TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

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U.S. Senate Committee on Finance

"Tax Reform Options: Marginal Rates on High-Income Taxpayers,
Capital Gains and Dividends"

September 14, 2011

Good morning, Chairman Baucus, Ranking Member Hatch, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee continues to look at tax reform. In particular, I appreciate the opportunity to discuss individual tax rates, an especially important issue for small business owners.

The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. We represent businesses in a number of industries and of various sizes, with the average member employing between 8 and 10 employees.

Taxes and tax rates are regularly a concern for small business owners. According to the most recent NFIB Small Business Economic Trends Survey (SBET), taxes rank third as the most important problem facing small business. For the majority of the last year, taxes have been the second most important problem after lost sales.

Tax rates in particular are a major concern for small business owners. Federal tax rates ranked third out of 75 issues in the most recent NFIB Research Foundation's Small Business Problems and Priorities survey.[1] In fact, noting how important taxes and reforming the tax code is to small business owners, four of the top ten issues identified in the survey are tax-related.[2]

Choice of Entity and Individual Tax Rates

Individual rates are especially important to small business owners because the majority of them – about 75 percent - structure their businesses as pass throughs.[3] No matter what business entity the small business owner chooses, you cannot separate the business owner from the business.

The business structure is chosen for a variety of reasons. According to an NFIB Small Business Poll of the few businesses that changed their business structure, 39-percent of small businesses changed to avoid liability and 27-percent for tax reasons.[4] Liability and tax issues were the top two responses. From a tax perspective, the pass through model makes sense for the typical small business. A small business has fewer financial resources than a typical larger corporation, so to pay a double tax – first at the corporate level and then on wages or on a return of business investment - would be especially onerous.

While a business structure like a sole proprietor or a partnership will protect the business from double taxation, the liability protection that a C-Corp offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. The Tax Reform Act of 1986 made several changes to the taxation of S-Corps, reducing the tax liability for small businesses, but also providing the liability protection of a C-Corp. The passage of those changes has led to a substantial increase in the number of S-Corps. In 1985 22-

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

percent of all corporations were S-Corps, by 1990 the figure has risen to 43-percent, and today the majority of corporations are S-Corps.[5]

Pass Through Businesses and the Economy

As the Committee continues to consider tax reform, it is important to keep in mind the importance pass through businesses play in the economy.

Pass through businesses have been a growing source of entrepreneurship. From 1985 to 2005, the number of S Corps increased from 725,000 to 3.7 million and from 1993 to 2005 the number of LLCs taxed as partnerships grew from 17,000 to almost 1.5 million.[6] Many of these are small businesses, which account for about 50 percent of GDP and 50 percent of employment in the overall economy.[7]

A recent study further highlights the role pass through businesses play in the U.S. economy and how they may be impacted by tax reform.[8]

Based on 2008 tax data, pass through businesses represented 95 percent of all business entities. These businesses employed a majority – 54 percent – of the total private sector workforce.[9] In fact, in all but two states – Delaware and Hawaii – pass through businesses accounted for a majority of the private sector workforce. In six states – Idaho, Maine, Montana, South Dakota, Vermont, and Wyoming – they accounted for more than 60 percent of the private sector workforce.[10]

Pass through businesses also report a considerable amount of income. Between 2004 and 2008, individual owners of pass through businesses reported 54 percent of all business net income.[11]

Individual Tax Rates and Pass Through Businesses

Because of the important role these businesses play in the overall economy - and especially for small businesses - as the Committee focuses on tax reform, it is important to examine the individual tax provisions. As many have said, the goal of tax reform is to create a simpler tax code that encourages economic growth. To achieve these goals, individual tax rates must be part of any tax reform plan.

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[5] *SOI Bulletin*, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data – table 13, Winter 1999-2000.
[6] *Treasury Conference on Business Taxation and Global Competitiveness, Background Paper*, U.S. Department of the Treasury, July 23, 2007.
[7] *How Important is Small Business to the U.S. Economy,* Frequently Asked Questions, SBA Office of Advocacy. (http://www.sba.gov/advocacy/7495/8420).
[8] Carroll, Robbert 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.
[9] Ibid.
[10] Ibid.
[11] Ibid.

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

At the same time, some have proposed raising taxes on those pass through businesses reporting more than $200,000 or $250,000 in income. The owner of a pass through business may report a higher amount of income on their return than they actually take home, but that income is the money invested back into the business. This is the capital they use to purchase new equipment, pay the salary and benefits of workers, and meet day-to-day expenses.

