ADDING TO UNCERTAINTY: SMALL BUSINESSES' PERSPECTIVES ON THE TAX CLIFF

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, AND CAPITAL ACCESS

OF THE

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UNITED STATES
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THURSDAY, SEPTEMBER 13, 2012

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

The Subcommittee met, pursuant to call, at 10:15 a.m., in room 2360, Rayburn House Office Building, Hon. Joe Walsh (chairman of the Subcommittee) presiding.

Present: Representatives Walsh, Chabot, Mulvaney, Schrader, Clarke, Cicilline, and Chu.

Chairman WALSH. Welcome, everybody. This hearing of the Small Business Subcommittee on Economic Growth, Tax and Capital Access is called to order.

I would like to thank the witnesses for appearing today to discuss one of the most important issues facing small businesses and, for that matter, our economy: The looming expiration of the 2001 and 2003 tax rates.

Despite a feeble economic recovery at home, economic turbulence abroad, and a series of political and policy actions in Washington that have left small businesses as uncertain as ever, many of our Nation's small firms have learned to survive and adapt to whatever the marketplace or Washington has thrown at them. Understanding the challenges they face and how we in Congress can foster an environment where they can succeed is a constant focus of this Committee.

Most businesses in the United States are small, and unlike many of their large counterparts that are subject to corporate income taxes, the vast majority of small businesses are organized as pass-through entities, where the taxes are paid by their owners at individual rates. Acknowledging and understanding this distinction is important.

While there is broad agreement that allowing all of the tax relief enacted in 2001 and 2003 to expire is inappropriate and should be avoided, there is wide disagreement on the composition of an extension and what it means for small businesses.

The Obama administration and some of my colleagues on the other side propose that taxes should revert to higher rates for taxpayers earning more than $200,000 a year. They claim that this proposal would only raise taxes on 3 percent of small businesses. But that 3 percent figure accounts for more than 900,000 small businesses.

Most of my Republican colleagues and I support an across-the-board extension of current lower tax rates. We believe that imposing the higher marginal rates on earners making more than $200,000 a year would most directly affect those small firms responsible for generating the majority of small business income and new jobs.

We would also note that, in addition to higher marginal rates on these businesses, the administration's proposal could also result in small pass-through businesses being taxed at rates higher than some of our Nation's largest multibillion corporations. That is not my definition of tax fairness.

Finally, in addition to the prospect of higher marginal income tax rates, small businesses must also contend with uncertainty created by the expiration of the estate tax and how this unresolved policy issue affects long-term business planning.

The purpose of today's hearing is to examine these issues in more detail and to understand how policy actions in Washington are continuing to create uncertainty for small businesses.

Before I yield to Ranking Member Schrader for his opening statement, I ask for unanimous consent to insert into the record these statements small businesses have submitted to the committee's open mic web forum regarding their concerns about higher taxes and tax uncertainty.

Without objection, so ordered.

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

Mr. SCHRADER. Thank you, Mr. Chairman.

I appreciate the committee's indulgence and apologize to the panel and others for being here late. I had some constituents come in unexpectedly, and they came a long way. I am from Oregon. So one does what one has to do.

The economy has been gaining strength, largely because of the powerful role played by small businesses in America's economy. It has been a tough haul the last few years, been a very tough haul. It has been our history that small firms have been the biggest job creators in America, bolstering the economy in the tough times and bringing us out of the depths of these recessions. This has been a tough one. This has been a very tough one.

When it comes to providing assistance and assuring small firms that they have the tools they really need, one thing has been clear. The Internal Revenue Code has provided a lot of obstacles to each and every one of us.

As I have said in previous hearings, as a small businessman myself there was a time when I did my own taxes for my business. That has long since gone away, long since gone away.

A lot of small firms depend on certain tax incentives to offset the costs of innovation and expansion, and I have supported those temporary tax provisions and extenders because it is important to give small business men and women every tool in the toolbox in these tough and difficult times.

The expiration of many of these tax provisions is fast approaching, the so-called fiscal cliff that we all hear about; and small business owners have some very difficult choices to make and don't know which way to turn, given the uncertainty that has been created out there. Your input here today will be vital, I believe, in helping the chairman, myself, and the rest of the Members of Congress decide which of the extenders are of great value, which are of some value, and which are of less value.

As many of you know, we have our own budget to deal with. We seem to have a great deal of trouble passing budgets these days, which is a shame, because you have to do that every year and plan in advance. We have a long way to go to catch up with a lot of you all.

And right now, in my humble opinion—this is myself talking—there is a lot of rhetoric on both sides about taxing this group or not taxing that group or taxing people below certain income levels. I come from Oregon. $250,000, you are pretty darn well off if you have got $250,000. So this rhetoric about millionaires' tax and 250 I think misses the mark.

What many of us are looking for in the real world is comprehensive tax reform and, as the chairman indicated, not just for corporate America, not just for C corps. Most of American businesses, most American small businesses are S Corps or LLCs or partnerships or sole proprietors. This is a group that we want to make sure gains through tax reform.

A lot of proposals out there for it. It means different things to different people. Everyone sees it through their own eyes, if you will. But there are some very exciting proposals about just getting back to basics, eliminating maybe all tax breaks and reducing tax rates.

So today I hope we have an opportunity to chat about which of the extenders are most important should we decide to continue with that policy and what effect eliminating all tax breaks would have on small businesses if we are able to buy down your tax rates dramatically like has been proposed in several different bipartisan proposals out there.

So look forward to hearing from the Committee, Mr. Chairman, and appreciate you having this hearing.

Chairman WALSH. Thank you, Congressman Schrader.

If Subcommittee members have an opening statement prepared, I ask that they be submitted for the record.

Chairman WALSH. Each witness will have 5 minutes to deliver your testimony. Try your best to adhere to that limit.

We will begin with Theresa Kern, our first witness. She is the owner of MA Steel Erectors, Inc., a construction company located in the greater Chicago area of my home State, Illinois. MA Steel Erectors has been in business for more than 30 years and is organized as a Subchapter S business. Ms. Kern will be testifying today on behalf of the Women Construction Owners & Executives, where she recently served as that organization's president.

Ms. Kern, thank you for appearing today. I look forward to your testimony.

STATEMENT OF THERESA KERN, MA STEEL ERECTORS, INC., PALOS HEIGHTS, ILLINOIS, TESTIFYING ON BEHALF OF WOMEN CONSTRUCTION OWNERS AND EXECUTIVES, USA

Ms. KERN. Good morning, Mr. Chairman, members of the Subcommittee. My name is Theresa Kern, and I am the owner and president of MA Steel Erectors, headquartered in Palos Heights, Illinois. We are a union-signatory specialty trade subcontractor that provides labor to install reinforcing steel in commercial, industrial, heavy, and high-rise construction projects. MA Steel is incorporated as a Subchapter S pass-through corporate entity, and I am the sole shareholder.

I am testifying today as both a small business owner and in my capacity as immediate past president of Women Construction Owners & Executives, a 30-year-old national organization whose mission is to simply create contracting opportunities for our members, women who have chosen to build a career and a business in the nontraditional construction industry.

Thank you for giving me the opportunity to testify before you today at this very important hearing.

As you know, the lingering economic recession has significantly damaged the construction industry, and most small businesses in our industry have been hit disproportionately hard. Yet WCOE members are optimistic about the future as the construction industry economy begins a slow recovery.

The future tax policy of the United States will have a profound effect on our members' ability to stabilize and then grow their businesses. MA Steel is a labor-intensive business, as are most construction companies, and business growth has a direct correlation to creating badly needed jobs to help the American economy grow and prosper.

While media headlines blare "corporations don't pay their fair share", let me assure you that small business corporations not only pay their fair share but are a major contributor to the economy as well as the tax base of this country and have often been referred to as the lifeblood of the U.S. economic growth engine.

Ernst & Young is reporting that 90 percent of all U.S. businesses are corporate pass-through entities and employ more than 50 percent of the private-sector workforce while representing over a third of all U.S. business receipts. Pass-through entities are Sub S corporations, S Corps, and limited liability corporations, LLCs, that have specific limits as to the number and type of shareholders. IRS reports that there are over 4.5 million Subchapter S corporations alone. It is often said that small businesses are the cornerstone of the American economy and corporate pass-through entities are the cornerstone of America's small business community.

Generally, entrepreneurs are advised by their CPA or attorney to incorporate using one of these congressionally chartered tools in order to separate her business from her household assets without the onerous paperwork and reporting requirements of a C Corp.

Congress also decided in 1958 that these special privately held corporate entities would not be taxed as a corporation, but rather, because the owner-entrepreneur was investing her own money into the enterprise to get it started and often to keep it running, the income or loss generated by the Sub S or LLC corp would be reported by the owner on their individual tax returns as earned income or loss. The pass-through corporation, whether a Sub S or LLC, is therefore not liable for income tax, but the shareholder is. The business's entire profit or loss is passed through to the individuals who report it on their household tax return at the rate for their total household tax bracket. Conversely, profit distributions to C corp owners are treated as dividend income to the shareholders and currently taxed at up to 15 percent.

When the media trumpets headlines like "90 percent of corporations pay no taxes", they may be statistically correct, but these are not corporations as the general public defines corporations. These are mostly small business owners who have been advised to protect their household assets by incorporating and to use an LLC or Sub S corporate structure to eliminate the requirement for big corporate boards of directors, annual meetings, elections, expensive audits, and activist shareholders. With the 2002 passage of Sarbanes-Oxley, which mandated even more rigorous reporting requirements for C corps, pass-through entities are even more attractive.

What is critically important to understand is that profits in a business incorporated as a Sub S or LLC entity does not translate to cash in the pocket of the owner. But a loss in a business nearly always requires the owner to either forego her own salary or even invest more of her own money into the firm.

There is one other thing that all corporate pass-through entity owners know. While the company may show a profit in the financial statements, there may be no cash in her corporate or personal bank account. Further, there is no relationship between the amount of profit a Sub S or LLC entity shows on a financial statement and the amount of money an owner has actually withdrawn.

Please let me also explain one of the anomalies about the construction industry. Unique to construction is the issuance of a surety bond, which is a guarantee of performance on a project that an owner of a construction company must collateralize with the business's balance sheet and personal assets. Nearly all construction projects require a surety bond performance guarantee from all of the contractors and subcontractors working on a project. Because construction company balance sheets have taken a severe hit during the past 4 years, banks and bonding companies are insisting that balance sheets be strengthened by keeping profits in the company.

It is important to note here that the surety bond on a specific project cannot be released until the final retention is released at completion and acceptance by the owner. My ability to begin a new project is restricted by my balance sheet, which remains encumbered until those assets are released when the bonded work is accepted and final payment received, a process that often takes many, many months after project completion. If I want to take on another project prior to the release of the retention money in order to keep my crews busy, I need to have sufficient assets available to secure another bond.

Let us assume I am lucky enough for MA Steel to make a nice profit this year. My bank and bonding company will require that I not only pay myself a minimal amount but that I leave the profits in the business in order to show a stronger financial position. As a Sub S corp, however, all of that nice profit will be reported as income to me, and I will have to pay tax on it, even though I may not have one penny of it in my personal checking account.

When we are talking about an average contract value of $500,000 and dozens of projects a year, it is not unrealistic to expect annual business profits to exceed $250,000, all of which is reported as retained earnings in the business and as income to me. Yet the majority of that profit stays in the business and never makes it to my personal checking account for my own use.

I am liable for payment of the income taxes due on this phantom income at the individual tax rate. Increasing the rate of this tax by even 10 percent will have a significant deleterious effect on my ability to grow my business. I have to keep the profits in the business per demands of the bank and bonding company if I want to grow, yet I have to take the profits out of the business to be able to pay the taxes.

The members of WCOE fully support simplification of the Tax Code and closing tax loopholes that are beneficial only to the most sophisticated financial analysts. We also support efforts to decrease the Federal budget deficit, but to do it on the backs of America's robust entrepreneurial community will be counterproductive.

I would like to give you one more relevant example of what the current uncertainty with the Tax Code means to small business owners like me.

Chairman WALSH. Ms. Kern, thank you. I need to stop you right there. You are doing great. I need to stop you right there. Your entire testimony will be part of the record——

Ms. KERN. Okay.

Chairman WALSH [continuing]. But we need to move onto the other witnesses. But thank you very, very much.

Ms. KERN. Okay. All right. Thank you.

Chairman WALSH. Let's move to Doug Harmon, our next witness. He is CEO of Twin City Die Castings Company, a second-generation family owned business located in Minneapolis, Minnesota. Twin City Die Castings is a Subchapter S business employing about 250 full-time workers. He is testifying today on behalf of the North American Die Casting Association, where he serves as a member of that organization's government affairs committee and board of governors.

Mr. Harmon, thank you for appearing today. We look forward to your testimony.

STATEMENT OF DOUG HARMON, CEO, TWIN CITY DIE CASTINGS CO., MINNEAPOLIS, MINNESOTA, TESTIFYING ON BEHALF OF NORTH AMERICAN DIE CASTING ASSOCIATION

Mr. HARMON. Good morning, Chairman Walsh, Ranking Member Schrader, and members of the Committee. Thank you for the opportunity to testify today.

I am here to discuss the severe economic consequences that small manufacturers will face due to the so-called fiscal cliff as it relates to taxes that will occur in January, 2013, unless Congress intervenes. Failure to act on the looming year-end tax increases would yield the largest tax increases in American history.

My name is Doug Harmon. I am the CEO and owner of Twin City Die Castings Company, a second-generation family owned business employing 250 employees. We manufacture hundreds of different types of precision aluminum and magnesium die castings for the automotive, recreational, industrial equipment, defense, aerospace, computer, and medical industries.

I am testifying today on behalf of the North American Die Casting Association, where I serve as a member of the Government Affairs Committee and on the board. NADCA is the sole trade and technical association representing over 300 U.S.-based companies and industry suppliers that produce and sell castings essential to the manufacturing process.

Twin City Die Castings is one of the oldest die casting companies in North America. It was founded in 1919. My father took a gamble and purchased the small business in 1974 with family savings. After college, my brothers and I joined the business. My dad taught us not only how to produce quality castings but the need to invest in our employees and the shop.

On the table in front of me are just a few examples of the wide variety of castings we have produced. This happens to be a military application, a hospital application, and an automotive application.

We operate three die casting facilities in the U.S., and we are exporting 22 percent of our total castings in eight different countries around the world. In all our operations we provide good-paying blue collar jobs, health reimbursement accounts, and other benefits to our employees, whom we consider as members of our extended family.

The recession hit our industry and my company hard. A number of die casters that had been in business for more than 25 years were forced to shut their doors. We were faced with downsizing our workforce to 155 workers from 250 when millions of dollars of orders simply dried up. Fortunately, orders have been slowly coming back, and we were able to rehire many of our employees, but we are still not back to pre-recession production and sales levels.

In 2012, we have been much more cautious in our hiring and the types of capital improvements that we have undertaken, given the uncertainty of our taxes and the fragile economy. For manufacturers like me, this tax cliff is a serious threat.

Not knowing whether or not Congress will renew the Bush-era tax cuts and the pro-business tax extenders, which expired at the end of 2011, is keeping many die casters and, for that matter, most manufacturers from investing as much as they could to grow their business, purchase new equipment, and hire more employees. In order for die casters to prosper in this country, we need two things: stability with a pro-growth approach and transparency in our Tax Code.

How die casters are organized and the way we pay taxes has the single greatest impact on our industry. Our company is structured as a Subchapter S corporation, where the individual owners pay the taxes. More than 70 percent of manufacturers are structured as S corporations or other flow-through entities, meaning they pay taxes at the individual rate. Since we are put in the top tax bracket, we could see our rates jump to 39.6 percent from 35 percent. We could also face a 3.8 percent tax on certain types of investment income passed in the Affordable Care Act effective in 2013.

On top of these increases, small businesses like mine will also have to deal with a .9 percent surtax on wage income earned above $200,000 for individuals and $250,000 for couples.

Bottom line for Twin City Die Castings Company is that if the current tax rates are not renewed by January 1, 2013, and individual rates increase by nearly 5 percent, we will face a hefty increase in our tax bill. We will not be able to reinstate the 401(k) match for our employees' retirement, nor will we have the extra funds to increase our workers' health reimbursement accounts.

Unlike larger corporations, small manufacturers like us are required to provide a personal guarantee for most loans when purchasing capital equipment or expanding our facilities. This means as a small business owner I put my family's home on the line and take significant risks if I want to grow the business and compete in the global economy. This is where tax deductions and credits come in as the only tool we have to reduce our effective tax rate unless Washington can finally act on a comprehensive tax reform.

Several key business tax breaks currently available are set to change or expire entirely after December 31, 2011. In particular, we urge lawmakers to renew tax extenders widely used by manufacturing companies such as the R&D credit, bonus depreciation, and section 179 expensing. These historic capital investment incentives have had a positive impact and incentivized manufacturing, purchasing, and job creation in recent years.

In conclusion, small manufacturers cannot compete globally or even survive domestically if we do not continually invest in equipment and our people. This is why tax reform is so important to manufacturing companies across the country, to free up capital for investing in people and equipment, to provide more certainty so we can plan for future years. We cannot afford to fix our Nation's problems on the backs of small businesses and their employees.

Thank you for the opportunity to testify before the Committee today, and I look forward to answering your questions.

Chairman WALSH. Thank you, Mr. Harmon.

I now would like to introduce Scott Hodge, president of the Tax Foundation, a nonpartisan tax research group based right here in Washington, DC.

Mr. Hodge, welcome. I look forward to your testimony.

STATEMENT OF SCOTT HODGE, PRESIDENT, THE TAX FOUNDATION, WASHINGTON, DC

Mr. HODGE. Well, thank you, Mr. Chairman, Mr. Schrader, and members of the Committee. I appreciate the opportunity to talk about this really important issue.

As we have heard, American entrepreneurs are facing a lot of uncertainty right now not only with the stalled economy but obviously the fiscal cliff that we are facing at the end of the year. And, unfortunately, there is many in Washington who say, well, we shouldn't worry about the economic impact of allowing these top tax rates to expire because only 2 percent of pass-through businesses will be impacted.

Now, I think this view is badly mistaken. I think it is like saying that, well, we shouldn't worry about the economic impact of cancer because NIH tells us that only .5 percent of Americans will be diagnosed with cancer this year. Well, as you know, we spend tens of billions of dollars each year on cancer research, testing, and treatment because we understand how much it costs the economy each year in lost productivity, not to mention about a half a million of us that are expected to die of cancer this year.

And it is the same with the impact of higher taxes on business. The issue is not how few businesses will be impacted. The relevant economic question is how much business income will be hit with higher taxes. And no matter how you parse the data, the evidence is very clear that the vast majority of pass-through business income is earned by high-income taxpayers, and they would be disproportionately harmed by a such a tax increase.

In fact, Tax Foundation research has determined that nearly 40 percent of any new revenue raised by boosting these top tax rates would come from the most successful businesses; and based on the most recent revenue estimates, we expect this could amount to a tax increase of $377 billion over the next 10 years on these pass-through businesses. And by all accounts, that would amount to a success tax on our best and brightest entrepreneurs and probably the largest tax increase on small business in American history.

To understand the impact of this, we need to understand some basic facts.

First, there are more than 30 million pass-through businesses today, compared to less than 2 million traditional corporations. And there is now more business income that is taxed under the individual Tax Code than under the traditional C code. And Treasury estimates that as much as 40 percent of all business taxes are now paid on individual tax forms, and high-income individuals earn the vast majority of this business income.

The Joint Committee on Taxation now estimates that if the Bush-era tax rates were to expire 53 percent of net business income will be reported on returns that will have a marginal tax rate of either 36 percent or 39.6 percent. IRS data shows that 72 percent of all pass-through income is earned by taxpayers earning over $200,000 a year, and 36 percent of all that pass-through income is earned by people with a million dollars or more on their tax returns.

The economic evidence is very clear, and it suggests that increasing top marginal income tax rates on individuals would be very detrimental to America's long-term economic growth. Economists at the OECD have determined that high personal income taxes are second only to corporate income taxes in their harmful effects on long-term economic growth.

It is well known that the U.S. has the highest corporate tax rate in the world today, but I bet few of you realize that America has the most progressive personal income tax system in the industrialized world. What that means is the top 10 percent of taxpayers pays a larger share of the income tax burden than their counterparts in high tax countries such as France and Sweden.

The economic research is quite clear that there is a big trade-off between tax policies that enhance growth and tax policies that are aimed at equity. Meaning the more we try to make the income tax system more progressive, the more we undermine the factors that lead to economic growth such as investment, risk taking, entrepreneurship, and productivity.

