuinely am concerned for our country and kids future.

Matt Horn (Sykesville, MD)
Ditch Witch of Maryland Inc.

I hear a lot about cutting the corporate tax rate as a fix for unleashing small business. None of the small business owners I know (myself included) are affected by the corporate tax rate. We are mostly S-corporations. That means the tax burden is passed on to my personal income tax via K-1. I have to pay a firm over $25,000 per year just to file the 3000+ pages in tax returns. That's on top of the 30+ percent of my annual hard earned revenue that we have to pay each year. How can you lessen that burden?

Rob Fitzgerald (Newport News, VA)
BOSH Global Services

I went with S-Corp to minimize the tax consequences. Despite this, the state and fed take 40% of my profit. I am trying to build a contracting business, but need to bond my work. My bonding determines how much I can bid, and my bonding capacity is determined by my retained earnings. When 40% of my earnings go to the Fed Gov it greatly restricts my growth. I had hoped to add three jobs this year, but my only add one and that only if I can get a couple more contracts. Cut taxes. Set up a charity for each of the Fed Gov departments and let people donate what they want of the savings to where they think it should go. I doubt much will go to welfare!! I would donate to the Defense, parks and state departments.

Brett Hanke (Wentzville, MO)
Hanke Constructors

My wife and I own a small business, and yes, we have a combined income of just over $250,000. Once again, president Obama is intent on raising my income taxes. Please understand the following * we already pay more than our fair share in local, state, and federal taxes.* As an S-Corp we are forced to declare all profits from our small business as income to the two of us. This in money we'd like to save to reinvest in our company, including hiring more employees. Unfortunately, our current tax code discourages us to do so. * We are not millionaires. I am sick and tired of the president and his supporters making the claim that anyone with a combined annual income of $250,000 or more is a millionaire, and insinuating we don't pay our "fair share" of taxes. The current economic environment and this administrations inability to articulate a clear vision for turning it around are the biggest hurdles preventing the growth of my small business. This climate of uncertainty and finger pointing helps no business - small or large.

Randy Jennings (St. Louis, MO)
Education Technology Partners

Eliminate taxes on the first $1MM in S-Corp and C-Corp profits for businesses grossing under $25MM (the small business size standard for many NAICS codes). Watch what happens to investment in employee retention and training, infrastructure upgrades and innovation. Our politicians seem to be crafting tax code from an ivory tower with no real connection to how business owners think and respond tax "incentives"

Steve Goldsby (Montgomery, Alabama)
ICS Inc.

I am the only employee in my small S-Corporation. Even though I lost several long-term clients this year (estimating about $6k monthly), my business expenses and payroll taxes are still due and extremely high! Small Businesses need relief. I've been in business 37 years and this is THE WORST YEAR EVER! My family is no longer middle income. Times are tough! Where's the break for small businesses? So tired and discouraged.

Beverly Browning (Mesa, AZ)
Bev Browning and Associates Inc.