Exactly who are the businesses most likely to be impacted by an increase in higher individual tax rates? An NFIB Research Foundation poll, combined with U.S. Census Bureau statistics, indicates that the businesses most likely to face tax increases are businesses that account for a substantial portion of the workforce. The NFIB survey shows that about 10% of small business owners report more than $250,000 in income and the businesses most likely to report income above that threshold are firms with 20 to 250 employees. In fact, over 30 percent of firms with between 20 to 250 employees would see their taxes increase if the individual rates are increased for those reporting more than $250,000 in income.[12] In 2007, these businesses accounted for over one-quarter of the U.S. workforce, employing about 33.5 million workers.[13]

Regardless of how many small businesses would be impacted by this tax increase, simply drawing a line in the sand at $250,000 is a blunt instrument, meaning that some small business owners will see their taxes increased. When state and local tax rates, many of which are also going up, and new taxes included in the Affordable Care Act are included these small business owners could see their tax rates climbing above 50 percent.

Tax increases can have a negative impact on business investment. As one study notes, a 5 percent increase in the individual tax rate, reduces by 10 percent the number of entrepreneurs making new capital investments and reduces the likelihood of hiring workers.[14] At a time when we are trying to promote business investment and job creation, why would we also be pushing policies that reduce investments and hiring?

An increase – or even the threat of an increase – in the taxes these businesses will pay can drive business decisions. The change could be delaying a one-time investment, since the more money that comes out of the business to make tax payments means less money the business owner has to spend on the business. Tax increases could also impact more complicated decisions like choice of business entity.

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[12] *Finance Questions – NFIB Small Business Poll,* NFIB Research Foundation, Volume 7; Issue 7: 2007.
[13] U.S. Small Business Administration, Office of Advocacy, based on data provided by the U.S. Census Bureau, Statistics of U.S. business 2006.
[14] Carroll, Robert, Douglas Holtz-Eakin, Mark Rider, Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," Working Paper No. 6374, National Bureau of Economic Research, January 1998.

Of courses, as long as a business owner is paying taxes, they will factor the tax implications into their business decisions. As the Committee looks at the tax code, a goal should be to minimize the impact taxes have on business decisions as much as possible. With the economy continuing to struggle, especially for small businesses, the tax implications of various business decisions will be even more closely considered and the threat of an increase will drive even more decision making.

Tax Reform and Individual Rates

Small business owners are encouraged, but wary, that Congress is turning its attention to tax reform. Taxes are a consistent concern expressed by small business owners. While they are encouraged that Congress wants to address their concerns, they are wary because they continue to hear about tax increases.

Much of the discussion around tax reform has focused on the corporate tax rate. Addressing the current corporate tax rate, especially as it relates to the rate being paid in other countries, is important. In addition, many small business owners are organized as C corps, so addressing the corporate rate would be beneficial to them.

Any tax reform plan that wants to encourage economic growth should include individual rates and pass through businesses. Focusing simply on the corporate rate could put the owners of pass through businesses at a distinct disadvantage. With a potential rate increase and the potential loss of business deductions, pass through business owners could see a substantial change in their tax position. Such unbalanced changes could force business owners to make costly changes to their business.

Tax reform should support these businesses, making it easier to run their business and provide opportunities to grow and make new investments. As our economy continues to struggle, in particular as it relates to job creation, putting the businesses that account for more than half of the private sector workforce at a disadvantage makes little sense.

In addition, tax complexity and the cost of tax compliance is a major problem faced by small business owners. In fact, small business owners pay 67 percent more to file their taxes compared to larger businesses.[15]

Some of the complexities in the code are in deductions and credits, meaning for a small business owner to take advantage of a tax benefit they have to rely on accountants and other consultants. Simplifying the code by examining some deductions and credits provides Congress with the opportunity to lower rates. This means small business owners can keep more of the money they earn and make the kind of investments that are best for their business.

Adding to the complexity is the constant changes in the tax code. With many provisions expiring from year-to-year, it has become harder for business owners and their advisors to plan. A good example is the individual rates. While the extension of the current rates for two years

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[15] Crain, W. Mark; *The Impact of Regulatory Costs on Small Firm*, Small Business Research Summary, SBA Office of Advocacy; September 2005.

was a step in the right direction, many small business owners are once again facing a tax increase if those rates expire. Business conditions change and business owners have to work through good times and bad. But they should not have to face the same kinds of ups and downs because of constant changes in the tax code.

Finally, Congress should work to keep the capital gains rates low. Keeping the capital gains rate low is an incentive to invest in capital assets with the certainty that any gain realized on that investment will be subject to a lower rate of tax.

Tax reform is an opportunity to address the major tax impediments that impact small business owners and to strengthen the overall economy. The current tax code is a challenge for all taxpayers – small and large businesses, as well as individual taxpayers. The Committee's focus on individual tax rates, capital gains, and dividends is an important step in examining the entire tax code. We look forward to working with the Committee to minimize the tax burden on small businesses and establish a simplified, more growth oriented tax system.