Our economists estimate that cutting the top personal income tax rate by 10 percentage points could lead to an increase in total GDP growth of 7.5 percentage points over a 10-year period of time. We would see even greater economic growth by cutting the corporate rate by 10 percentage points.

Let me conclude, Mr. Chairman, by saying, you know, they say when you tax something you get less of it. So why would we want fewer small businesses, lower wages, and less economic growth? Because those are the consequences of allowing the top tax rates to expire on January 1. But by reforming the Tax Code and cutting tax rates on businesses, we would see higher economic growth, higher wages, and better living standards for all Americans, and that should be priority number one for all public policies.

Thank you very much, Mr. Chairman.

Chairman WALSH. Thank you, Mr. Hodge.

I now yield to Ranking Member Schrader so he may introduce our next witness.

Mr. SCHRADER. Thank you very much, Mr. Chairman.

It is my pleasure to introduce Jeffrey Porter, founder and owner of Porter & Associates in Huntington, West Virginia. His firm concentrates on providing tax planning and business advice for small and medium businesses and high net worth individuals. Mr. Porter has been active in the American Institute of Certified Public Accountants, a group we should probably take advice from more often, for over 20 years and currently serves as the vice chair of the Tax Division Tax Executive Committee.

Welcome, Mr. Porter.

STATEMENT OF JEFFREY A. PORTER, CPA, MST, PORTER & ASSOCIATES, CPAS, HUNTINGTON, WEST VIRGINIA, TESTIFYING ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PORTER. Thank you.

Good morning, Chairman Walsh, Ranking Member Schrader, and members of the Subcommittee. I am Jeffrey Porter, vice chair of the American Institute of CPAs' Tax Executive Committee and a sole practitioner at Porter & Associates in Huntington, West Virginia. I consider myself a small business, and I provide tax planning and business advisory services for small- to medium-sized businesses and their owners. On behalf of the AICPA, I am pleased to have the opportunity to testify today on the topic of the small business perspectives on the tax cliff.

This year has been an extraordinary year for uncertainty in taxes as well as the macro economy, making it difficult for small businesses and their owners to make informed business and financial decisions. Unfortunately, this uncertainty is not limited to one or two provisions but instead affects many areas of the Internal Revenue Code. The uncertainty becomes even more unsettling when you look at the potential changes in tax treatment for some of these items.

For example, qualified dividends are currently taxed at a maximum rate of 15 percent. However, beginning next year, the same dividends might be subject to an income tax rate of 39.6.

Multiyear planning and the ability to predict or at least to estimate business profits and taxes are critical in operating a business. It is also essential to know the future income tax rates in structuring major business transactions, such as in the sale of a business or of its assets. In order to determine a sales price acceptable to both the buyer and seller, both parties need to understand their potential tax liability for the current year as well as any future year. Without this information, it is extremely difficult for either party to make an informed decision.

Tax considerations are even more substantial if the sale is structured as an installment sale and the seller will report income or capital gains over a number of years. This situation happens frequently, since banks are hesitant to lend money in many types of these transactions.

Next, I would like to discuss the tax extenders, which in the last several years have repeatedly created uncertainty and confusion. The on-again, off-again nature of extenders, coupled with retroactive tax law changes, make long-term planning difficult. They result in the filing of amended returns and significantly increase the overall complexity.

Two of the most significant tax incentives for businesses to invest in machinery and equipment, the section 179 election and bonus depreciation, are both part of these extenders. These areas have a substantial impact on businesses, as the ability to write off a substantial capital expenditure at one time may determine whether a business owner purchases an asset this year, next year, or perhaps not at all. Although income taxes are not the only factor in making most business decisions, prudent business owners want to understand the tax consequences of a transaction.

We also urge you to address the AMT rules. The AMT tax rates and exemption levels are not indexed for inflation; and, as a result, the AMT exemption has become an annual problem. For example, there is currently no AMT patch for 2012. As a result, estimated tax planning for small businesses has to take into account the lower AMT exemption amount. This means that many small businesses will essentially provide the government with an interest-free loan or risk paying an underpayment penalty if the AMT patch is not passed retroactively. It is a no-win situation for these taxpayers.

It is important for Congress to reach an agreement with regard to the expiring tax provisions as soon as possible. The uncertainty of the tax law unnecessarily impedes long-term planning for businesses and prevents owners from making informed decisions.

I also strongly urge you not to underestimate the effect the tax cliff has on tax administration. If Congress waits until late in the year or even into next year to enact tax law changes, the IRS and commercial software vendors must scramble to revise tax forms and update software. As we experienced just a couple years ago, this process would likely delay the initial date when many taxpayers, including small business owners, can file their income tax returns. As a result, affected taxpayers would receive their refund checks later than usual, which is particularly concerning for businesses operating under a tight cash flow.

Last-minute changes are also very problematic for CPAs. Our members, a vast majority of whom are small businesses themselves, would face an increasingly compressed and perhaps hectic busy season. They would need to educate clients on the changes in the rules, advise owners on the tax consequences of business transactions, assist small businesses with tax and cash flow planning, and prepare income tax returns, all in a relatively short period of time.

Thank you again for the opportunity to testify, and I would be pleased to answer any questions you may have.

Chairman WALSH. Thank you, Mr. Porter.

Thank you to all the witnesses.

I just have one quick question, because I want to hear from my colleagues, Congressman Schrader, and everyone else.

Mr. Hodge, the Joint Tax Committee estimates that the administration's proposal for higher marginal rates will apply to more than 50 percent of small business income. You focused on income in your testimony, as opposed to the aggregate number of small businesses affected. Why is that emphasis more important, focusing on income as opposed to the number of small businesses that might be affected?

Mr. HODGE. Mr. Chairman, it really has do with the economic power or success of these businesses, as opposed to just their sheer number.

As you mentioned in your opening remarks, these are over 900,000 small businesses. But these are really the most successful, dynamic, and hopefully growing businesses; and, thus, they will bear the disproportionate share of any tax increase.

Chairman WALSH. One quick follow-up on another topic. I suppose then that wouldn't be, by definition, a follow-up. So a quick question on another topic.

Undoubtedly, when I am home talking to small business owners every single day, the estate tax comes up——

Mr. HODGE. Oh, yes.

Chairman WALSH [continuing]. Again hitting us at the end of the year. How does this tax inhibit small business decision-making?

Mr. HODGE. Well, there is the uncertainty that Mr. Porter talked about. And I don't know any small business person today who can plan around what is going to happen with the estate tax. But there is an awful lot of money spent, I think needlessly, on preparing for the estate tax. And there are some economic estimates that say the compliance costs and economic burden of the estate tax actually exceeds the amount of revenue that it generates for the Federal Government.

The real people getting rich here today off the estate tax, maybe to a small degree the Federal Treasury, but are really the insurance companies, Mr. Porter and his colleagues that are helping people try to minimize their estate tax burden, plan for it, and avoid having their company sold or undermined as a result of those higher taxes.

Chairman WALSH. Quickly, in terms of promoting economic growth, what is the appropriate estate tax exemption and rate? Is there one?

Mr. HODGE. There should be no estate tax. The estate tax is double, triple taxation, in some cases, even more. It is really an abomination. And, unfortunately, it is sold as a way of controlling long-term wealth or the concentration of wealth. It really does not have that impact.

In many respects for many small businesses, it is an accidental tax, because they weren't thinking about it. And all of a sudden the owner passes away, the family now is left to sell the business, and, to me, that is a crushing effect on the economy.

Chairman WALSH. Thank you. Thank you, Mr. Hodge.

Congressman Schrader.

Mr. SCHRADER. Thank you, Mr. Chairman.

Good testimony. I am worried about our small business men and women, how we get out of this at the end of the day, and a lot of different competing proposals.

As I alluded to in my opening remarks, unfortunately, we have to balance our budget, too. So while we would love to be Santa Claus to everybody, we have to make some very tough decisions. Hopefully, we will get around to making some tough decisions one of these days in Congress. But it is important for us to have information, and that is why we have you guys here.

A couple quick things. I don't care who takes this particularly, but I was interested in explaining for folks, I think the panel has some pretty good understanding, but, you know, the profit. Everyone says $250,000—I said it in my remarks—is a lot of money for an individual. But when you are a heavily capitalized business, a lot of that can be taken up and you don't ever see that income on your balance sheet. There is two or three things that come to my mind, but it would be more powerful hearing from you.

In a business, making big investments either in equipment or in personnel, how does that show up on your income tax statement and how might it affect how much you actually take home at the end of the day?

Ms. KERN. Well, the $250,000 that may show up on your financial statement reverts to your personal tax return. But the problem is it never leaves the business because your bank, your bonding company, they require those assets to remain in the business so that the business is qualified to be extended a line of credit or purchase equipment. You know, it is collateral. So, in some cases, you don't even see that $250,000. It just sits in your business and has to stay there. It depends on what your bank requires of you to extend their line of credit to you if you need one.

Mr. SCHRADER. And your principal payments?

Ms. KERN. The principal payments on what?

Mr. SCHRADER. Say your big piece of machinery, big piece of equipment.

Ms. KERN. Oh, absolutely.

Mr. SCHRADER. You don't take home that either, and yet that would appear potentially on your tax statements——

Ms. KERN. Right.

Mr. SCHRADER. [continuing]. As money that you would have.

Ms. KERN. Right.

Mr. HARMON. We are a very capital-intensive business, as is the die casting industry as a whole. And I know if you go back and look at our investments in our business, we have averaged close to $3 million a year in investments, new equipment, new CNC machines, different technologies.

We are in a global economy. We have to compete with the Chinese. And to do that we have to be more productive. We have to hire young kids that have technical abilities in programming, these machine cells. This is where we have a machine, a robot, and a trim press. But it takes a heavy investment.

We are over $40 million in sales, between $40 and $50 million in sales, and $250,000 of profit is nothing. That is less than a percentage point of profit on sales. We need those funds to invest in equipment.

But even more so, it is the people. We have a lot of training needs and technology seminars, things like that. We need to invest in our people and equipment.

Quite honestly, since the recession, we have had to cut back on benefits. In 2009, we had to pull benefits back, cut hours, cut salaried people's wages. We are now just starting to get back to where we can get some of those back in place.

And now all of a sudden to have a 15 percent tax increase—I mean, from 35 percent to 39.5 percent, besides some of the other taxes that come into play, it could be a 15, 20 percent increase in our tax burden. So it is just critical for manufacturing companies that are capital-intensive to have that money available.

The other thing is covenants with the bank. We owe millions of dollars to the bank because we have had to borrow over the years to build our company up. And so there are covenants on what an executive can get such as what I can get for a pay increase, and what I can pull out of the company in a dividend. So I am under the control of the bank that we borrow money with.

It is so important to have those funds available, again, for the training and giving our employees' benefits back and also for the equipment expansion. These are good blue collar paying jobs. I had our IT manager run an analysis of last year on what our average wage was, and it was over $50,000. These are good paying middle-class jobs that are being impacted here.

Mr. SCHRADER. Mr. Porter, real quick, as an accountant, you must be pulling your hair out, the fact that we don't have anything closely resembling certainty in terms of what to advise your clients to do at the end of the tax season here. And you lived through this nightmare 2 years ago.

Mr. PORTER. Absolutely.

Mr. SCHRADER. And curious if it is different this time and how you try and advise people. And, frankly, it is pretty obvious, I think to everybody at least here in Washington, DC, we are going to do absolutely nothing until after the election. And then, frankly, it depends a lot on who wins the Presidency as to whether or not we do anything in the lame duck session. What impact is that going to have on our economy and small business men and women?

Mr. PORTER. Well, we did live through it 2 years ago. And I think it is probably a little more severe this time, just again because we have got the whole election cycle that we are into, and it makes it a little harder to even handicap what we think is going to happen.

You know, many times you are telling your clients you don't know. You know, you will try to sit down and you will say, well, we think if this happens then this may happen. And if we think this happens, then this may happen. And that certainly doesn't bring any consistency or continuity for the clients to make business decisions about what they are wanting to do and invest moneys.

Mr. SCHRADER. And I guess one of the concerns I have would be that while we sit here in Washington assuming, well, geez, the deadline isn't until—taxes aren't—you know, we have got time. It is not January 1, April 15. But maybe some of you could talk about the timeline that businesses have to have to make decisions. There is a certain lead time you need between your decision—you have to assume certain things if you are going to make investments in this economy. Particularly if you are a tool and die manufacturer, are you going to depreciate off this equipment? Do you buy it now? Assuming the tax breaks go away. If they continue, what do you do? I think there is a timeline I think that businesses have to make decisions by that we don't take into account here in Washington, DC.

Mr. PORTER. I mentioned in my written testimony that I have a client that is wanting to buy a $2 million press, but I can't tell him what the depreciation schedules are going to be for that. Because if he orders it today it is 6 or 8 months before he actually gets that press and can place it into service. How can he decide if he wants to buy that if he is not going to be able to determine the after-tax costs? At this point, we can't tell him with any certainty what that is.

Mr. SCHRADER. Mr. Hodge?

Mr. HODGE. I would also say that probably one of the reasons the economy is as slow as it is is because of the temporary nature of some of the fixes that we try to enact. Expensing bonus depreciation are key to that. Had that been a permanent law, then you could have businesses make those long-term decisions which they can't now. And so I think that the benefits—the economic benefits of expensing were completely undermined by its temporary nature.

If Mr. Harmon wants to build a new factory, that is probably a multiyear process. So he can't make that decision if expensing is only in effect for 2 years. So it is really, I think, important for lawmakers to understand that these provisions need to be made permanent.

The R&D credit is another one which, as you I am sure have heard from many constituents, is really ineffective because it is simply on this temporary schedule. Half the Tax Code now is on sort of a month-to-month or year-to-year lease. And that is no way to run a tax system.

Mr. SCHRADER. So last question, just quick answer from each of you because I am probably over my time, but there has been a lot of discussion about tax reform. This is one of the few times probably in my lifetime where we actually have a confluence of horrific events and budgetary needs here in Washington, DC, as well as at home, that comprehensive tax reform has some buzz. And we have got a lot of big corporations, probably mostly C Corps, come in and talk to us about they would be willing to give up all of their tax breaks, all of their tax extenders, R&D, bonus depreciation, oil depletion allowances, you name it, in exchange for significant rate reduction.

Mr. Hodge, you testified in that 8 to 10 percent rate reduction, where we have the highest tax rates in the world as of this past summer and stuff. Would it be advantageous—we will go down this way, because I want to hear Mr. Porter's summing up, given his background.

But would it be advantageous, do you think, for America and maybe for your business, maybe think beyond your own personal business, to get rid of all—almost all these tax breaks, maybe a cadre of some, but almost all, which means you would have to give up yours—let's assume that in this discussion—in order to get a significant rate reduction, you know, from 36 down to somewhere between 26 and 28, but down from 24 to about 15—if you are really low income, hopefully, you are making a little more than that, although in this economy, who knows—from 15 down to about 10 percent?

Ms. Kern, would you lead off with that?

Ms. KERN. I think everybody in this country is willing to do their fair share. And I also do feel that if we had some sort of a reduced tax rate that was commensurate with where we are kind of at, or could be at now, I would be willing to do that if in fact those tax loopholes were—or deductions—were stopped for everybody.

You know, if it was a unilateral tax cut, reducing people's, you know, deductions or whatever and if it was a good tax rate that you could decide upon, I would be willing to do that. And I am willing to pay my fair share if I make money.

Mr. SCHRADER. The bottom line.

Mr. HARMON. It would be nice—if the high tax rates that American manufacturers pay would be reduced a little bit. I would be willing to just keep the tax rate neutral. Why I am here today is I just don't want to see these tax rates go up. Again, in a capital-intensive business you need that money to reinvest. That is my concern, if all of a sudden these rates go up. I don't know how the calculations would be as far as getting the tax rates neutral or maybe reducing it a bit. But it is the increase that is my concern.

Mr. SCHRADER. Sure.

Mr. HODGE. We cannot separate corporate and individual tax reform, unfortunately. Because if we broaden the corporate base, we are going to be hitting the S Corps and the LLCs just as hard. And, really, there is only about a hundred billion dollars—I say only a hundred billion—worth of tax expenditures in the corporate code, and those are shared between the C Corps and the S Corps. So we have to be very careful.

And not every loophole should be eliminated. Expensing, for instance, is not—I would not consider a loophole.

And we have to be very, very careful about having differential rates. This is the first time in the history of the Tax Code that the top corporate rate and the top individual rate are exactly the same at 35 percent. And we ought to keep that parity so we don't have arbitraging between the business forms. There are already various reasons, double taxation, and so forth, to do so, but I don't think the rates should be part of that. And I think we ought to keep that parity.

Yeah, there is a lot of provisions that ought to be eliminated from the Code. But let's not throw out also the baby with the bath water, such as expensing the R&D credit and so forth.

Mr. SCHRADER. Mr. Porter.

Mr. PORTER. I can tell you that many of my clients regularly tell me they would like tax reform, and they regularly suggest percentages that they think would be appropriate. Many times I am not sure they know what they are saying when they say that.

But as the AICPA, we are on record as supporting Congress and encouraging Congress to do fundamental tax reform. We believe that we need good, clear tax policy, we need consistency so that businesses can plan, but we have not stated a desire or a particular position for any rate. But we do encourage Congress, and we have some principles that we think you ought to consider, called the principles of good tax policy, and it goes out and lays out what we think are fundamentals in terms of similarly situated taxpayers being treated the same so you can't game the system a lot.

But there is a lot of those, and we encourage you to take a look at those, and we would be happy to assist in tax reform in any way that we could.

Mr. SCHRADER. Thank you very much; and thank you, Mr. Chairman.

Chairman WALSH. Thank you.

Maybe we all agree to something permanent. How about permanency?

Congressman Chabot from Ohio.

Mr. CHABOT. Thank you, Mr. Chairman.

Relative to the permanency of the tax cuts and the fact that these were only for 10 years, the 2001 and 2003 cuts, I was here at that time, and I think a little reflection on what actually happened might be in order. In the then-Republican-controlled House, we wanted to make these tax cuts permanent. That was our goal.

Unfortunately, it doesn't become law unless it passes the other body; and over in the Senate, they didn't have 60 votes to make them permanent. In fact, the colleagues—our colleagues on the other side of the aisle didn't want to cut taxes at all. And so there was a compromise, and the compromise was, well, we will make it for 10 years. And what we were hoping is we would ultimately get the votes and be able to make these permanent.

Same thing with the death tax. The fact that you can—the Federal Government can take up to 55 percent of what a person has paid taxes on throughout their life when they die is just abhorrent, as far as I am concerned. And the same compromise happened there, where it scaled down year after year after year and then went back up if we couldn't get our act together up here in Congress.

But that was why the tax cuts weren't permanent, and I would just like to have a response relative to how much better would it be if the tax cuts were permanent for your businesses and, if you think so, for the overall economy?

And I would be happy to hear from anybody who would like to comment.

Ms. KERN. I think anytime that a business owner can have permanency of ideas and guidelines it makes their business prosper—at least try to prosper. And it is very difficult if you have to keep changing your method of operation every few years or every—whatever. I mean, we need to have some sort of normalcy going forward. We have enough things that are hitting us from every other possible place in the universe. If we could have at least some guidelines in the tax law or in the estate tax, we would know where to go from here to retirement, hopefully, which is going to be a lot longer now than it was 5 years ago.

Mr. CHABOT. Mr. Harmon, would you like to comment?

Mr. HARMON. Yes, permanency would be a wonderful thing in the Tax Code. There is the R&D credit and there is bonus depreciation. Some of these provisions that are out there would have a significant impact on what you do year after year.

In manufacturing, we face global competition; and we have got to continue to invest in the equipment, the technology that is out there, training for our workforce, and the new research and development that our country participates in and our industry participates in.

Mr. CHABOT. Thank you.

Mr. Hodge.

Mr. HODGE. Nothing undermines economic growth more than uncertainty. And there is—as you know, there has been at least 5,000 changes to the Tax Code in the last 10 years. And I think the economic benefits of these tax provisions, such as expensing, such as the lower rates, have been undermined by the uncertainty, by their temporary nature. And so the Tax Foundation has always stood by the principle of certainty in the tax system, that there shouldn't be wild changes, because it really does undermine the economic impact of them. And I think the more that we can set aside these arbitrary budget rules and scoring rules and start thinking about sound policy and the longevity of these things the more we are going to see the economic benefits. But it is really because we adhere to these really arbitrary and sometimes really silly budget rules we undermine sound tax policy, and the economy is the big loser.

Mr. CHABOT. Thank you.

Mr. Porter, I have only got 1 minute left, so I wanted to get to one final question, and I would be happy if anybody wants to respond here.

You all, as small business folks, how would you respond to this allegation that has been made far too frequently—I guess because it is a campaign year, political year more than others—but this allegation that business folks—and yourselves included in that area—relative to taxes, you just don't want to pay your fair share of taxes? You are these 1 percenters that are trying to take advantage of the rest of our citizenry.

Any response to that? I assume you have probably heard this before.

I see you nodding in affirmation, Ms. Kern. Would you like to comment?

Ms. KERN. Well, as I mentioned before, I am not opposed to paying my fair share and have been paying my fair share of taxes for the past 31 years. It is when the tax structure is out of whack that it kind of I think upsets people. But I don't think that is a fair statement to make about small business.

As Mr. Harmon has mentioned, we provide health care, we provide 401(k)s, or we try to do everything that we can for our employees. I don't have 250 employees. I have 30 to 40 employees. And, again, they are mostly union—or they are union-signatory except for the office people. So, I mean, their health and welfare is, you know, $14 an hour. Their benefits are $35 an hour on top of their pay scale.

So, you know, we do pay a lot of things to keep our people employed; and that is the cost of doing business.

But I really take offense to the fact that we are trying to scam anybody and not pay what we have to pay. If I make money, I am more than happy to pay taxes and have in the past.

Mr. CHABOT. Mr. Harmon?

Mr. HARMON. I think that is an offensive statement. I think that small businesses and small——

Mr. CHABOT. Just to be clear now, it is not my point of view.

Mr. HARMON. No, no, no, I understand.

But the idea that we want to scam the system or not pay our fair share, we want to pay our fair share. We want permanency and stability in the Tax Code.

We are small businesses, small manufacturers. I read the paper and see what some of the multinational companies pay. And I can tell you we had a tough year last year, and we paid a lot more taxes than GE did.

Mr. HODGE. Here are the actual facts: About 50 percent of all American households pay no income taxes, and many of those people get refundable tax credits even though they owe no income taxes. And there is about $100 billion a year in refundable tax credits coming out of the IRS. Actually, more in refundable credits than what is available in the corporate code for tax expenditures. But the top 1 percent of tax filers pays a greater share of the income tax burden than the bottom 90 percent combined.

Mr. CHABOT. Could you repeat that?

Mr. HODGE. Yes. The top 1 percent of tax filers pays a greater share of the income tax burden than the bottom 90 percent combined. So that top 1 percent, which is comprised of about 1.4 million tax filers, pays close to 40 percent of the income taxes today. And that is a greater share of the burden than is paid collectively by everyone earning under about $120,000 a year combined.

Those are the facts from the IRS.

Mr. CHABOT. Mr. Porter?

Mr. PORTER. We certainly hope, as a profession, we are out there helping everybody pay their fair share of taxes and do it properly and report it in the way it should be reported.

Mr. CHABOT. Very diplomatic answer. Thank you.

I yield back, Mr. Chairman.

Chairman WALSH. Thank you.

Congresswoman Chu.

Ms. CHU. Well, I certainly was impressed with your stories, Mr. Harmon and Ms. Kern. Mr. Harmon, the success of your die casting business, it being a second-generation family owned business, and Ms. Kern, as a woman-owned business of a steel erectors company, that is really impressive.

And I noted with interest, Ms. Kern, that you wanted to partake of SBA's 504 loan program approved to small businesses with long-term fixed rate financing for expansion or modernization; and, also, Mr. Harmon, that you want to continue your contracts with the defense industry. That is, of course, critical to your company.

But I do have great concerns. Because if we extend all the Bush tax cuts, it will increase our debt by $3.3 trillion over the next 10 years; and in order to rein in our excessive spending, the government would be forced to make cuts to critical programs, such as small business loan programs, such as the 504 loan program, as well as in the defense industry. That is why I am concerned about extending those Bush-era tax cuts, and that is why I support President Obama's tax plan. Because we have to have an overall view of our budget here in Washington, DC.

Mr. Hodge, you gave a passionate argument about not hurting small businesses who are the entrepreneurs in this country, and I certainly agree with that. I just want to make sure that small businesses are truly the ones that are the beneficiaries of our policy, and I want to ask you about what is really a small business and whether the pass-throughs are really all small businesses.

And, in fact, I have a suspicion that some of the pass-throughs are not necessarily small business owners. They include law firms, doctor offices, hedge funds, and lobbying firms whose businesses are structured as partnerships for tax purposes. They also include passive investors, such as those in real estate partnerships. Passive investors don't participate in any of the risky business decisions yet receive all the benefits of the pass-throughs.

In addition, many S corporations that are defined as a pass-through entity are not small. In 2009, only 0.3 percent of S corporations had incomes exceeding $50 million, yet they accounted for 35 percent of all S corporation incomes.

Isn't it overreaching to say that these are all struggling small business owners? Should these very high-income earners be in a different tax category? And how can we make sure that the truly small business owners get the help they need?

Mr. HODGE. Well, we tend to think of these things in monolithic terms. And while the official definition of a small business may be "firms under 500," according to the SBA, small businesses—hopefully—become larger businesses, become successful businesses. And raising taxes on these businesses as they try to go through the stages of business life is counterproductive to them becoming successful.

We all want these businesses, whether they start out as a couple of college graduates with tremendous computer skills becoming the next Bill Gates or Steven Jobs or Steve Wozniak, they have to get there from here to there. And increasing their taxes as they go along the way and simply drawing some arbitrary line in the sand saying, oh, well, then at this point, they become a big business, I think is simply arbitrary.

And there is no economic rationale for this. There is no economic rationale to say that only 500 businesses is a small business.

And the real problem here is that we have all of these different business forms. It does treat some businesses differently. And we need to maybe make sense out of it. But the real point here is that higher taxes on these businesses is counterproductive. It does have economic impacts, no matter how you define what that business is.

Ms. CHU. Well, let me ask this: Of course, in the past 4 years, the administration had the Small Business Jobs Act. It helped relieve small business tax burdens. It permanently allowed qualified small businesses to carry back their general business credits to offset 5 years of taxes. It put in place the elimination of all capital gains taxes for those who invest in small business and extended the 50 percent bonus depreciation.

You made quite an argument of saying these are just temporary provisions, that they are counterproductive. Are you saying that we shouldn't have had these at all?

Mr. HODGE. Well, number one, in order to take advantage of all of those, you need to have positive profits. You need to be able to have income for which to deduct or make some of those deductions from. So for a lot of those businesses, bonus depreciation wasn't helpful because they simply did not have enough income to take advantage of that.

I would prefer, rather than seeing these sort of targeted, in a way, like pork barrel tax policy, see broader reform where we absolutely lower tax rates across the board for all individuals, all businesses, rather than try these sort of shotgun approaches to specific constituencies.

Ms. CHU. So you wouldn't have had any of these provisions?

Mr. HODGE. I would have lowered rates across the board, rather than try this sort of shotgun, as I say, targeted approach.

Ms. CHU. Thank you.

I yield back.

Chairman WALSH. Thank you.

Congresswoman Clarke.

Ms. CLARKE. Thank you very much, Mr. Chairman.

I want to also add my voice to both Mr. Harmon and Ms. Kern. The success of your businesses and the growth and development of them, the fact that you are operating a second-generation company, Mr. Harmon, begs to ask the question—and, Ms. Kern, having been in business for over 30 years now—that you have had the experience of operating your businesses at pre-2001 levels prior to the Bush tax cuts going into effect.

And so my question is, it seems to me that, prior to the Bush tax cuts, your companies were successful. What the Bush tax cuts have enabled you to do, I am assuming, is to bring more capital into your companies. So when we talk about the extension of the Bush tax cuts, I am wondering whether the uncertainty is one of companies that may have started or have been in a growth period during the Bush tax cut era versus those companies that have been in existence prior to that. And I wanted to know, what do you think is the best course of action, given that we haven't done or addressed comprehensive tax reform? And which is worse, the uncertainty of reauthorizing Bush tax cuts or the stability of knowing one way or another where you stand in terms of your companies and a comprehensive Tax Code that meets the needs of your companies?

Mr. HARMON. That is a good question.

Again, our business has been around for 93 years. These tax cuts took effect in 2001, 2003, the Bush-era tax cuts.

Around that time, if I am not mistaken, we were in a recession. I think that might have been some of the stimulus for some of these tax cuts.

But the other thing is that in manufacturing, and in our business, we started facing global competition back in the 1980s. Japan came onboard with their manufacturing, so American manufacturers had to really gear up for that. China came into play in the mid-'90s, Mexico for a little bit in the early 1990s.

We didn't have this type of global competition. Before 1995, it wasn't a huge global-type economy and the competition that we have today. Since China has come onboard, it has been just extremely difficult. We have got to be investing in new technologies, in new equipment, faster equipment to compete with the Chinese products that come over to America.

So that is why these cuts that are in place help. It would be nice to get them permanent, but the bonus depreciation and the research and development credit are two that we can utilize to help make us more competitive in the world market.

Ms. CLARKE. And you would say that that applies to your type of company as well?

Ms. KERN. It does but in a different way. I am primarily a labor-intensive company, but I am also subject to the Fortune 500 companies that want to build a plant or want to relocate. That impacts my work. We have had a really, really tough 4 years. The past 4 years have been awful.

But the other thing is the heavy and highway. We try to supplement our work with roadwork. But, again, the transportation bill hasn't been funded, and that is another issue.

But, yes, it does. I was in business prior to the tax cuts, but that was a different economy. We had more work then. So I shudder to think of what we would have been like since 2001 if those tax cuts weren't in place, because maybe a lot of us wouldn't be here.

Ms. CLARKE. The tax cuts, in and of themselves, are not the end-all to be-all. Because, on the one hand, we are looking at the overall national budget. And, as you stated, if we don't have funding and transportation bills, which are a significant part of what helps make your company robust, then there is still a shortfall.

So it is truly a balancing act, just from what I have heard from you both. And I think that we need to give a greater degree of scrutiny beyond the expiration or the tax cliff as to where the balance is. Because, right now, we are not striking that balance in our rhetoric. We are not being as balanced as we should be in really looking at the nuts and bolts of the companies that fall within the small business arena. And you two are examples of that.

However, there may be companies that don't face this same type of global competition as does Mr. Harmon's company, and there may be other companies that are much more reliant on a domestic base clientele. So we really have to take a look at that.

Because I am not convinced that these tax cuts are the end-all to be-all. And that is some of what I hear the debate being framed as, and I don't think that that is a healthy way of looking at a 21st century economy and how we support our entrepreneurs and small business, because there are so many other variables that are bearing on it.

Did anyone else want to add anything there?

Mr. Hodge, you look like you have a light bulb going off.

Mr. HODGE. Well, Mr. Harmon's comments I think were very illuminating, because he is dealing in the global economy. And, as I mentioned, not only does the U.S. now have the highest corporate tax rate in the world, at 35 percent, but the 35 percent individual rate that affects S corporations is also the highest business tax rate in the world, by definition. So he is now competing against a global economy with much, much lower tax rates.

Actually, 75 countries have cut their corporate tax rates in the last 5 years to be more competitive and to attract business jobs and investment away from high-tax countries like the United States. So it is incredibly important that not only we cut our corporate rates so that we can be more competitive but cut our individual rates so that these types of businesses can also be competitive globally. And it is the expansion of Mr. Harmon's company that can help Ms. Kern's company because she would be doing the metalwork on his factory. So that domestic investment is benefited by someone who can compete globally.

Ms. CLARKE. Clearly—and, Mr. Chairman, I am wrapping up. I just wanted to say that when we look at the domestic budget that helps to really provide a catalyst for their companies, notwithstanding the tax cuts. If we are cutting defense contracts, if we are cutting and are unable to put out a robust transportation bill, then, notwithstanding that, the competitiveness still is undercut by our inability to strike that balance.

So I just wanted to make sure that we sort of give a much more comprehensive look at what we are facing here and do our very best to bear that in mind as we go forward.

And I thank you, Mr. Chairman.

Thank you very much for your testimony here today.

Chairman WALSH. Thank you.

A quick 10-second answer from each Ms. Kern and Mr. Harmon. Directly, how would letting all these tax rates expire at the end of the year impact your ability to hire more employees?

Mr. Harmon, quickly.

Mr. HARMON. Significant influence and impact by having the tax rates expire. We would have to go back in a constriction mode, I mean a survival mode.

Chairman WALSH. Ms. Kern, quickly.

Ms. KERN. We are surviving on just razor-thin margins right now that are very difficult to maintain. And if they undo these tax cuts, then that is definitely not going to help us survive.

Chairman WALSH. Thank you. I want to thank everybody for your testimony. You have all provided important insight into how actions and inactions in Washington affect what you all do out in the real economy; and I, along with Congressman Schrader and the whole Committee, wish you success in your current and future endeavors.

I ask unanimous consent that Members have 5 legislative days to submit any additional comments and material for the record.

Without objection, so ordered.

Chairman WALSH. The hearing is now adjourned. Thanks.

[Whereupon, at 11:30 a.m., the Subcommittee was adjourned.]

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Women Construction Owners & Executives USA

TESTIMONY OF THERESA KERN

President of MA Steel Erectors, Inc. in Chicago, IL

On Behalf of Women Construction Owners & Executives USA

Before the Committee on Small Business

Subcommittee on Economic Growth, Tax and Capital Access

United States House of Representatives

On

"Adding to Uncertainty:

Small Businesses Perspectives on the Tax"

September 13, 2012

Women Construction Owners & Executives USA

"Consequences of Tax Uncertainty for Small Businesses Structured as Corporate Pass-through Entities

Good morning Mr. Chairman and Members of the Subcommittee. My name is Theresa Kern and I am the Owner and President of MA Steel Erectors, Inc. headquartered in Palos Heights, IL. We are a union-signatory specialty trade subcontractor that provides labor to install reinforcing steel in commercial, industrial, heavy and highway construction projects. MA Steel is incorporated as a Subchapter S, pass-through corporate entity and I am the sole shareholder.

I am testifying today as both a small business owner and in my capacity as Immediate Past President of Women Construction Owners & Executives USA (WCOE), a 30 year old organization whose mission is simply to create contracting opportunities for our members – women who have chosen to build a career and a business in the non-traditional construction industry.

Thank you for giving me the opportunity to testify before you today at this very important hearing.

As you know, the lingering economic recession has significantly damaged the construction industry and most small businesses in our industry have been hit disproportionately hard. Yet, WCOE members are optimistic about the future as the construction industry economy begins a slow recovery.

The future tax policy of the United States will have a profound effect on our members' ability to stabilize and then grow their businesses. MA Steel is a labor intensive business as are most construction companies, and business growth has a direct correlation to creating badly needed jobs to help the American economy grow and prosper.

While media headlines blare "Corporations don't pay their fair share", let me assure you that small business corporations not only pay their fair share, but are a major contributor to the economy as well as the tax base of this country and have often been referred to as the "life blood of the US economic growth engine".

Ernst & Young is reporting that 90% of all US businesses are corporate pass-through entities and employ more than 50% of the private sector workforce while representing over a third of all US business receipts. Pass-through entities are Subchapter S Corporations (S Corps) and Limited Liability Corporations (LLC's) that have specific limits as to the number and type of shareholders. IRS reports there are over 4.5 million Subchapter S corporations alone. It is often said that small businesses are the cornerstone of the American economy and corporate pass-through entities are the cornerstone of America's small business community.

Generally, entrepreneurs are advised by their CPA or attorney to incorporate using one of these Congressionally-chartered tools in order to separate her business from her household assets without the onerous paperwork and reporting requirements of a "C" Corporation.

Congress also decided in 1958 that these special privately held, corporate entities would not be taxed as a corporation, but rather because the owner/entrepreneur was investing her own money into the enterprise to get it started and often to keep it running, the income or loss generated by the Sub S/LLC corporation would be reported by the owner(s) on their individual tax returns as earned income or loss. The pass-through corporation, whether a Sub S or LLC, is therefore not liable for income tax, but the shareholder is: the businesses entire profit (or loss) is passed through to the individual(s) who report it on their household tax return at the rate for their total household tax bracket. (Conversely, profit distributions to "C" Corporation owners are treated as dividend income to the shareholders and currently taxed at up to 15%.)

When the media trumpets headlines like "90% of corporations pay no taxes" – they may be statistically correct. But these are not corporations as the general public defines corporations – these are mostly small business owners who have been advised to protect their household assets by incorporating, and to use an LLC or Sub S corporate structure to eliminate the requirement for big corporate boards of directors, annual meetings, elections, expensive audits, and activist shareholders. With the 2002 passage of Sarbannes-Oxley which mandated even more rigorous reporting requirements for "C" corporations, pass-through entities are even more attractive.

What is critically important to understand is that profits in a business incorporated as a Sub S or LLC entity does not translate to cash in the pocket of the owner. But, a loss in a business nearly always requires the owner to either forgo her own salary, or even invest more of her own money into the firm. There is one other thing that all corporate pass-through entity owners know – while the company may show a profit in the financial statements, there may be no cash in her corporate or personal bank accounts. Further, there is no relationship between the amount of profit a Sub S or LLC entity shows on a financial statement and the amount of money an owner has actually withdrawn.

Please let me also explain one of the anomalies about the construction industry. Unique to construction is the issuance of a surety bond which is a guarantee of performance on a project that the owner of a construction company must collateralize with her business's balance sheet and personal assets. Nearly all construction projects require a surety bond performance guarantee from all of the contractors and subcontractors working on a project.

Because construction company balance sheets have taken a severe hit during the last 4 years, banks and bonding companies are insisting that balance sheets be strengthened by keeping profits in the company.

It is important to note here that the surety bond on a specific project cannot be released until the final retention is released at completion and acceptance by the owner. My ability to begin a new project is restricted by my balance sheet which remains encumbered until those assets are released when the bonded work is accepted and final payment received – a process that often takes many months after project completion. If I want to take on another project prior to the release of the retention money in order to keep my crews busy, I need to have sufficient assets available to secure a bond.

Let's assume I'm lucky enough for MA Steel to make a nice profit this year. My bank and bonding company will require that I not only pay myself only a minimal amount but that I leave the profits in the business in order to show a stronger financial position. As a Subchapter S corporation, however, all of that nice profit will be reported as income to me and I will have to pay tax on it, even though I may not have one penny of it in my personal checking account.

When we are talking about an average contract value of $500,000, and dozens of projects a year, it is not unrealistic to expect annual business profits to exceed $250,000 all of which is reported as retained earnings in the business and as income to me – yet the majority of that profit stays in the business and never makes it into my personal checking account for my own use.

I am liable for payment of the income taxes due on this phantom income at the individual tax rate. Increasing the rate of this tax by even 10% will have a significant deleterious effect on my ability to grow my business. I have to keep the profits in the business per demands of the bank and bonding company if I want to grow; yet I have to take the profits out of the business to be able to pay the taxes.

The members of WCOE fully support simplification of the tax code and closing tax loopholes that are beneficial only to the most sophisticated financial analysts. We also support efforts to decrease the Federal budget deficit, but to do it on the backs of America's robust entrepreneurial community will be counter-productive.

I would like to give you one more relevant example of what the current uncertainty with the tax code means to small business owners like me.

I have finally located a reinforcing steel fabrication plant that I would like to buy to expand my business by being able to provide the rebar that we install. My CPA is telling me that unless I could close escrow before the end of this year, I would be foolish to proceed because there is no certainty about tax policy in just 4 short months. Something as simple as the current Section 179 tax law which would allow me to write off a major portion of this investment instead of depreciating it over dozens of years makes the project financially feasible. It is impossible to get an SBA 504 loan, close escrow and finish capital and equipment improvements before the end of this year. So for now, I am forced to sit and wait while the economy sputters along and factory workers remain unemployed because there is no productive tax policy in place that will give me the confidence I need to make this investment.

In summary, these last 4 years have been very difficult for the construction industry. We have lost many women owned construction companies who could not find a way to survive. Those of us who have hung on and managed to create profits, albeit small, are looking to rebuild our communities by growing our businesses and creating jobs.

We are encouraged that this House Subcommittee is working on the issue of taxation for small business owners and how the current uncertainty is holding back investment and the natural job creation that comes from that investment.

Thank you for the opportunity to talk with you today. I would be happy to answer any questions.

TWIN CITY
DIE CASTINGS CO.
Since 1919

Twin City Die Castings Company - 1070 SE 33rd Avenue - Minneapolis, MN 55414

Testimony
of
Doug Harmon, CEO, Twin City Die Castings
Before
the House Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access

"Adding to Uncertainty: Small Businesses' Perspectives on the Tax Cliff"

September 13, 2012

Good morning, Chairman Walsh, Ranking Member Schrader, and members of the Committee, thank you for the opportunity to testify today. I am here to discuss the severe economic consequences that small manufacturers will face due to the so-called "fiscal cliff" as it relates to taxes that will occur in January 2013, unless Congress intervenes. Failure to act on the looming year-end tax increases would yield the largest tax increases in American history coupled with draconian, ill-designed, across-the-board discretionary spending cuts. These increases will hurt not only my business and employees, but my customers as well.

My name is Doug Harmon. I am the CEO of Twin City Die Castings Company, a second generation family-owned business employing two hundred fifty employees. We manufacture hundreds of different types of precision aluminum and magnesium die castings for the automotive, recreational, industrial equipment, defense, aerospace, computer, and medical industries.

I am testifying today on behalf of the North American Die Casting Association where I serve as a member of the Government Affairs Committee and on the Board. NADCA is the sole trade and technical association representing over 300 U.S. based companies and industry suppliers that produce and sell castings essential to the manufacturing process. Die casters supply to almost every industry segment in North America and many are tier-one and/or tier-two supplier to the biggest names in the automotive industry. In fact, U.S. die casters contribute over $7 billion to the nation's economy annually and provide over 50,000 jobs directly and indirectly throughout the country with the highest geographic concentration of facilities located in the mid-West.

Company Overview

Twin City Die Castings is one of the oldest die casting companies in North America. It was founded in 1919. My father took a gamble and purchased this small business in 1974 with our family savings. After college, my brothers and I joined the business. My dad taught us not only how to produce quality castings, but the need to invest in our employees and the shop. He remained active in the day-to-day operations and served as the Chairman of the Board until his passing in April 2011.

Here are a just few examples of the wide variety of castings we have produced this year - a control module that is used in the anti-lock braking system for the Boeing 787 Dreamliner. We are making a die casting that is used in hospitals on a pole clamp assembly which is used to hold IVs. We are also manufacturing a faceplate for a defense contractor located in Rochester, New York that goes on the Falcon 3 communications radio that is used by the military. On the automotive side, we are making an engine component for a German customer that sells to Ford called the EGR Valve. This assembly recirculates the exhaust gas of a diesel engine to reduce emissions.

Over the years, we have worked together to grow and expand our business. In fact, we now operate three die casting facilities in the U.S. – our original location is in Minneapolis, one is in Monticello, Minnesota and another is in Watertown, South Dakota. We are also exporting 22 percent of our total casting sales in eight different countries around the world, with Canada and Mexico being our top two export markets.

In order to compete in the global marketplace, Twin City Die Castings has continually invested in its employees, new equipment and technology which allowed us to reduce overall product costs, and at the same time, provide consistently high quality parts. The methods we've developed have been instrumental in helping us win multiple industry honors and awards. In all of our operations, we provide good paying blue color jobs, health reimbursement accounts and other benefits to our employees, whom we consider as members of our extended family.

The Recession hit our industry and my company hard. A number of die casters that had been in business for more than 25 years were forced to shut their doors. We were faced with downsizing our workforce to 155 workers from 250 when millions of dollars of orders simply dried up. Fortunately, orders have been slowly coming back and we were able to rehire many of our employees, but we are still not back to pre-recession production and sales levels.

Prior to the recession our average investment in equipment has been typically $3 million a year. The impact of the recession was really felt in 2010 when Twin City Die Castings was only able to invest $1.5 million in new die casting equipment. We were fortunate to have the funds available to purchase several expensive new die casting machines in 2011. In 2012, we have been much more cautious in our hiring and the types of capital improvements that we have undertaken given the uncertainty over taxes and the economy.

Impact of Tax Cliff Will Adversely Affect Small Manufacturers

For manufacturers like me, this tax cliff or taxmageddon is a serious threat. Come January 1, 2013, some $500 billion in tax increases will hit the U.S. economy, which already suffers from a weak economy and an uncompetitive tax code. In fact, trillions of dollars in tax provisions will expire, from the Bush-era cuts on income to a wide range of tax breaks for business.

As you well know, many tax provisions are enacted on a temporary basis - in large part due to budgetary and political constraints - requiring repeated extensions (occasionally even retroactively). The uncertainty resulting from such temporary tax policy makes it difficult for die casters, which rely on three- and five-year business strategies, to plan effectively for the future and remain competitive in an increasingly global economy.

Not knowing whether or not Congress will renew the Bush-era tax cuts and the pro-business tax extenders which expired at the end of 2011 is keeping many die casters and for that matter most manufacturers from investing as much as they could to grow their business, purchase new equipment and hire more employees. In order for die casters to prosper in this country we need two things – stability with a pro-growth approach and transparency in our tax code.
Given this uncertainty over taxes and other potential government regulations, instead of hiring new employees, increasingly the die casting industry is choosing to hire

temporary workers to fill their employment needs utilizing and/or implementing overtime with its current workforce.

How die casters are organized and the way we pay taxes has the single greatest impact on our industry. Our company is structured as a Subchapter S Corporation where the individual owners pay the taxes. More than 70% of manufacturers are structured as S-Corporations or other flow-through entities, meaning they pay taxes at the individual rate. Since we are put in this top tax bracket, we could see our rates jump to 39.6 percent from 35 percent. We could also face a 3.8 percent tax on certain types of investment income, passed in the Affordable Care Act effective in 2013. On top of these increases, small businesses like mine will also have to deal with a 0.9 percent surtax on wage income earned above $200,000 for individuals and $250,000 for couples.

Bottom line for Twin City Die Castings is that if the current tax rates are not renewed by January 1, 2013 and individual rates increase by nearly 5 percent (at a minimum), we will face a hefty increase in our tax bill. We will not be able to reinstate the 401K match for our employees' retirement nor will we have the extra funds to increase our workers' Health Reimbursement Accounts. We will likely hold off hiring any new employees. Furthermore, we are a very capital intensive industry and if the bonus depreciation goes away it will have a huge impact on our tax liability as well.

Other family-owned die casters have told me confidentially that the threat of increased taxes has already curtailed their investment spending and are holding off on investing in any new equipment in case they need to apply these funds to an increased tax bill. In addition, they have already started feeling the effects of their customer base not building up their inventory. Furthermore, if their taxes are increased, they will be forced to reduce wages and/or delay wage increases to their employees, as well as impacting their workers benefit packages.

As a small business, we may report thousands of dollars or more in profit, but few manufacturers take those profits home – they are overwhelmingly reinvested back in the business, our employees, facilities and equipment. This means that the less resources we have due to paying more in taxes the less resources we have for improving our employees' wages and benefits and buying new equipment.

Right now, the tax code forces die casters to make investment decisions based on the tax code, not by what is best for their business. As any business owner knows, you typically purchase capital equipment in one of two ways – out of your profits or through loans from the bank. Unlike larger corporations, small manufacturers like us are required to provide a personal guarantee for most loans when purchasing capital equipment or expanding our facilities. This means as a small business owner, I have to put my family's home on the line, and take significant risks if I want to grow the business and compete in this global economy. This is where tax deductions and credits come in as the only tool we have to reduce our effective tax rate – unless Washington can finally act on comprehensive tax reform.

In sum, when more money goes towards federal, state and local taxes, it results in reduced cash flow into the business – meaning less money is reinvested in our employees, equipment and manufacturing plants. It is imperative that Congress act this year to reduce the uncertainty facing manufacturers by addressing the tax cliff facing all businesses. For now, we urge Congress to extend the current tax rates and revive the tax extenders which will provide a bridge to comprehensive tax reform.

Importance of Pro-GrowthTax System

NADCA supports comprehensive reform of our current tax code to make it fairer, simpler, more competitive and predictable. Because of the critical importance of manufacturing to our nation's economy, any effort to rewrite the tax laws should result in a fiscally responsible plan that allows domestic manufacturers to prosper, grow, compete and create jobs.

NADCA believes it is important to keep our current tax system in place until lawmakers agree on a final reform plan. The expiration or pending expiration of a number of business tax extenders represents a tax increase for die casters and manufacturers that use these incentives. Similarly, other piece-meal changes or repeal of long-standing rules will inject more uncertainty into business planning, making U.S die casters even less competitive and threaten economic growth and U.S. jobs.

Several key business tax breaks currently available are set to change or expire entirely after December 31, 2011. In particular, we urge lawmakers to renew tax extenders widely used by the manufacturing sector, such as the R&D credit, bonus depreciation and Section 179 expensing.

It is critical that any tax reform plan recognize the important role of research and technology investment in the growth of U.S. jobs and innovation. U.S. manufacturers perform half of all R&D in the nation, which drives more innovation than any other sector. To maintain this competitive advantage, tax provisions must be enacted that will stimulate investment and recovery, including strengthening the

R&D tax credit and making it permanent.

Another key provision is bonus depreciation. From September 2010 through the end of 2011, manufacturers could elect to immediately deduct the cost of qualifying purchased property. Currently, however, we can only elect to deduct 50 percent of the cost of these investments. A real incentive for manufacturers to make investments in new equipment would be if Congress restored the 100 percent bonus depreciation through 2012 and 2013.

These historic capital investment incentives have had a positive impact and incentivized manufacturing purchasing and job creation in recent years.

Conclusion

The looming threat to our recovery, and the major concern to the business community, is how lawmakers will address the fiscal cliff that awaits the country at the end of the year.

If we go over the fiscal cliff, jobs will be lost, our company sales will likely decrease, investment will slow, and our nation's competitiveness will suffer. The President and Congress can prevent this from happening immediately extending all of the 2001 and 2003 tax rates (including current marginal rates, dividend and capital gains rates, and estate tax relief) for all taxpayers; extend expiring business tax provisions; provide alternative minimum tax (AMT) relief; and find spending cuts to replace a sequestration never intended to go into effect. This would go a long ways to avert America's impending fiscal cliff.

Die casters are ready to work with lawmakers on comprehensive tax reform in the next Congress and possibly forego some tax credits and deductions if it means a lower effective tax rate and helps solves our nation's budget crisis. However, we cannot afford to fix our nation's problems on the backs of small businesses and their employees.

Small manufacturers cannot compete globally or even survive domestically if we do not continually invest in equipment and our people. This is why tax reform is so important to manufacturing companies across the country – to free up capital for investing in people and equipment and to provide more certainty so we can plan for future years.

Thank you for the opportunity to testify before the committee today and I look forward to answering your questions.

Written Testimony
Of
Scott A. Hodge
President
Tax Foundation

Before the House Small Business Subcommittee
On Economic Growth, Tax and Capital Access
On Adding to Uncertainty: Small Business Perspectives on the Tax
September 13, 2012

Introduction

Mr. Chairman and members of the Committee, thank you for the opportunity to speak to you today on the impact of higher marginal tax rates on pass-through businesses.

Founded in 1937, the Tax Foundation is the nation's oldest organization dedicated to promoting economically sound tax policy at the federal, state, and local levels of government. We are a non-partisan 501(c)(3) organization.

For 75 years, the Tax Foundation's research has been guided by the immutable principles of economically sound tax policy that were first outlined by Adam Smith – taxes should be neutral to economic decision making, they should be simple, transparent, stable, and they should promote economic growth.

Introduction

America's entrepreneurs are facing tremendous uncertainty, thanks to the stalled economy and the impending expiration of the Bush-era tax rates at the end of this year.

While there are many in Washington who believe that allowing top marginal tax rates to jump from 35 percent to 39.6 percent will have a minimal impact on pass-through businesses and the economy, this view is badly mistaken.

The issue is not how few businesses will be impacted. The relevant economic question is how much business income will be hit with higher tax rates. No matter how you parse the data, the evidence is clear that the vast majority of pass-through business income is earned by high-income taxpayers and they would be disproportionately impacted by such a tax increase.

Indeed, past Tax Foundation research determined that nearly 40 percent of any new tax revenue raised by boosting the top two tax rates would come from the top 2 percent of private businesses. These are the most successful, growing, and profitable firms that are key to America's economic recovery. In every sense of the word, this would amount to a "Success Tax" on our best and brightest entrepreneurs.

Business Taxes are the Most Harmful Taxes for Economic Growth

The implications of allowing top marginal tax rates to rise are considerable because of the tremendous growth in non-corporate business forms over the past thirty years. Today, there are vastly more non-corporate businesses than traditional corporations and they now earn more net income than traditional corporations. Thus, an increase in the top individual tax rates could mean a substantial tax hike on a broad swath of private, or non-corporate, business income.

The economic evidence suggests that this would be very detrimental to the country's long-term economic growth. Indeed, OECD economists have determined that high personal income taxes are second only to corporate income taxes in their harmful effects on long-term economic growth. As is now well known, the U.S. has **the** highest corporate income tax rate among industrialized nations. However, it is not well known that the U.S. has **the** most progressive personal income tax system among industrialized nations.[1]

What that means is that the top 10 percent of U.S. taxpayers pay a larger share of the income tax burden than do the wealthiest decile in any other industrialized country, including traditionally "high-tax" countries such as France, Italy, and Sweden.[2]

What are the harmful effects of progressivity?

The economic evidence is quite clear that there is a "non-trivial tradeoff between tax policies that enhance GDP per-capita and equity."[3] Meaning, the more we try to make an income tax system progressive, the more we undermine the factors that lead to economic growth – investment, risk taking, entrepreneurship, and productivity.

After extensive study of the impact of tax reforms on economic growth across the largest capitalist nations, OECD researchers determined that "a reduction in the top marginal [individual] tax rate is found to raise productivity in industries with potentially high rates of enterprise creation. Thus reducing top marginal tax rates may help to enhance economy-wide productivity in OECD countries with a large share of such industries…"[4] The U.S. is once such country with a large share of entrepreneurship and non-corporate businesses.

Thus, the economic evidence suggests that cutting our corporate and personal income tax rates while broadening the tax base would greatly improve the nation's prospects for long-term GDP growth while helping to restore Uncle Sam's fiscal health. More importantly, these measures will

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[1] Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and Economic Growth," Organization for Economic Cooperation and Development, *OECD Economics Working Paper No. 620.*, July 11, 2008. p. 43.

[2] "Growing Unequal? Income Distribution and Poverty in OECD Countries," Organization for Economic Cooperation and Development, 2008. p. 112. http://dx.doi.org/10.1787/422013187855. Here income taxes refer to both personal and social insurance taxes.

[3] *Tax Policy Reform and Economic Growth*, OECD Tax Policy Studies, No. 20, OECD Publishing (2010), p. 22.

[4] "Tax and Economic Growth," p. 9.

lead to higher wages and better living standards for American citizens. And that should be priority number one of any policy.

America's Growing Pass-Through Business Sector

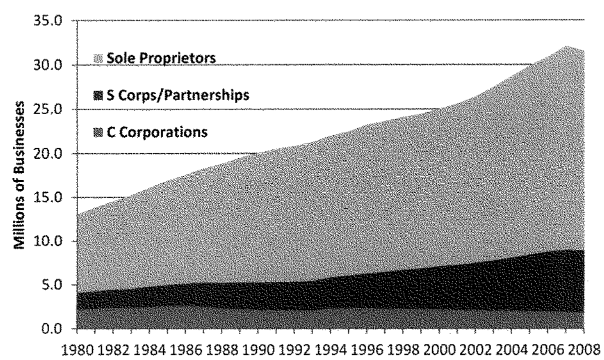
To understand the impact of higher tax rates on business income, it is instructive to look at the tremendous growth in taxpayers reporting business income over the past three decades as sole proprietors, S corporations, limited liability corporations (LLCs), and partnerships.

These non-corporate firm types are often referred to as "pass-through" entities because the firm's profits are passed directly through to the owners and taxed on the owner's individual tax return. By contrast, the profits of traditional C corporations are taxed at the corporate level first before being distributed to the owners (shareholders) who are then taxed again at the individual level.

Between 1980 and 2008, the total number of pass-through businesses nearly tripled, from roughly 10.9 million to 31.8 million.[5] Specifically, as Figure 1 indicates, the number of sole proprietors grew from 8.9 million to 22.6 million, while the number of S corporations and partnerships (which include LLCs) grew from 1.9 million to more than 7 million.

Meanwhile, the number of traditional C corporations declined steadily from 2.2 million to 1.8 million between 1980 and 2008. The popularity of C corporations as a business form ended by the late 1980s when they were exceeded in number by S corps and partnerships. These alternatives to the C corp have continued to grow at such a rapid rate that there are now three and one-half times as many S-corps and partnerships as traditional corporations.

Figure 1: Composition of U.S. Business Forms, 1980 - 2008



Source: IRS

Over time, as these pass-through firms grew in number, size, and profitability, they began to collectively generate more net business income than traditional C corporations. Figure 2 compares the growth in net income for all pass-through businesses to the growth in net income for all C corps between 1980 and 2008. After adjusting for inflation, net income for C corps roughly doubled during the period, from $752 billion to $1.4 trillion in 2005, and then collapsed to roughly $1.1 trillion in 2008. By contrast,

[5] When we reference tax return data, business income is considered the sum of income reported on schedules C, E (excluding royalty and estates), and F. For the data source, see: http://www.irs.gov/pub/irs-soi/80ot1all.xls.

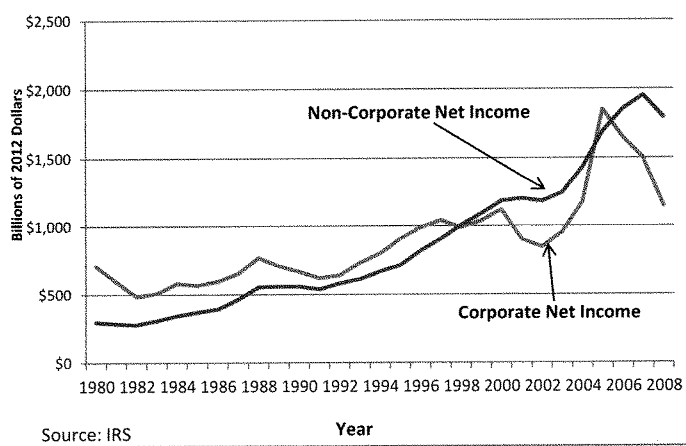
the combined net income from pass-through businesses increased six-fold, from $315 billion, after adjusting for inflation, to more than $1.8 trillion in 2007, before settling to $1.7 trillion in 2008.

In 1998, the combined net income of pass-through businesses exceeded those earned by C corps for the first time and, except for 2005, have remained above C corp net income in every year since. Indeed, in 2008, the net income of pass-through businesses comprised 61 percent of all net business income.

It is also interesting to note the relative stability of pass-through business income to the volatility of C corp income. The period between 1999 and 2008, shown on Figure 2, is a good example of how volatile corporate income can be. After the tech bubble burst in 2000, C corp income plunged 24 percent over the next two years, after adjusting for inflation, and then rebounded 119 percent by 2005. After this temporary peak, C corp income fell again by nearly 38 percent over the next three years.

By contrast, pass-through income has not gone through such wild gyrations. After the tech bubble burst in 2000, pass-through business income actually increased in 2001. In 2002, net income fell by just 2 percent but then rebounded by 5 percent in 2003. In the four years after the 2003 tax cuts, the net income of pass-through businesses grew by nearly 60 percent, after adjusting for inflation. In 2008, pass-through business income exceeded C corp receipts by 56 percent.

Figure 2: Net Income of Corporate and Non-Corporate Businesses: 1980 - 2008



Source: IRS

Who Earns Pass-Through Business Income

It is often assumed that a tax increase on high-income individuals will have little impact on business activity because only 2 or 3 percent of taxpayers with business income are taxed at the highest rates. While it is true that there are a small number of high-income pass-through businesses, the more economically meaningful statistic is how much overall business income will be taxed at the highest rates. There are a number of ways to measure this.

For example, the Joint Committee on Taxation has determined that if the Bush-era rates were to expire, "53 percent of the approximately $1.3 trillion of aggregate net positive business income will be reported on returns that have a marginal tax rate of 36 or 39.6 percent."[6]

How this breaks down by income groups can be seen in the most recent IRS data for 2010. In that year, individual taxpayers reported $693 billion in total net business income from all sources—including business and professional income, rents and royalties, partnership and S corporation income, and farm income.

As Table 1 and Figure 3 illustrate, nearly three-quarters (72 percent) of this pass-through business income was reported by taxpayers earning more than $200,000. Millionaire tax returns earned 36 percent of all pass-through business income while taxpayers earning between $200,000 and $1 million also earned 36 percent. Meanwhile, taxpayers with incomes below $100,000 earned 12 percent of all pass-through business income.

It is also illuminating to look at the distribution of specific types of business income. Table 1 shows the very different distribution of income generated by sole proprietors (business and professional income) versus the income generated by partnerships and S corporations. Whereas 31 percent of sole proprietor income is reported by taxpayers earning over $200,000, the overwhelming majority of partnership and S corp income is reported by these high-income taxpayers. Indeed, more than half of all partnership and S corp income is earned by millionaire taxpayers.

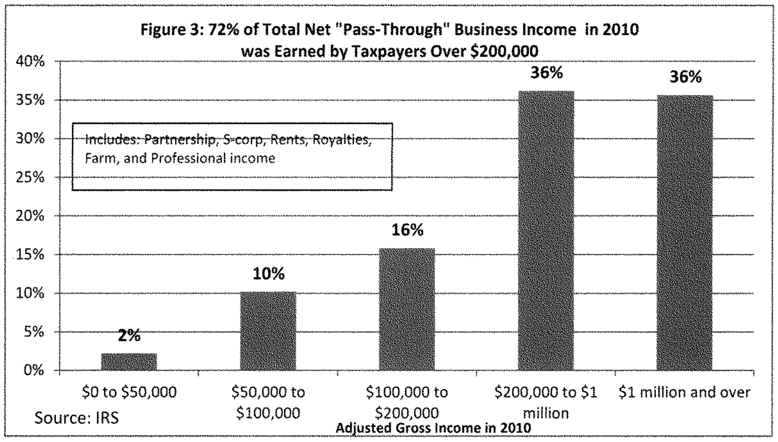
Table 1. Distribution of Pass-Through Business Income in 2010

	$0 to $50,000*	$50,000 to $100,000	$100,000 to $200,000	$200,000 to $1 million	$1 million +
All Pass-Through Income	**2%**	**10%**	**16%**	**36%**	**36%**
Net Business & Professional Income	30%	18%	21%	25%	6%
Net Partnership & S-Corp Income	-14%	5%	11%	42%	56%
Rents, Royalties and Farm Income	-29%	3%	32%	58%	34%

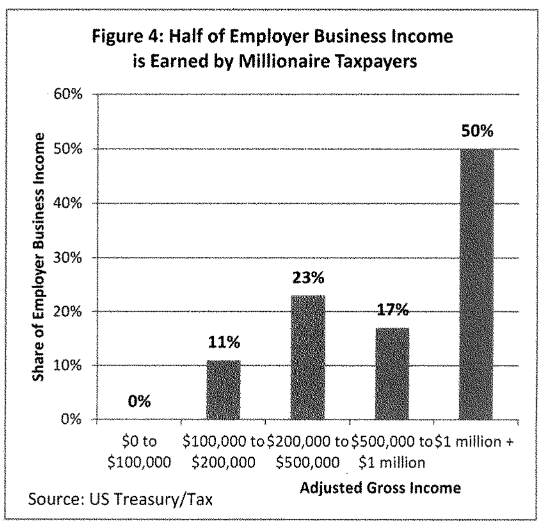
*includes returns with negative income

Source: Tax Foundation calculations based on IRS data

[6] Memorandum on Revenue Estimates to Finance Committee staff, from Thomas A. Barthold, Joint Committee on Taxation, June 18, 2012.



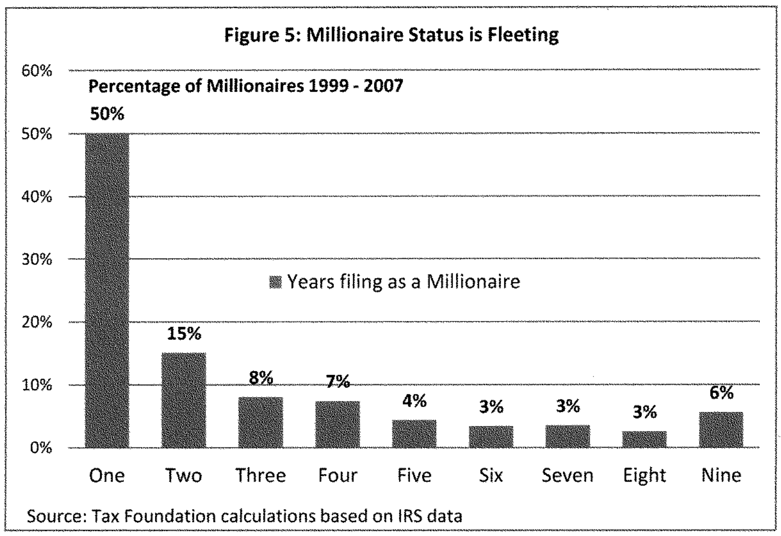
Of keen interest to policymakers is how many of these pass-through businesses are employers. A recent Treasury report analyzed IRS data from 2007 and found that roughly 4.2 million pass-through business returns—out of 34.7 million overall—were employers. As Figure 4 illustrates, 50 percent of the income generated by these employers accrued to taxpayers with incomes above $1 million. Fully 90 percent of this business income was generated by employers with incomes above $200,000.



Millionaire Status is Fleeting Because of Business Income

Debates over the equity of the tax burden tend to treat millionaires as a monolithic group even though research suggests that there is a significant amount of churning in and out of this elite status. Indeed, a recent Tax Foundation study used special Treasury panel data to look at the mobility of "millionaire" taxpayers between 1999 and 2007.[7] It found a great deal of mobility among the so-called rich.

During this nine year period, about 675,000 taxpayers earned over a $1 million for at least one year. As Figure 5 shows, of these taxpayers, 50 percent (about 338,000 taxpayers) were millionaires for only one year, while another 15 percent were millionaires for only two years. By contrast, just 6 percent (38,000 taxpayers) remained a millionaire in all nine years. Based on these results, it is clear that taxpayers move in and out of millionaire status with great frequency. The volatile nature of capital gains realizations and business income appear to be the leading factors for the transiency of millionaires.



How Much Would a Tax Hike Cost Successful Businesses?

The key question is, what is the ultimate impact of raising the top two tax rates on the most successful pass-through businesses? Tax Foundation economists measured this cost in 2010 when the Bush-era tax rates were first set to expire. They found that assuming that business income is the last dollar of income taxpayers earn, that 39 percent of the total tax increase on high-income taxpayers would be extracted from business income.[8]

[7] Robert Carroll, *Income Mobility and the Persistence of Millionaires, 1999 to 2007*, TAX FOUNDATION SPECIAL REPORT NO. 180 (June 2010), http://taxfoundation.org/article/income-mobility-and-persistence-millionaires-1999-2007.

[8] Scott A. Hodge, "Over One-Third of New Tax Revenue Would Come from Business Income If High-Income Personal Tax Cuts Expire," Tax Foundation *Special Report No. 185*, September 2010.

According to the most recent revenue estimate from the Joint Committee on Taxation, the revenue gain from increasing tax rates on taxpayers earning over $250,000 would raise $966 billion over the next ten years. Assuming that the Tax Foundation's earlier 39 percent estimate still holds, this means that roughly $377 billion of these new revenues would come from successful pass-through businesses.

Conclusion

As lawmakers consider policies to improve the competitiveness of American businesses, they should not forget that individual income tax rates are just as important to business activity as the corporate rate. The various proposals to raise income taxes on high-income earners, either by increasing the top marginal rate, closing "loopholes," limiting deductions, or implementing a minimum tax, would fall very heavily on America's non-corporate businesses. These flow-through businesses account for a large percentage of business income and employment in the United States. Raising taxes on them at this time could curtail their hiring and other investment plans, further delaying economic recovery.

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About the Tax Foundation
The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate the public on tax policy. Based in Washington, D.C., our economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

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WRITTEN TESTIMONY OF JEFFREY A. PORTER

ON BEHALF OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

PUBLIC HEARING ON

ADDING TO UNCERTAINTY: SMALL BUSINESSES' PERSPECTIVES ON THE TAX CLIFF

SEPTEMBER 13, 2012

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
WRITTEN TESTIMONY OF JEFFREY A. PORTER

U.S. HOUSE OF REPRESENTATIVES
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SEPTEMBER 13, 2012

Good morning Chairman Walsh, Ranking Member Schrader and Members of the Subcommittee. I am Jeffrey A. Porter, Vice Chair of the American Institute of Certified Public Accountants' (AICPA) Tax Executive Committee. I am a sole practitioner at Porter & Associates, CPAs, a local firm in Huntington, West Virginia, which concentrates in providing tax planning and business advisory services for small to medium sized businesses and high net worth individuals. On behalf of the AICPA, I am pleased to have the opportunity to testify today on the topic of small businesses' perspectives on the "Tax Cliff."

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125 year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Our members are well aware of the great uncertainty facing small businesses today in regards to income taxes rates, estate taxes rules, and the re-occurring, so called "tax extenders." Our members are receiving inquiries from their clients, sometimes on a daily basis, on whether the "Bush Tax Cuts" will be extended, what will happen with estate taxes, how the "Tax Cliff" will affect their businesses, and whether a particular tax incentive will be extended another year. This year has become an extraordinary year for uncertainty in taxes as well as the macro economy, making it extremely difficult for small businesses and their owners to make informed business and financial decisions.

EXPIRATION OF THE 2001 AND 2003 TAX CUTS

The Economic Growth and Tax Relief Reconciliation Tax Act (EGTRRA) of 2001 made substantial changes to the individual income tax law including to the ordinary income tax rates, the capital gains rate, and the tax rate on qualified dividends. EGTRRA also made substantial changes regarding the elimination of phase-outs of itemized deductions and personal exemptions, eliminated the marriage penalty on the standard deduction and the lower income tax bracket, as well as changes to the amount of and requirements to qualify for many other incentives (e.g., child tax credit, adoption expense credit and dependent care credit). These income tax changes were initially scheduled to expire after 2010, but were generally extended through 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA).

EGTRRA also made major revisions to the estate, gift, and generation-skipping transfer (GST) tax regimes. In December 2010, TRUIRJCA modified and extended temporarily the estate, gift, and GST tax provisions of EGTTRA and also created some new provisions.

All of the provisions of EGTTRA, as well as the provisions of TRUIRJCA, are scheduled to expire on December 31, 2012, and the income, estate, gift, and GST tax laws in effect prior to 2001 are scheduled to return.

Income Taxes

Small businesses, formed as corporations, pass-through entities, or sole proprietorships, are currently facing considerable uncertainty with regard to income taxes. This uncertainty is not limited to one or two tax provisions, but instead affects many areas of the Internal Revenue Code (Code), including income tax rates, long-term capital gains rates, the rate for qualified dividends, and whether, and to what extent, certain deductions, credits and exemptions will be available.

The uncertainty becomes more unsettling when you look at the potential changes in tax treatment for some items of income and deduction. For example, qualified dividends are currently taxed at a maximum income tax rate of 15%. However, these same dividends might be subject to a maximum rate of 39.6% beginning in 2013. This tax hike is a 164% increase. If you take into consideration the 3.8% Medicare tax on passive investments, the tax rate on dividends could reach 43.4% or nearly a 190% increase.

There is also a significant change scheduled to take effect in 2013 for many deductions and exemptions. For example, the phase-out of itemized deductions for high income individuals is scheduled to return. This means that a taxpayer, who received a $10,000 deduction for a $10,000 charitable contribution this year, may only receive a $2,000 deduction for the same charitable contribution next year. Assuming there is no change in income tax rates, a return of the phase-out rules could reduce the benefit of a taxpayer's charitable contribution by up to 80%.[1]

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[1] The phaseout and terminination provisions of the overall limitation on itemized deductions sunset on December 31, 2012, at which time an individual whose adjusted gross income exceeds the applicable amount, will have itemized deductions otherwise allowable reduced by the lesser of (1) 3% of the excess of the adjusted gross income over the amount, or (2) 80% of the amount of the itemized deductions otherwise allowable. *See* I.R.C. section 68(a).

Regardless of whether you support or oppose an increase in income taxes, it is important to understand the significance of what is at stake. For example, it is nearly impossible to estimate the true cost of a purchase of new equipment when income tax rates are uncertain. Although income taxes are not the only factor in making business decisions, prudent business owners want to understand the tax consequences of a transaction.

Multi-year planning and the ability to predict (or at least estimate) business profits and taxes are critical in operating a business. It is also essential to know future income tax rates in structuring major business transactions such as in the sale of a business or its assets. In order to determine a sales price that is acceptable to both the buyer and seller, both parties need to understand their potential tax liability for the current year as well as any future year. Tax considerations are even more substantial if the sale is structured as an installment sale. Since banks are hesitant to lend money in many of these types of transactions, the seller frequently finances the transaction for the purchaser over a number of years. In order to determine an agreeable sales price and appropriate interest rate, both parties need to calculate (or reasonably estimate) the ordinary income taxes and capital gains taxes due on the transaction for the current and subsequent years. Without this information, it is extremely difficult for either party to make an informed decision.

A number of individuals are also modifying their business plans solely to take into consideration income taxes. For example, I am aware of one small business owner who is eager to have certainty with regards to the taxation of dividends. The business owner is considering whether to pay a significant dividend, or perhaps two dividends, at the end of the year while the 15% rate is still available. If it were not for the possibility that dividends may be taxed at ordinary income tax rates in 2013, the owner absolutely would not consider paying a dividend this year.

Estate, Gift and Generation-Skipping Transfer Taxes

The AICPA urges Congress to take prompt action to enact permanent estate, gift, and GST tax provisions and thus provide needed certainty to taxpayers in planning their affairs. The uncertainty of these laws impedes proper estate planning for small business owners, and the necessity to revise estate planning documents multiple times places an undue burden on individuals.

Many small business owners are considering substantial gifts to fully utilize this year's lifetime exemption. For example, I am aware of one retailer who is planning to gift approximately $5,000,000 in his company's stock to his daughter even though it causes some issues with his overall business succession plan. According to the owner, the gift is not necessarily in the best interest of the business, but he does not want to forgo this "once-in-a-lifetime opportunity" to make a transfer of this size. Generally, a business succession plan takes several years to execute, however some small business owners feel pressure to accelerate or modify their plan given the uncertainty in transfer taxes.

The AICPA strongly recommends that Congress take into consideration some important tax administration issues when enacting permanent estate, gift, and GST tax provisions. Our suggestions, which have been submitted previously, are based on various studies and reports over the past decade. In developing these suggestions, we focused on the complexity of the current system, taxpayer planning and compliance burdens, ease of administration and revenue constraints. Our suggestions, in priority order, are:

1. GST Technical Modifications – Make permanent the technical modifications to the GST tax rules enacted in EGTRRA and extended temporarily by the TRUIRJCA, which provide relief from several GST tax "traps" that existed under previous law. (See AICPA's letter dated November 18, 2011 for more details on this important, non-controversial technical provision.)

2. Estate and Gift Tax Exemption – Maintain from the TRUIRJCA an applicable exclusion (exemption) amount indexed for inflation for gift and estate taxes that eliminates planning, filing, and estate tax payment burdens for all but the largest estates. If the gift and estate tax exemption amount is reduced below the current $5.12 million level, it is important that those taxpayers, who made taxable gifts in 2011 and 2012 in order to utilize all or a part of the current exemption, not be subject to gift or estate tax in the future on the amount that was excluded by the exemption in those (2011 and 2012) years. In other words, any statutory provision should make clear that the amount of taxable gifts covered by the exemption amount in 2011 and 2012 is not again included in the amount subject to gift or estate tax.

3. Uniform Exemption Amount – Maintain from the TRUIRJCA a uniform exemption amount for estate, gift, and GST tax purposes. This uniform exemption amount considerably simplifies planning for individuals.

4. Portability – Maintain the portability rules which allow a surviving spouse to utilize any unused portion of the first spouse to die's estate tax exemption. This provision, which was enacted as part of the TRUIRJCA, would significantly simplify estate planning and estate administration for married couples if they could rely on it. However, the portability provision is currently not very useful from a planning perspective since the provision is scheduled to expire on December 31, 2012. Married couples still need to obtain professional advice to assist them with attempting to equalize their estates by dividing up jointly owned property and establishing marital trusts. We also recommend that this Subcommittee consider making the GST exemption portable.

5. State Tax Credit – Reinstate the full state estate or death tax credit, or provide another mechanism (such as a surtax), that would allow states to uniformly

"piggyback" on the federal estate tax. To avoid diminishing tax revenues, many states have decoupled from the federal estate tax and enacted their own estate tax regimes, resulting in unnecessary complexity and uncertainty in both planning and administration.

6. Relief Provisions – Provide broad-based liquidity relief, rather than targeted relief provisions. Broad provisions that would apply to all illiquid estates would be both simpler and fairer to all taxpayers. At a minimum, the section[2] 6166 installment payment rules and its holding company provision should be modernized to allow eligibility for all types of business forms, including pass-through entities (i.e., partnerships, limited liability companies, etc.) in addition to currently-allowed corporations.

7. Number of Tax Brackets – Provide many tax brackets to avoid cliff taxation. We note that there have been some proposals in the past that have included a rate structure with a very limited number of tax brackets and a large gap between brackets. For example, such a system might provide for only two brackets, such as 15% and 30%, with estates over a certain size paying the higher bracket (30% in this example), and estates below that number paying the lower bracket (15%). In such a proposal, there would be significant uncertainty in the planning process for married couples with sizeable estates. For example, taxpayers may have to consider if estate tax should be paid at the death of the first spouse at a 15% rate compared to an alternative of paying the tax in the future but at a higher rate. In addition, this type of "cliff" taxation allows too much disparity among similarly situated taxpayers, where one receives estate planning advice and pays significantly less tax when compared to the individual who does not receive such advice.

We note that the Administration's budget proposals for fiscal year 2013 would make permanent the portability provisions enacted in TRUIRJCA. In addition, the Administration's budget proposals would make permanent at the 2009 law levels the provisions enacted in 2001. As a result, the GST tax technical provisions would be made permanent as part of the broader effort to accomplish estate tax reform by making permanent certain estate, gift and GST tax provisions enacted in 2001. We applaud this effort to permanently extend these expiring provisions. Furthermore, the AICPA advocates that the GST tax technical provisions in EGTRRA, as extended by TRUIRJCA, should be made permanent, without any interruption in their applicability, due to undue burdens upon taxpayers who relied on these provisions in managing their affairs since 2001 and the need for the simplicity provided by these provisions going forward.

[2] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise specified.

TAX EXTENDERS

The AICPA appreciates your efforts in examining small businesses' perspectives on tax extenders, which in the last several years have repeatedly created uncertainty and confusion. While some measures, such as those designed for economic stimulus, are appropriate for temporary and sporadic use, longstanding, continually renewed, temporary tax provisions, including many incentive provisions, have become far too common. In its January 2012 report[3] on expiring tax provisions (affecting individuals and other taxpayers), the Joint Committee on Taxation notes more than 60 different tax provisions expired on December 31, 2011, and more than 42 tax provisions will expire on December 31, 2012.

These ever-changing, often expiring, short-term changes to the tax laws make it increasingly difficult for small businesses and their owners to do any long-term tax, cash-flow or financial planning. These planning challenges are further compounded when tax laws are changed after the year has already begun but are slated to take effect that same tax year. When tax laws are issued late in the year or at the last minute, individuals try their best to comply with no ability to plan for such last-minute provisions, no matter how well-intentioned.

Uncertainty also breeds complexity. The need to extend expiring provisions (e.g., the research and experimentation credit) adds confusion and, in many cases, undermines the policy reasons behind these incentives. The on-again-off-again nature of these provisions, coupled with retroactive tax law changes, make long-term planning difficult, result in the filing of amended returns, and significantly increase the overall complexity.

Future tax changes should be enacted with a presumption of permanency, except in rare situations in which there is an overriding and explicit policy reason for making provisions temporary, such as short-term stimulus provisions or when a new provision requires evaluation after a trial period.

Alternative Minimum Tax

Small businesses, including those operating as pass-through entities, are at risk of being subject to the alternative minimum tax (AMT). Originally adopted as a way to ensure that all taxpayers pay a minimum amount of tax on their economic income, the AMT has evolved into one of the tax law's most complex components. In fact, the AMT is a separate and distinct tax regime from the "regular" income tax, which requires taxpayers to make a second, separate computation of their income, expenses, allowable deductions

[3] Joint Committee on Taxation, *List of Expiring Federal Tax Provisions, 2011-2012* (JCX 1-12), January 6, 2012.

and credits. This separate calculation must be performed on all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations.

As complex as the calculations for the AMT are, Congress also chose not to index the AMT tax rates or the exemption levels for inflation unlike the normal tax rates schedules. As a result, the AMT exemption has become an annual battle for Congress and the inflation factor is typically implemented retroactively. As of today, Congress has allowed the inflation indexing to expire for 2012. As a result, estimated tax planning for small businesses has to take into account the lower AMT exemption amount.

For example, when the "AMT patch" is not in place at the start of a tax year, many individuals must factor AMT in their quarterly estimated tax payments. This means that a small business owner, who possibly is strapped for cash, may have to pay a substantial amount in estimated taxes during the year. If the AMT patch is eventually passed, the Internal Revenue Service (IRS) will issue a refund for any overpayment of taxes once the small business owner files a return. However, the small business owner essentially provides the IRS with an interest-free loan or risks paying an underpayment penalty if the AMT patch is not passed. It is a no-win situation for these taxpayers.

The AICPA has a long-standing position of supporting repeal of the AMT for both individual and corporate taxpayers. However, we recognize there is a significant revenue cost associated with this simplification reform. Alternatively, we strongly urge Congress, at a minimum, to permanently index the AMT for inflation – which would eliminate a significant amount of uncertainty in tax planning.

Section 179 Expensing and Bonus Depreciation

One of the most important tax incentives for small businesses to invest in machinery and equipment is to allow for faster cost recovery of the business property. Generally, businesses are allowed to deduct the cost of capital expenditures over time according to depreciation schedules. However, Congress has passed certain exceptions to the rule over the years, the most significant of which are scheduled to change at the end of 2012.[4]

First, to help small businesses quickly recover the cost of capital outlays for qualifying personal property, small businesses can elect to write off these expenditures in the year of acquisition instead of recovering the costs over time through depreciation. This expense election is commonly referred to as the "Section 179 election."

For 2010 and 2011, small businesses were allowed to expense up to $500,000 of capital expenditures. In order to ensure the incentive was only available to small businesses, the maximum expense amount was gradually reduced once qualifying property placed in

[4] *See* I.R.C. sections 179(b) and 168(k)(5).

service during the year exceeded $2,000,000.[5] For 2012, the maximum write off amount is $139,000 and subject to reduction once a taxpayer's aggregate expenditures exceed $500,000.[6] For 2013, the maximum expensing amount and phase-out threshold are scheduled to drop to $25,000 and $200,000, respectively.[7]

The other incentive which is in doubt is commonly referred to as "bonus depreciation." In previous legislation, Congress allowed businesses to more rapidly deduct capital expenditures by permitting an additional first-year write-off of 50% of the cost.[8] For investments placed in service after September 8, 2010 and before December 31, 2011 (through December 31, 2012 for certain property), the law provided for 100% first-year depreciation.[9] In other words, the entire cost of qualifying property placed in service during that time frame can be written off, with no limitation. For the 2012 tax year, however, the law reverted back to allowing 50% additional first-year depreciation. The bonus depreciation rules are scheduled to expire on December 31, 2012. Thereafter, small businesses can only recover the cost of property over the life of the asset (unless section 179 applies).

Unfortunately, the uncertainty surrounding the ability to use accelerated recovery methods has resulted in unease for many small business owners and has been outright crippling for other business owners. For example, one small manufacturer, for which I am personally familiar, is currently evaluating whether to purchase a new printing press. The cost of the press is approximately $2,000,000, which is a *significant* expenditure for this company. If the owner orders the needed new press, he will receive and pay for the press in approximately six to eight months. However, the owner has decided to temporarily postpone the purchase during this time of uncertainty. Without the ability to determine his after-tax cost of the equipment, he is unwilling to make such a significant investment.

In summary, depreciation is an area of the tax law where uncertainty has a significant impact on business decisions. The ability to entirely write off a capital expenditure can influence small business owners' decisions. Likewise, the difference in 50% bonus depreciation, 100% bonus depreciation and no bonus depreciation is substantial for small businesses and undoubtedly impacts their decisions. The difference in taxes may determine whether a business owner purchases an asset this year, next year or perhaps not at all.

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[5] I.R.C. section 179(b)(1).
[6] *Ibid.*
[7] *Ibid.*
[8] I.R.C. section 168(k).
[9] I.R.C. section 168(k)(5).

Other Tax Extenders

Our members frequently receive inquiries and address concerns on a wide variety of other temporary tax incentives depending on the nature of their practice. For some small businesses, the research and experimentation credit is critical since a significant amount of the owners' time is spent developing new or improved products or processes, which may qualify for the credit. Other businesses are more concerned about the expiration of the work opportunity credit or new markets tax credit.

TAX REFORM

While this Subcommittee is examining the impact of the "Tax Cliff," we also urge you to consider how small businesses could greatly benefit from tax reform. Small businesses and their owners face challenges in making long-term decisions as well as compliance burdens when confronted with confusing, overlapping and inconsistent tax provisions.

The AICPA strongly supports Congress undertaking a comprehensive consideration of tax reform in the upcoming year. We are available to assist you in this process, and believe there are a number of issues affecting small businesses which should be addressed in any comprehensive tax reform. Specifically, we suggest you consider how to improve the administration of the Code by examining the following important issues:

1. Phase-Outs – The Code includes many exclusions, exemptions, deductions, and credits which are phased-out for taxpayers whose incomes exceed certain levels. There should be greater consistency across phase-outs in how income thresholds are determined, the income range over which the phase-out applies, and the method of applying the phase-outs.

2. Different Definitions of the Same Term – There are several terms which have multiple and inconsistent definitions in the Code, such as, "modified adjusted gross income," and this leads to confusion. Definitions should be consistent where the same term is used.

3. Retirement Plan Options – The Code provides for more than a dozen tax-favored employer-sponsored retirement planning vehicles, each subject to different rules pertaining to plan documents, eligibility, contribution limits, tax treatment of contributions and distributions, the availability of loans, portability, nondiscrimination, reporting and disclosure. These provisions should be simplified and the number of available plans should be reduced.

4. Inflation Adjustments – Inflation eventually erodes the equity of certain tax provisions. Although many items are now adjusted on an annual basis for inflation, some are not. Examples of items not adjusted for inflation include the business gift deduction, the capital loss limitation, and the definition of a

small business under section 1244. In these cases, the Code should allow for annual inflation adjustments.

We also suggest that you review the AICPA's Tax Policy Concept Statement #1: Guiding Principles for Good Tax Policy to assist you in identifying problems in the Code as well as to test any new proposals against the principles of good tax policy.

* * * * *

It is important for Congress to reach an agreement with regards to the expiring tax provisions as soon as possible. The uncertainty of the tax law unnecessarily impedes long-term tax and cash-flow planning for businesses, and prevents owners from making informed decisions. Any further delay will magnify the frustration of many small business owners.

On behalf of our members and their small business clients, I also strongly urge you to not underestimate the effect that the Tax Cliff has on tax administration itself. If Congress waits until late in the year or even into next year to enact tax law changes, the IRS and commercial software vendors must scramble to revise or issue new tax forms and update software. As we experienced just a couple of years ago, this process would likely delay the initial date of when many taxpayers, including small business owners, can file their income tax returns. As a result, affected taxpayers would receive their refund checks days or perhaps weeks later than usual, which is particularly concerning for businesses operating under a tight cash flow.

Last-minute changes to the tax laws are also extremely problematic for CPAs. Our members, a vast majority of whom are small businesses, will face an increasingly compressed and perhaps hectic busy season in order to educate clients on the changes in the rules, advise owners on the after-tax consequences of business transactions, assist small businesses and individuals with tax and cash-flow planning and prepare income tax returns.

The AICPA appreciates this opportunity to comment today and we urge this Subcommittee to consider our suggestions as Congress decides how to address the expiration of the 2001 and 2003 tax cuts, the estate tax provisions, and the tax extenders.

Does the Expiration of Tax Rates Impact Your Business?
-asked on small business Open Mic during week of 9/11/2012

"As owner of a small business that just turned 5 years old and is a Subchapter S, we've grown from 3 employees to almost 50 in the last 5 years. The growth has kept our income low, as we've invested back into the company in the form of additional jobs and equipment. We have always had to tax plan at the year's end because we've never seen a penny of what the company has made, with the exception of what we've had to pull out for taxes on the income we've not seen. Bottom line, raising our taxes means we'll quit growing, lay off people and stay under the $250K level for income. We are not the problem."

-Steve Piechota (San Jose, CA) ***Netronix Integration***

"This additional tax, along with the Health Care Act would definitely suppress our growth. We would have to make sure that we continually upgrade our staff while keeping our active staff at a low number. Our margins are already stressed to the max and this would hurt our lower income employees. My guess is that we would have to start looking for ways to outsource some of our jobs in order to keep the company solvent. This is the worst time to put this kind of pressure on any small business. If the Government is trying to reduce hiring and to reduce the number of small businesses then they are on target. If they wish to grow employment and increase the tax base then they are way off target."

-Steve Woodall (Houston, TX) ***Reliant Business Products***

"My wife and I own a subchapter (S) business that develops and manufactures realistic artificial wounds and medical mannequins to train combat medics and emergency medical personnel. If we make a year-end profit, it gets taxed at the individual rate, yet we have never taken that profit for ourselves. We always use it for our cash flow needs--paying the 23 employees, buying the necessary raw materials, paying all of the overhead bills, and investing in new equipment. Thanks to the Bush tax cuts, we have been able to expense the equipment and company truck purchases instead of amortizing them. If Obama succeeds as he announced today, we will be "rich" and pay higher tax rates, and probably lose the other advantages of the Bush tax cuts as well."

-Dave Parry (Willow Grove, PA) ***MPS Techline of PA, Inc.***

"I understand what the President is trying to do - I really do, but he is not going about it the right way. Small business is the backbone of our country and allows us to keep American's working. Since any profit is a pass-through on a personal tax return - it very seldom actually goes into the hands of the business owner. It allows the business owner to grow the business and expand -

employing more Americans and increasing wages of those already working hard. If we have to take our profits as we have in the past and hand them over in the form of taxation - it will force companies like mine to keep wages lower and hire less people - or lay off those working for us to compensate for the taxes. It is not in the best interest of our country."

-Gloria Cuerbo-Caley (Canton, OH) ***Media Resources, Ltd***

"This kind of taxation is what is hurting our small businesses today. We are forced by the Administration to jump hurdles that really should apply only to large businesses. We provide Health Care, Retirement Benefits and matching payroll funds to our employees like any other business does, but yet we are continually being over-taxed by the Government. Of course unemployment is running high, no one can afford to add employees at this time. We just work leaner with longer hours to get by and have less to show for it in the end. Wealthy - I don't think so."

-Becky Hinkle (Kansas City, MO) ***Bears Printing, Inc.***

Statement of the National Association of Manufacturers (NAM)

For the Hearing Record

of the

Committee on Small Business

Subcommittee on Economic Growth, Tax and Capital Access

U.S. House of Representatives

On

"Adding to Uncertainty: Small Businesses' Perspectives on the Tax Cliff"

September 13, 2012

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Statement
of the National Association of Manufacturers

For the Hearing Record
of the
Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access
U.S. House of Representatives

Hearing on
"Adding to Uncertainty: Small Businesses' Perspectives on the Tax Cliff"

September 13, 2012

Overview

The NAM is the largest industrial trade association in the United States, representing over 11,000 small, medium and large manufacturers in all 50 states. We are the leading voice in Washington, D.C., for the manufacturing economy, which provides millions of high wage jobs in the U.S. and generates more than $1.6 trillion in GDP. In addition, nearly two-thirds of our members are small businesses, which serve as the engine for job growth. NAM members commend Chairman Walsh and Ranking Member Schrader and the Committee for holding a hearing on the impact on small businesses of the so-called tax cliff at the end of 2012.

The NAM is a strong advocate for reform of our current tax code to make it simpler, fairer and more competitive, and we welcome the current focus on tax reform. At the same time, until policymakers agree on a final reform plan, we believe that it is important to keep our current tax system in place. In particular, we believe it is critically important to continue the current lower individual income tax rates enacted in 2001-2003 and set to expire at the end of the year. These preferential tax rates have been a tremendous benefit to many small and medium-size manufacturers and have helped them survive very challenging economic times. In contrast, the expiration of the existing tax rates will raise their tax bills, inject more uncertainty into business planning, making U.S companies even less competitive and threaten economic growth and U.S. jobs.

Small Manufacturers and Current Tax Rates

Tax policy plays a critical role in manufacturers' ability to thrive in the United States and effectively compete in the global economy. Manufacturers support extending current lower tax rates for all Americans to provide time for Congress to complete comprehensive tax reform. To that end, we supported H.R. 8 that passed the House in July.

The lower rates enacted in 2001 and 2003 have played a key role in helping the nearly two-thirds of manufacturers operating as S-corporations or other pass through entities–most of which are small and medium-sized manufacturers (SMMs)–retain and create high-paying manufacturing jobs. Raising taxes on these SMMs would be counterproductive, particularly as we face persistently high unemployment rates and stagnant economic growth.

Unfortunately, the debate about extending the 2001-2003 tax relief often overlooks the potential impact on smaller manufacturers of not extending all the tax relief. According to 2008 IRS data, the average net taxable income for small and medium sized manufacturers is $384,000. Consequently, extending some but not all of the current individual income tax rates will have a direct and negative impact on many manufacturers.

Manufacturing is a capital intensive industry and the capital to grow and expand operations, increase product lines, hire additional workers, most often comes directly from the owners. In fact, a March NAM/*Industry Week* Survey of Manufacturers found that 56 percent of respondents believed that the tax increases slated to go into effect in January 2013 would negatively impact business investment and job retention/creation. Even more alarming in the most recent NAM/*Industry Week* Survey, more than 78 percent of respondents cited uncertainty regarding the fiscal abyss as their chief concern. In addition, the number of manufacturers with a negative outlook on the future of their business has doubled in the past three months.

Indeed, according to calculations based upon the Treasury Department's technical paper released last fall defining small businesses, it is "estimate(d) that 44 percent of income generated by small business owners would be affected by a change in the top two rates".[1] This fact should help dispel the notion that the impact on business owners of a rate increase would be small.

If Congress does not act to prevent tax hikes on smaller manufacturers, the impact will very likely resonate throughout these job creators. S-corporations and other flow through entities employed 54 percent of the private sector workforce as of 2008.[2]

Small Manufacturers and Tax Reform

Manufacturers also believe it is imperative for Congress to extend the 2001 and 2003 tax relief for all Americans to provide time for Congress to complete consideration of much needed, and long awaited comprehensive tax reform.

Moving forward, a central element to the discussion about remaking the tax code into one that will ensure the competitiveness of U.S. companies is ensuring that that any tax reform plan does not disadvantage smaller manufacturers. As noted above, nearly two-thirds of manufacturers are organized as subchapter S corporations (S corps) or other flow-through entities and pay taxes at the individual rates. These companies play a critical role in our nation's manufacturing capacity. Any tax reform plan must be comprehensive and any changes, or base-broadening that occurs to reduce tax rates must adjust for the special impacts on these flow-through businesses.

For more than 60 years, business owners have chosen to organize as S corps or other flow-through entities to benefit from comprehensive liability protection and a single level of federal taxation. According to IRS data, between 1980 and 2008 the total number of flow-through businesses more than tripled to nearly 31 million, employing in 2008 an estimated 54 percent of

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[1] Testimony of Martin A. Sullivan, Ph.D., Chief Economist, Tax Analysts, before the House Committee on Ways & Means, March 7, 2012.

[2] Robert Carroll 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

the entire private sector workforce. As a result, when considering tax reform, Congress should pay special attention to the impacts of any tax reform proposals on this type of business entity.

In addition, it is important for Congress to consider the unique impacts that specific types of base broadening would have on these smaller manufacturers and to address these impacts to ensure that tax reform does not increase the tax burden on these companies to pay for other tax reform measures.

Conclusion

As outlined in NAM's "A Manufacturing Renaissance: Four Goals for Economic Growth,[3]" a key objective for the Association is to create a national tax climate that enhances the global competitiveness of U.S. manufacturers. Manufacturers very much appreciate the efforts of the Small Business Committee for their commitment to fostering the growth and success of America's small and medium sized businesses. It is essential that Congress work to reform the U.S. tax system to put U.S. manufacturers on a level playing field with their competitors in other countries, as well as making the United States a more competitive environment in which to do business. We appreciate the opportunity to share our thoughts and concerns with you. Manufacturers look forward to further discussing these issues and working with the Congress to achieve a pro-growth, pro-competitiveness and pro-manufacturing tax system.

[3] Available at http://www.nam.org/

Statements from Small Businesses Submitted to the Small Business Committee's Open Mic Web Forum.

"As owner of a small business that just turned 5 years old and is a Subchapter S, we've grown from 3 employees to almost 50 in the last 5 years. The growth has kept our income low, as we've invested back into the company in the form of additional jobs and equipment. We have always had to tax plan at the year's end because we've never seen a penny of what the company has made, with the exception of what we've had to pull out for taxes on the income we've not seen. Bottom line, raising our taxes means we'll quit growing, lay off people and stay under the $250K level for income. We are not the problem."

-Steve Piechota (San Jose, CA) Netronix Integration

"This additional tax, along with the Health Care Act would definitely suppress our growth. We would have to make sure that we continually upgrade our staff while keeping our active staff at a low number. Our margins are already stressed to the max and this would hurt our lower income employees. My guess is that we would have to start looking for ways to outsource some of our jobs in order to keep the company solvent. This is the worst time to put this kind of pressure on any small business. If the Government is trying to reduce hiring and to reduce the number of small businesses then they are on target. If they wish to grow employment and increase the tax base then they are way off target."

-Steve Woodall (Houston, TX) Reliant Business Products

"My wife and I own a subchapter (S) business that develops and manufactures realistic artificial wounds and medical mannequins to train combat medics and emergency medical personnel. If we make a year-end profit, it gets taxed at the individual rate, yet we have never taken that profit for ourselves. We always use it for our cash flow needs--paying the 23 employees, buying the necessary raw materials, paying all of the overhead bills, and investing in new equipment. Thanks to the Bush tax cuts, we have been able to expense the equipment and company truck purchases instead of amortizing them. If Obama succeeds as he announced today, we will be "rich" and pay higher tax rates, and probably lose the other advantages of the Bush tax cuts as well."

-Dave Parry (Willow Grove, PA) MPS Techline of PA, Inc.

"I understand what the President is trying to do - I really do, but he is not going about it the right way. Small business is the backbone of our country and allows us to keep American's working. Since any profit is a pass-through on a personal tax return - it very seldom actually goes into the hands of the business owner. It allows the business owner to grow the business and expand - employing more Americans and increasing wages of those already working hard. If we have to take our profits as we have in the past and hand them over in the form of taxation - it will force companies like mine to keep wages lower and hire less people - or lay off those working for us to compensate for the taxes. It is not in the best interest of our country."

-Gloria Cuerbo-Caley (Canton, OH) Media Resources, Ltd

"This kind of taxation is what is hurting our small businesses today. We are forced by the Administration to jump hurdles that really should apply only to large businesses. We provide Health Care, Retirement Benefits and matching payroll funds to our employees like any other business does, but yet we are continually being over-taxed by the Government. Of course unemployment is running high, no one can afford to add employees at this time. We just work leaner with longer hours to get by and have less to show for it in the end. Wealthy - I don't think so."

-Becky Hinkle (Kansas City, MO) Bears Printing, Inc.

"We have been in business 32 years, as a family owned S Corp, and have weathered ups and downs before. We are at capacity with current staff and really should expand, but the uncertainty of what our healthcare costs will be next year, the prospects of higher taxes, the uncertainty of what will happen with the national debt and the economy are holding us back. Why should we expand, take on the additional headaches, if the government is just going to tax and take away what little more we would be able to make?"

-Keith Kramer, Keith M. Kramer Associates, St. Louis, MO

"We have a few hurdles we are facing. One, the lack of being able to get any decent funding or loans to help expand our company. We have been in business for 17 years and have a staff of over 12 employees and could use more but don't have the funds to cover the extra expense, nor the healthcare costs. The uncertainty in the tax laws also hurt us because we can't budget because we don't know what our rate will be, and what extra expenses we will have from Obama Care."

-Michael Evans, National Billing Inst., West Palm Beach, FL

"I had the opportunity to build two new buildings to expand our business in two cities. However, because of the risk associated with the uncertain financial health of our country, future interest rates, proposed tax hikes, the healthcare debacle, etc. we decided to forego our plans to build and expand. There are just too many question marks..."

-Clifford Laverty, Total Radio, Inc., Tulsa, OK

"...The uncertainty of what the current Administration will do next to hamper our business deters us from hiring some new people. The excessive regulations are choking small business. The Administration wants to demonize and punish successful small business with increased taxes. The Administration is absolutely clueless to help small business."

-Ronald Gibbs, Emery Air Conditioning, Port Charlotte, FL

"...This business climate is worse, and more unpredictable, than the administration understands. Its stifling to business owners to live in a climate of uncertainty, and not being able to plan for tax liabilities."

-Patricia Secore, Archetype International, Santa Ana, CA

"What is killing small businesses are the uncertainty of "obamacare", the uncertainty of new taxes, the certainty of more presidential directives and regulations, and the certainty of a hostile small business environment within this administration. Let the entrepreneurial spirit flourish - Government, get out of our business!"

-Chris Fuedo, UREdge Security Solutions, Fairfax Station, VA

"Uncertainty is our biggest deterrent. We don't know how the health care bill is going to affect costs (besides knowing the cost is going to go up). Don't know what our federal tax rate is going to be, so we can't accurately plan. We try to project every year what are costs are going to be but in this rhetoric filled administration, it is hard to determine what is actually going to become policy."

-Karen Russell, Russell Oilfield, Houston, TX

"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" which may cause me to taxed even more. Not every household "making millions" is rich. I certainly am not..."

-Jorge O., Hawk Construction, El Paso, TX

"As owner of a small business, 30 years, and a Subchapter S, we've grown from 2 employees to as much as 225 employees and presently to approx. 40 employees. The last few years have been hard to survive especially with such uncertainty in the economy. Raising our taxes means less growth, less passion and motivation for growth, lay off people and stay under the $250K level for income. Possibly retiring as that seems to be a better future of securing our years of very hard work to have retirement as an option..."

-Mary Avila, MJVila Construction, Fresno, CA

"Our small business faces major uncertainty in three areas that are exacerbated by Government policy 1. As a defense contractor we face major uncertainty as to what the effect of the pending defense cuts will be next year. 2. As a "S Corp" the impact of higher taxes hits the business directly. Requiring the owners to take more cash out to pay taxes impacts our working capital, increases our borrowing costs and directly impacts our ability to invest in capital equipment. This required cash distribution in April has a major negative financial impact on our entire business 3. The uncertainties surround health care implementation and increasing costs are also a major negative. Overall, we are hunkering down, trying to preserve cash and buying as little as possible, shedding all but core employees until things become more certain."

-Gary Smith, Brandywine Communications, Tustin, CA

"Owning a small manufacturing company has been a real trial in the last few years due to continuing uncertainty in the overall economy, particularly in the industrial sector. We do almost exclusively sales to other businesses and manufacturers and everyone has put stuff on hold and delayed repeatedly which has, in turn, made our production schedule very up and down. This makes it nearly impossible to add to our workforce with any long term employment as tomorrow we may not have the business to support the number of employees..."

-Paul Jones, LM Containers, Caruthersville, MO

“As a small manufacturing business owner in the current business environment, we are continually faced with rapidly changing cost of supplies driven by the cost of fuel, taxes, and uncertainty (i.e., healthcare reform, etc.). In the past (2009),we have employed as many as 17 and are now at 10 employees due to loss of business and becoming more productive.”

-Manny Ornellas, CDG Technology, LLC, Redding, CA

“There is little investment during periods of high uncertainty. Much of the uncertainty which is killing progress is coming from Washington. American planning and the ingenuity of business leaders, large and small, can handle most any situation. They can't handle uncertainty--taxes or no taxes; more fiscal stimulus or drastic fiscal reductions during a recession; mounting federal debt with no plan to handle or balanced approaches. Washington is killing progress and needs to act. Establish a fixed environment for the near term, it doesn't make a great difference which you chose, and business will plan for it and we will begin to grow again.”

-George Geyer, HyperLearning Technologies, Virgina Beach, VA

“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 this 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, Ditch Witch of Maryland, Sykesville, MD

“My small business needs a stable forecast of Government regulation and taxation. Business investment needs certainty of risk, business owners need confidence of calculated risk. Confidence and belief in a stable future is what's lacking in America today. My business investments are calculated risk, today there are to many unknowns to calculate that risk therefore my investments in my business have waned.”

-Brian Olson, Imperial Coffee, Pierre, SD

“We would like to hire another employee/operator but the uncertainty in this economy restrains our decision. How can we make the commitment to give a stable income to support a household, a car payment, telephone, send the kids to school etc... with the uncertainty that surrounds every aspect of our lives at this time. We are taxed as individuals and then as a corporation or a business from every governing level i.e., from City, County, State to Federal and all in between.”

-Susan Terrell, A-Line Crane Rental Services, Orange, CA

“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…The current economic environment and this administration's 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, Education Technology Partners, St. Louis, MO

“I have had a motto since our beginning in 2006: we can only be as successful as our customers. Well, our customers are facing constant uncertanty from Washington DC. New regulations, budget shifts, consumer concerns, and new health care taxes are some of the characteristics of a very, very uncertain environment. If my customers can't invest because of uncertainty, how can I?”

-Patrick McNally, VI-grade, Dexter, MI

“We are a single owner S Corp. If we are fortunate to have a net profit this year of 200K then, when you add mine and my wife's salary we could end up with a taxable income of 400K. That may sound like a lot, but profit is not cash. We invest our profits back into the business. We're not millionaires, nor are we corporate jet owners, in fact we may have to borrow money to pay taxes. There is something wrong with that. Uncertainty is why small business is not creating jobs. We need the federal government to stop borrowing money. Reduce spending, stop strangling us with regulations, we don't want the federal government to do anything except take care of their own budget and leave ours alone.”

-Ron Kensey, Kennon Products, Inc., Sheridan, WY

"I will instead speak to the uncertainty in the market and the lack of a clear economic plan as reasons that many of us have curtailed hiring (and even growth). Business owners do not hire blindly or make decisions without obtaining all related information first. That said; we will not hire, generally, without first understanding exactly how much we will be taxed for doing so. Simply promising to temporarily suspend additional employment taxes is not enough. I should add that business owners view the mandatory health coverage as an additional tax, assessed against the business, as well. Simply put we are concerned about how much it will cost us to hire additional employees, even at the potential cost of losing business due to not having adequate staffing to provide the service/s needed."

-Eric Morgan, Centurion Private Security, Morro Bay, CA

Associated Builders and Contractors, Inc.

September 13, 2012

The Honorable Joe Walsh
Chairman
Subcommittee on Economic Growth,
Tax and Capital Access
House Committee on Small Business
2361 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Kurt Schrader
Ranking Member
Subcommittee on Economic Growth,
Tax and Capital Access
House Committee on Small Business
B 343-C Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Walsh and Ranking Member Schrader:

On behalf of Associated Builders and Contractors (ABC), a national association with 74 chapters representing 22,000 merit shop construction and construction-related firms, I am writing in regard to the Economic Growth, Tax and Capital Access subcommittee hearing entitled "Adding to Uncertainty: Small Business' Perspectives on the Tax Cliff." With the growing specter of the broadest and steepest tax increase in history, immediate congressional action is necessary to spare taxpayers and millions of small businesses from plunging into the fiscal abyss.

Absent bipartisan legislative agreement, one thing is certain: Every American wage earner faces a significant tax hike come Jan. 1, 2013, ultimately totaling as much as $500 billion. First and foremost, individual tax rates are set to rise for every income level. With pass-through entities such as S corporations and LLCs employing the majority of American workers, these increases will have a devastating effect on job creation and the U.S. economy as a whole. After more than a decade of steady tax policy, these rates will jump across the board, along with rising taxes on capital gains, dividends and succession. What's more, small businesses face $18 billion in new and increased taxes on wages and investments to finance President Obama's health care law. Finally, the annual "extenders" charade has been pushed to the brink yet again, imperiling and ultimately undercutting the efficacy of certain vital business tax incentives.

Just months away from the so-called tax cliff, the two chambers remain dangerously far apart in their respective proposals. House-passed H.R. 8 remains the only bill that forestalls this massive hike in its entirety, and the only measure to enjoy bipartisan support. Senate-passed S. 3412, on the other hand, falls woefully short. By allowing the top two brackets to expire, the bill would mean a double-digit tax increase on 14 percent of small business employers, according to the National Federation of Independent Businesses. A recent study by Ernst & Young also found these tax increases would cost more than 700,000 American jobs and reduce the economy by 1.3 percent while diminishing capital investment and lowering wages on the very middle class the bill is meant to support. With roughly 80 percent of commercial contractors paying business income taxes at the individual level, this scenario would disproportionately harm the construction industry.

Worse yet, the Senate bill ignores the resurgent estate tax burden that is poised to harm family businesses across the board. Under this proposal, uncertain business owners would be faced with an escalated 55 percent rate with a severely diminished $1 million exemption. According to the National Small Business Association, one-third of all small business owners would be forced to sell outright or liquidate a significant portion of their company to pay this punitive tax. In a capital-intensive industry such as construction, with a large proportion of closely-held and family-owned businesses, a reversion to pre-2001 estate tax levels would be nothing short of disastrous.

Rather than exposing American taxpayers and job creators to a perilous fiscal cliff, Congress must act swiftly to extend current policies as a bridge to comprehensive tax reform. We appreciate the committee devoting its time to this important issue, and we look forward to working with you toward the extension of current policies on marginal rates, estate tax, capital gains and dividends, and worthy tax extenders.

Sincerely,

Liam P. Donovan
Director, Legislative Affairs

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STATEMENT FOR THE RECORD

AMERICAN DENTAL ASSOCIATION

BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON SMALL BUSINESS SUBCOMMITTEE ON ECONOMIC GROWTH, TAX AND CAPITAL ACCESS

ADDING TO UNCERTAINTY: SMALL BUSINESSES' PERSPECTIVES ON THE TAX CLIFF

SEPTEMBER 13, 2012

The not-for-profit American Dental Association (ADA) is the nation's largest dental organization, representing more than 156,000 dentist members. The premier source of oral health information, the ADA has advocated for the public's health and promoted the art and science of dentistry since 1859. Mr. Chairman and members of the subcommittee, thank you for conducting a hearing on the very important issue of how small businesses could be affected by the impending "tax cliff." The tax cliff is a combination of tax increases and spending cuts that are scheduled to go into effect on January 1, 2013, and which could trigger a "significant recession" if not adequately addressed according to the Congressional Budget Office.

There are more than 127,000 employer dental practices in the United States and a little over 60 percent of them are incorporated. Virtually all of these dental practices are sole proprietors, S corporations, limited liability corporations, or partnerships where the practice's profits are passed directly through to the owners and taxed as individual income. Like all similarly situated small businesses, employer dental practices would be adversely affected by the potential increase in income tax rates and the phase-out of deductions and exemptions, such as estate, gift and generation-skipping transfer taxes, as well as the phase-out of itemized deductions for high income earners. Dentists who own their practices rely on section 179 expensing of investments in new equipment and dental operatories to expand and update their facilities. The very significant reduction in the amount that can be deducted under section 179 (the maximum write off is $139,000 for 2012 but will drop to $25,000 in 2013) and the continual uncertainty in this area will have a chilling effect on needed capital expenditures in the dental profession.

Dental practices are important economic contributors in their communities, but higher taxes would compound the adverse effects of the economic downturn, making it less likely that lenders will provide necessary financing. Most dentists have at least 4 to 5 employees and virtually all of them buy a substantial amount of supplies each month. With office overhead as high as 60-70% most of the practice receipts are reinvested in the supply chain benefiting the economic growth of the dental industry sector, as well as hiring employees from the local communities. The practices also create employment for dental laboratories that make the crowns and dentures for our patients. The sum of all the taxes will have a chilling effect on dental practices and would make it much more difficult to hire new employees or invest in new equipment and technology.

The ADA is also concerned that the Patient Protection and Affordable Care Act (ACA) could make access to healthcare less affordable and could act as a deterrent to patients seeking oral health care.

- A coalition of organizations representing dentists, dental product manufacturers, and dental laboratories[1], continues to support repeal of the 2.3 percent medical device excise tax scheduled to take effect Jan. 1, 2013. The coalition estimates that the tax will increase the cost of dental care by more than $160 million annually.

- In 2013, there is 0.9 percent payroll surtax on wage and salary income over $200,000 for single filers or $250,000 for joint filers. The Medicare Hospital Insurance (Part A) tax for the Medicare Hospital Insurance (HI) Trust Fund is now 1.45 percent of all salary income, with an equal 1.45 percent paid by employers. Starting in January, 2013, the new tax will be 2.35 percent on all earnings above $200,000 for individuals and $250,000 for married couples. For the self-employed, the rate goes from 2.9 percent to 3.8 percent.

- In 2013, there is also a 3.8 percent tax on some investment income of taxpayers whose modified adjusted gross income (MAGI) exceeds $200,000 for single filers or $250,000 for joint filers. Investment income includes rents, dividends, interest, royalties, and capital gains on property sales (with a partial exclusion for primary residence sales).

The bottom line is the ADA believes increasing taxes on employer dental practices would only succeed in exacerbating an already very sluggish economy and will increase the cost of providing care, and thereby undoubtedly have a negative impact on access to care.

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[1] Academy of General Dentistry, American Academy of Periodontology, American Academy of Oral and Maxillofacial Pathology, American Academy of Pediatric Dentistry, American Association of Oral and Maxillofacial Surgeons, American Dental Association, American Society of Dentist Anesthesiologists, Hispanic Dental Association, National Dental Association, Dental Trade Alliance, and National Association of Dental Laboratories

National Small Business Network

Comments for the Record
House Small Business Committee
Subcommittee on Economic Growth and Capital Access
Hearing on Small Business Perspectives on the Tax Cliff
13 September 2012

Our Current Economic Problems

America is in trouble and the future economic security of our citizens is in doubt. After years of deficit spending, 9.4% of last year's federal budget was spent just paying the interest on past spending, even at today's historically low interest rates. Fiscal mismanagement from too much spending and too little tax revenue has put a burden of over $550,000 in unfunded Federal obligations on every American household. Over the past 4 years federal spending has been 24.4% of GNP but revenue has only been 15.4% of GNP. Last year's official deficit alone was over $1.29 Trillion, and this year's will be over $1.1Trillion, for a total cumulative sovereign debt of over $16 Trillion. This exceeds our entire annual Gross National Product, and is 6.5 times total annual Federal tax revenues. Even these amounts do not include the large unfunded future obligations for federal retirement benefits, veterans benefits, Social Security, Medicare, and Medicaid, which are currently estimated to be over $115 Trillion, or over 48 times total annual Federal tax revenue. Using standard accrual accounting practices that the government requires of businesses, but not of itself, last fiscal year's total unfunded expenditures were almost an additional, $5 Trillion.

The status of the dollar as the world's reserve currency for international transactions is also being challenged, with potentially severe devaluation consequences if it loses that function. Our sovereign credit rating was downgraded by a major rating agency, with warnings from others. The only thing protecting us from significantly higher interest rates for our national debt is the current weak demand for capital and the fact that other major countries have similar debt problems. If Treasury average interest rates rise to just 6%, as some European countries are now experiencing, the annual interest on the debt would consume 39% of current total Federal tax revenue.

The broad "middle class" prosperity that drove our economy for the last 200 years is disappearing as more of our national wealth is concentrated in the top 1% of the population. As of 2007, this top 1% controlled 35% of total personal net worth and 43% of financial assets. From 1982 to 2006 the income of this the top 1% of the population increased from 12.8% of total personal income to 21.3% and the income of the bottom 80% dropped from 48.1% to 38.6% of total income. As an individual's income increases, they generally spend a progressively smaller percentage of their disposable income on consumption which reduces the economic multiplier of their income on the general economy. This decline of our nation's middle class is resulting in declining total consumption and a permanent decline in secondary economy jobs that depended on that spending.

In the past, our technological innovation and high workforce skills increased individual productivity and were a major factor in our manufacturing and economic growth. Today, that advantage is rapidly declining as first the production, then the engineering, and now the research and development of new technologies has moved to other countries. The quality of our education system and the skills of our workforce are also declining in relation to other countries, particularly in key science and engineering areas. In addition, the world has become an open market for both consumers and investors. Much of our nation's individual and business investment is now being directed to stocks and bonds of foreign businesses that hire foreign workers and benefit foreign economies. Ironically, we continue to reward foreign investments with the same special income tax incentives on capital gains and dividends as direct investments made to start or grow an American business that hires American workers.

Our current partisan political process seems unable to confront and correct these problems, even though adequate information is available to recognize the problems and develop workable solutions. Political conflict has let these problems grow into a national and international economic crisis that resulted in the recession we are still facing and a loss of faith in America's future. After last year's failure of the Special Select Committee on Deficit Reduction to overcome these political biases, **solving this economic crisis is now the responsibility of every member of Congress**! Although the scale is much larger, the government's problems of expense control, income generation, and maintaining credit worthiness are really no different than those faced everyday by America's businesses and families. If Americans can logically solve these problems as individuals, why can't we resolve our economic problems as a nation?

The following recommendations may not be politically easy to implement, but every year we fail to correct the problems, the consequences of inaction, and the costs of correction, grow larger. Collectively these economic issues present just as much a risk to America, and our citizen's way of life, as any foreign military threat. Many members of the Congress served our country in the armed services. Overcoming these economic threats will require the same patriotism, sacrifice, and a willingness to work together for the common good.

It is time to put aside partisanship and political self-interest. It is time to think about the economic security of our country, of our children, and of the generations that will follow. It is time to Put America First!

These policy recommendations are based on data from recent reports by the JCT, CRS, CBO, special Presidential Commissions, and numerous economic research organizations. Many of these background reports are available on the NSBN website at http://www.NationalSmallBusiness.net/issues.htm. This report focuses on using the extensive information available to make logical, information driven, non-partisan, recommendations for re-building a sustainable American economy.

The Goal:

We share the general goals of the President's Commission on Fiscal Responsibility and other deficit reduction research groups for progressively returning to a sustainable federal fiscal policy. Most have suggested an initial 10 year plan, starting with the 2012 budget, to progressively eliminate annual deficits and reduce the federal debt to 60% of GDP by 2025, and 40% of GDP by 2035, while keeping maximum total Federal tax revenues below 21% of GDP. We also share the conclusion of the other groups that **deficit reduction will require both significant spending cuts and some revenue increases**. We believe that about 60% to 75% of deficit reduction should come from tighter budget control over all areas of federal expenditures, including "entitlement" programs and military spending, with the remainder to come from additional tax revenue.

Congressional actions needed NOW in 2012:

Unfortunately, our fiscal problems have now reached critical mass as past attempts to stimulate the economy with tax cuts and deficit spending are all expiring this fall, potentially creating a perfect economic storm. The projected deficit will also again require an increase in the national debt limit with the potential of a congressional deadlock which could result in a default on our national obligations, and severe international economic impacts. In addition, unless Congress enacts a more logical deficit reduction program, we face mandated budget sequestration under the Budget Control Act of 2011, which will impact the economy by reducing governmental purchasing.

Even with the potential short-term economic consequences we recommend that the 112th Congress:

I. **NOT Continue to cover up the hard realities.** Instead, the Administration and Congress should demonstrate clearly to American tax payers, to the holders of our national debt, and to the rest of the world that the Congress recognizes the severity of our fiscal crisis and can work together, regardless of personal political considerations, to reduce government expenditures, increase revenues, and reduce the debt. Until everyone "feels the hurt" rational budget and tax reform will not be politically possible.

II. **Change the requirements of the Budget Control Act of 2011 in only two ways.**
   a. **Reduce the FY2012/13 mandated reductions by 50%** to adjust for the first full year's cuts being applied over only 9 months, and to give federal agencies, program recipients, and the overall economy, a year to transition to the new budget realities.
   b. **Change the reduction allocation formula** from the adopted GRH language that applies the cuts across the board at the individual program level which is inefficient and illogical. Instead, apply the budget reductions at the agency level. Rather than weakening all programs, this would allow agencies to identify and adequately fund the most important and effective programs and eliminate less important programs and their administrative expense. All agencies should then be required to report to Congress before the end of the fiscal year to explain the basis on which they prioritized the remaining funding and their program priorities for future budget years, the allow Congressional review.

III. **Allow the 2001, 2003 "Bush" tax cut provisions to expire as scheduled on 12-31-12.** The country can no-longer afford the loss of revenue from these tax cuts and the effect they have had on the economy. In 2013 the Congress can develop more strategic and effective tax reform proposals to enhance long-term economic growth as outlined below.

IV. **Pass by November an extenders package of the highest economic impact tax expenditure incentives** which expired last year or will expire on 12-31-12 as included in House W&M and Senate Finance committee approved bills. The highest long term economic benefit from tax dollars comes from targeted incentives for long-term private domestic investment in businesses and infrastructure, not from public works projects.

V. **Pass, with bi-partisan support, an increased federal debt limitation along with an enhanced resolution to control deficit spending and start to reduce our national debt.**

Congressional actions needed in 2013 and beyond:

We believe that the public debt is now so large in relation to the country's expected economic potential and current tax revenue collections that building sustainable economic growth and reducing the debt will require immediate action by the 113th Congress in at least six areas.

1. Budgeted Program Expenditure Control Recommendations:

The purpose of government is to provide a stable structure in which people can live and work, and to provide important services collectively that individuals cannot effectively provide for themselves. Unfortunately the federal budget has grown so large that it is difficult for decision makers to evaluate its program effectiveness, or understand the long-term economic impacts of spending policies.

A. **Develop a multi-tiered performance based budgeting process** similar to successful businesses and several state governments which have "re-invented" their budget processes. Congress should regularly evaluate program expenditures and agency budgets in relation to the value and efficiency of the services delivered. This approach rewards the program's current importance to citizens, rather than historical expenditure levels. Prioritization based on clearly defined performance measures should occur at the program level, department level, and finally between agencies. The process should focus on minimizing "non-value added costs" that do not significantly improve service delivery, and on identifying programs that provide the greatest benefit to taxpayers in relation to their cost. Current service level, "use it or lose it" budgeting, or "across the board" percentage reductions such as sequestration, often waste resources on in-efficient or unneeded programs, and under-fund more beneficial programs. Review and replace, when possible, intergovernmental and private contractor "cost plus" reimbursement agreements, which often reward inefficiency, with programs that reward cost reduction.

B. **Put a greater emphasis on analyzing the broader economic impacts of all legislation** and budget allocations prior to adoption. Too often legislation is crafted to look revenue positive during the 10 year scoring period without considering longer term revenue consequences. A perfect example was Congress using the short term tax revenue from allowing the conversion of taxable IRAs to Roth IRAs to "pay for" the Bush tax cuts, without considering the long term loss of tax revenue. Revenue scoring also often focuses only on potential federal tax revenue without adequate consideration of the governmental administrative costs and private sector compliance costs. The now repealed expansion of Form 1099 purchase reporting in the 2010 health reform bill was an example of this.

C. **Develop a stronger and more detailed 10 year running budget and revenue plan** for the federal government with a congressionally adopted policy to keep expenditures below projected revenues over the 10 year period with a goal to reduce the national debt below 60% of GDP by 2025.

D. **Using the 10 year budget plan as a base, assure that annual budgets are evaluated by the Congress and approved at least 3 months prior to the start of each fiscal year.** This would allow agencies to more efficiently make transitions needed for future funding and program changes. Doing this will require catching up on the budgeting process and making it a top priority at the start of every congressional session. The recent habit of not passing agency budgets until well after the start of a budget year shows a basic lack of proper control over the expenditure process, and encourages wasteful spending and program disruption. The government should also search for and reclaim unused prior year grants and revenue sharing expenditures and reuse the funds in current budgets.

E. **When short-term economic stimulus or "emergency" deficit spending is needed to help the economy through cyclical downturns or disasters, legislation should provide a source of offsetting revenue** later in the 10 year budget planning period. The focus of any short term economic stimulus incentives should also be on creating long-term jobs that are likely to continue beyond the funding period.

F. **Develop a bi-partisan strategic National Economic Growth Plan** identifying the best potentials for future international traded sector economic growth. Identify, and invest in, the kinds of education and training programs needed to develop the workforce skills to successfully compete with other countries in the future. This will also reduce the need for foreign workers to provide needed skills. Maintain and improve our economic infrastructure and develop sustainable energy sources needed for the future. Improve government programs, regulatory policies, and tax policies to encourage and support future economic growth in these key economic sectors, within the legal limits of international trade agreements.

G. **Expand the roles of the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), and the Government Accountability Office (GAO), to help the Congress better evaluate the comparative performance and cost efficiency of agencies and programs.** Detailed and unbiased evaluations of program performance and value are necessary for a successful performance based budgeting process.

2. Off Budget Expenditure Control Recommendations:

A. **There should be no continuing off budget expenditures**, for military activity, disaster assistance, or any other purpose. Congress should review and approve supplemental budget authorizations for any non-budgeted expenditures at least every 6 months, including making adjustments to other budget items, or providing additional revenue if necessary. Recurring "emergency" spending needs, such as disaster assistance, should be budgeted for based on average expected expenditures. There is no value to having a budget for fiscal control unless all significant expenditures are included.

B. **Congress must also prevent the growth of unfunded future budget commitments** such as federal employee retirement benefits, veteran's benefits, or other programs, by properly accounting for estimated future liabilities and providing adequate reserves in current program budgets for the future payments. For example, the VA indicates that almost 45% of the 1.6 million veterans from the Iraq and Afghanistan wars are seeking disability compensation. When possible, convert new federal employee and military retirement benefits from defined benefit programs to defined contribution plans which will automatically prevent the growth of unfunded pension obligations.

3. Regulatory Program Recommendations:

Regulatory programs are an important function of government, but also result in both regulatory agency expense, and significant non-value added compliance costs for businesses and individuals. The Federal government should expand, and make permanent as part of the regulatory process, a "Regulatory Efficiency Initiative" building on recent efforts by the Administration and Congress. Much of the non-value added cost of the current regulatory structure results from poor regulatory design and poor coordination of new regulatory legislation with the existing regulatory processes of other Federal agencies and with state regulatory processes. The result is overlapping regulatory responsibilities and duplicate administrative costs, as well as duplicate reporting and compliance costs for businesses. Unfortunately regulatory agencies, like other organizations, naturally seek to enlarge their responsibilities, employee base and budgets. Without careful Congressional oversight, regulatory programs can grow beyond their original need adding to governmental cost and private sector burden.

A. **When budgeting for regulatory agencies, Congress should demand increasingly efficient performance results**, and should base program funding, and state government or private sector cost reimbursements, on the use of the most efficient administrative processes and technologies. This would include improving economies of scale from using or combining existing agencies and administrative processes, and using combined reporting and compliance programs with state governments when appropriate. State government program partners and private service providers should be required to use standardized electronic reporting and accounting software to reduce costs and improve program accountability. The non-value-added cost impacts on the private sector, on state governments, and on the economy, must also be considered in evaluating the need for, and performance of, all regulatory programs.

B. **Expand the responsibility of the OMB, CBO, and GAO to assist the Administration, the Congress, and agency management in developing a more coordinated and economically efficient regulatory structure.** This could include recommendations for consolidating similar federal regulatory requirements, reporting processes, and possibly agencies. The process should also include continuation and expansion of initiatives to work more directly with the states to coordinate taxation and regulatory programs, and share reporting information and regulatory overhead costs.

4. Tax Policy Recommendations:

High taxes are not the cause of our current economic and under employment problems. With the exception of payroll taxes, most American businesses pay Federal taxes only when they are profitable. The current federal tax level on individuals and "pass-through" business entities is lower than it was during times of economic prosperity and growth, and is lower than most other leading industrial nations. The tax rate on large corporations appears higher than the stated tax rate of other nations, but when adjusted for US business tax incentives and other taxes imposed by foreign countries, such as value added taxes, it is similar to other leading industrial nations.

For the past 10 years tax rates have been lower than historical averages, particularly on the wealthy who are receiving an increasing percentage of all income. This is a major cause of our spiraling debt. The lower rates encouraged speculation, but as the last 10 years have proved, they did not promote sustainable economic growth. A common definition of insanity is doing the same thing again and expecting a different outcome, and we can't afford to continue the current economic trends.

Tax law can be a major factor in economic decisions by both businesses and individuals, including the selection of their type of business entity. It is also one of the few remaining strategic tools to provide targeted economic incentives for domestic business growth. International agreements now limit our ability to use tariffs and other trade restrictions. Other nations such as China have used domestic tax policy very effectively to target international economic growth. Tax policies that "broaden the base and reduce the rate" would reduce the ability of Congress to provide such strategic incentives. Flat tax structures will encourage speculation instead of long term direct investment, and encourage movement of investment capital anywhere in the world the potential return is highest. This may benefit wealthier investors, particularly if capital gains rates are lower, but may also result in a declining national economy, increased unemployment, and unsustainable national debt.

A. **Selectively increase the total Federal tax burden up to a maximum of 21% of GDP with all the increase dedicated to reducing budget deficits and the debt**, until the debt is reduced below 50% of GDP. The current total federal tax burden, including, income tax, payroll tax, corporate tax and estate tax is estimated to be about 18 % of total GDP. The largest share of this additional tax revenue should come from high income taxpayers who benefited the most from the low tax rates of the last 10 years. Much of this revenue increase would occur just by allowing prior tax reductions to expire as scheduled. Unfortunately the additional 3.8% investment tax provisions of the PPACA will increase the tax burden, but not produce significant net revenue for deficit reduction because of increased program costs. When individuals benefit from something, they understand their obligation to pay for it, even when that is difficult. Congress also needs to understand it's obligation to the nation, and to future generations, to pay down our debt from past expenditures, regardless of political motivations.

B. **Reduce the economic impact of higher maximum personal tax rates on small business growth, by separating out, in the personal tax code, a category of "Small Business Operating Income" (SBOI).** This would be income that a taxpayer receives from pass-through business entities or from a Schedule C or F in which the taxpayer actively participates. By doing this, Congress could provide much better targeted incentives such as lower tax rates or special deductions. This would incentivize small business reinvestment and growth, without the high revenue loss that results from tax reductions on all forms and sources of personal income. Treasury research found that only 20% of the benefit of the personal tax reductions in the Bush tax cuts went to pass-through business entities that have employees.

As many economists and others have pointed out, increasing maximum rates on personal income may discourage small business investment and growth which has been the best source of net employment growth. This is because most small businesses are "pass-through" taxpayer entities that report their business income on their personal tax return <u>on top</u> of their other normal salary and investment income. As a result, small business income is often taxed at the maximum personal tax rate and also causes the phase out of the individuals AMT exemption. This adds additional tax burden on small business income and discourages reinvestment and business growth.

Separate treatment of a limited amount of active business income would encourage small business growth, and allow better equality with the effective tax rate on larger businesses, particularly if C corporation rates are reduced. It would also give business owners an incentive for reinvesting in their business, rather than municipal bonds or dividend paying stocks which offer lower risk and higher tax benefits. The provision should not apply to investment partnerships or other holding companies which are not active businesses. A maximum limit on the special treatment of this income of perhaps $500,000 per taxpayer could limit the total amount of the tax expenditure. This would encourage direct new domestic business investment in equipment, facilities, and employees rather than speculative investments in the secondary market, and even foreign markets, which currently receive preferential tax treatment. To prevent the incentive from being nullified by the Alternative Minimum Tax, a matching tax treatment for this income must also be added to the AMT provisions.

C. **Adjust the calculation of capital gains to remove inflation distortions.** Long-term equity capital investment provides stability for a business and for the economy. However, much of the taxable "capital gain" from the sale of a truly long-term investment is actually just the monetary inflation that occurred over the investment period. The true value or purchasing power of the sale proceeds may be no greater than the economic value of the original investment, even though there may be a significant "taxable" gain. Using Bureau of Labor Statistics (BLS) inflation data, the percentage of taxable gain resulting <u>just from monetary inflation</u> for a business or other asset sold in 2012 is 82% for investments that had been held 40 years: 56% for 30 years, 39% for 20 years and 22% for 10 years. Taxing this inflationary change, rather than the true economic gain is unreasonable and unjust. More importantly, failure to adjust for inflation makes the optimum tax incentive holding period for capital assets just 366 days. This encourages short term speculation, and discourages long term capital investments needed for economic growth. Rather than a lower flat rate on investments held for 366 days or more, the amount of taxable gain on investments held more than a year should be proportionally reduced by adjusting the basis amount by the monetary inflation over the investment period. The adjustment would be a simple multiplication based on an IRS published grid of cumulative BLS year to year inflation change data. Although recent inflation has only been 3% or 4% the Federal Reserve has been increasing the money supply at 8 to 10 time the true economic growth rate which could lead to dramatically higher inflation in the future.

If any special tax rate is continued on capital gains, limit the special rate to capital gains on sales of US corporation stocks or other US based assets. Winning or losing on shorter term secondary speculative investments such as traded stocks or other financial instruments, particularly foreign investments, provides no more direct benefit to business growth or the economy than gambling in Las Vegas. "Carried interest" income for investment firm general partners should also be taxed at regular income rates.

D. **Review all tax expenditure provisions and tax rate incentives for their true value** as an economic and employment incentive. Reduce or eliminate those of lesser value. Continue or expand the targeted tax incentives such as business deductions, credits, and accelerated write-offs that most effectively support direct domestic business investment and employment. To get the best impact from tax expenditures do not waste resources on retroactive incentives, or general tax reductions that are not directly linked to increased investment, employment, or other desired economic activity.

E. **Allow the 2003 "Bush" tax cuts to expire**, including the lower rates and across the board reductions for capital gains and dividends. Congress should use this additional revenue to reduce the deficit and provide more targeted tax incentives for direct investment in domestic businesses that employ Americans. Treasury research found that only 20% of the benefit of the personal tax reductions went to pass-through business entities that have employees. The loosely targeted Bush tax reductions provided an equal incentive for individuals to make foreign stock investments as well as domestic investments. They also provided an equal incentive for speculative investments such as traded stocks, financial derivatives, and even short sales of stock, instead of actual long term direct investment to start or grow a business and create jobs. This contributed to the speculative bubble, and the eventual economic collapse, that created the need for massive stimulus programs, which further increased the debt.

F. **Expand the roles of the Joint Committee on Taxation and Congressional Budget Office** to provide the Congress with a broader analysis of the long-term economic impacts of proposed tax legislation, including government and private sector administration costs, in addition to the scoring of short term federal revenue impacts.

G. **Enact simple, consistent, targeted tax incentives for business investment in depreciable capital equipment and nonstructural real property** improvements of up to $500,000 in purchases per year. A higher limit could be provided for industry sectors identified in a national economic growth plan as having the highest potential for increasing export sales and American job growth. Limited provisions should also be made to allow deduction of nonstructural business real property improvements to property owned by the business owner under the same terms as leased property.

H. **Restore some of the historic progressivity of the tax code** which has been reduced in recent years in both the income tax and estate tax rate structure. Add a 42% tax rate for joint filer taxable income over $5 million until the debt is significantly reduced. Adjust the Estate Tax progressive rate brackets so they apply progressive rates on taxable estates above the $5 million exclusion. If a lower tax rate is continued on dividend income, limit the lower rate to the first $250,000 of joint filer dividend income, or $150,000 for single filers.

I. **Modernize and simplify the tax code, and provide targeted tax expenditure incentives that promote small business growth and job creation.**

J. Provide better equality in the Alternative Minimum Tax exemption on small business income with C corporation income.

K. Remove the remaining listed property reporting requirements on portable business computers and communication equipment.

L. Permanently equalize the deductibility of self-employed health insurance premiums.

M. Limit and simplify state income tax and business activity taxes for out of state businesses which restricts interstate commerce and can add a heavy administrative burden on businesses without significantly increasing total state revenues.

N. Improve the incentives for direct equity investment in small US businesses.

O. Provide equitable employee "cafeteria" benefit options for pass-through businesses.

P. Modernize the outdated "luxury" automobile depreciation limits.

Q. Update and coordinate all tax code inflationary adjustment provisions.

R. Return the contribution date for regular IRA investments to the extended due date to encourage retirement contributions. Change Roth IRA limits to allow direct contributions from higher income individuals without a two-step transfer.

S. Revise the tax code provision requiring Form 1099K reporting of payment card processing to require processors to report the net payment amount after credits, cash advances, and processing fees, rather than the gross purchase amount.

A more complete analysis of these issues may be found on our website at www.NationalSmallBusiness.net in the policy paper on "Small Business Tax Code Modernization."

5. Social Insurance Program Recommendations:

The funding deficit for the social insurance programs, Social Security and Medicare, deserves separate evaluation, because they are dedicated programs with a separate payroll tax funding source. Both programs are currently underfunded for their projected future benefit payout and have a negative cash flow. This is a result of rapid growth in benefits paid out for the large number of "baby boomers" now retiring with substantially increased life expectancies, and a declining growth in the working population and average taxable wage base. The problem was compounded by the 2011-12 reduction in the employee FICA tax rate as a short-term economic stimulus. Making these programs sustainable is technically simple, as any insurance actuary knows, and should have been done years ago.

There are only 3 options to restoring stability – Increase the payroll tax rate or maximum wage limit; further limit the benefits to those most in need; or provide additional funding for the programs from general revenue sources. In selecting a balanced solution from those alternatives it is important to remember that the programs were intended as "social insurance" safety nets for those who need them most, not as pre-paid benefit programs for every citizen. People buy many kinds of insurance every year; even though most never collect any actual benefit from it. If current benefit levels are going to be continued with projected participant levels, payroll taxes would have to increase on current wage earners, with negative economic impacts. The current payroll tax base limits for the programs are also regressive by limiting the tax contributions from higher income wage earners while taxing all the wages of lower income workers.

A. **Increase the Social Security early retirement, and full retirement, ages** to better reflect current life spans and working patterns.

B. **Continue the current method of taxing Social Security benefits to reduce the net after tax benefit** to those with other income. The estimated value of the taxes paid on social security benefits should be transferred from general revenues to the Social Security "trust fund."

C. **Continue to work to reduce the actual cost of health care**, particularly "end of life" care, which is the major cost factor for both individuals and the Medicare and Medicaid programs. The provisions of the 2010 PPACA did not adequately reduce overall health care costs and additional health care cost control reforms are needed including limitations on high cost - low benefit services

D. **Remove the Social Security taxable wage limitation so it matches the Medicare program provisions.**

6. Workforce and Population Recommendations:

The root cause of any long term governmental deficit is a cost of governmental services that exceeds the economic and tax revenue contribution of its citizens. As a result, an important factor in restoring economic sustainability is the composition and average economic productivity of the US population. Two hundred years ago we had a vast continent, with seemingly unlimited resources and a great need for people to develop it. We now face a different world where technology advances in agriculture, manufacturing, and most other types of businesses, have reduced our need for labor in relation to our GDP. This has been compounded by a "flatter world" which has caused many of our middle income jobs to be "out sourced" to lower cost foreign workers in foreign economies, reducing the domestic economic multiplier of our consumption expenditures.

The percentage of our population who are unemployed, under employed, unemployable, or prematurely "retired", continues to grow. Many citizens simply do not have the skills needed for todays higher value, higher income jobs. This results in lower per capita economic productivity, lower consumer spending, and greater need for governmental social program expenditures, but with lower per capita income tax and payroll tax revenues to pay for the government programs.

A. **Develop a more comprehensive national economic and workforce redevelopment plan**. Target Federal tax incentives and education programs toward developing the workforce skills needed to compete in the future world economy.

B. **Provide stronger incentives in unemployment and social welfare programs** to get more recipients into retraining and work experience programs. Partner with private businesses, trade groups and state Employment Departments to develop training programs to match specific regional workforce needs.

C. **Provide significant, simple and consistent incentives for business to hire and train military veterans, the disabled and displaced workers.**

D. **Stop avoiding the issue of immigration policy reform.** Review and update US immigration laws to resolve long standing issues such as: the quantities and skills of foreign guest workers needed for the current economy and the process for admitting them; the status and citizenship options of long-term illegal alien residents and their children; and the current need for giving automatic citizenship to children born in the US of non-citizen parents.

7. Monetary Policy Recommendations: *The last Option*

The last option to reduce the national debt burden is to use the government's ability to simply print more money to pay our national debt. It is the simplest alternative, but also one of the worst. Monetary policy decisions are made by the Federal Reserve Bank, not the Congress. Since August of 2009, the Federal Reserve has increased the M1 monetary supply by over 20% and during the last 12 months it continued to increase it at an 18% seasonally adjusted rate. This is well beyond the growth rate of the economy. Much of this monetary expansion is being used to "purchase" Treasury notes to fund the deficit in an accounting maneuver that would be illegal in the private sector. When the money supply is increased significantly beyond the growth rate of an economy the potential for future inflation and devaluing of the currency can occur.

Much of our money supply is currently absorbed by its role as the world's "reserve" currency for international transactions and foreign bank reserves. If we increase the supply to a level which foreign and domestic holders see as excessive, they may abandon the dollar and move to other currencies or exchange systems resulting in a rapid excess supply of dollars and devaluation. If excessive growth in the money supply results in higher inflation, the true value of every American's savings and investments is reduced and the cost of basic necessities such a food and energy increases. In addition to the negative impacts on every American's life, particularly on our poorest citizens, high inflation rates will increase federal program costs and borrowing interest costs, which may increase the national debt, rather than reduce it.

Working together, we can correct our fiscal crisis, reduce our national debt, and rebuild a sustainable economy. But, we can only do it if we put politics aside, and <u>Put America first!</u>

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