To: Senate Finance Committee

Attention: Subcommittee on Business Income Tax

Subject: Graduating corporate taxes

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About Bill Parks

- Founder and President, NRS, Inc. 1972 to present. Started with $2,000, and now 100% employee owned, NRS has grown to over $40,000,000 in sales and is the world's largest paddlesports accessory provider.
- Finance Faculty Univ. of Oregon, Colorado State Univ. and Univ. of Idaho 1965-94.
- PhD. in Finance and Economics, Michigan State University
- Accountant, Cadillac Division, General Motors Corporation, 1958-60.

Make America the Best Place in the World to Start and Grow a Business[1]

Stirring words, but history shows that in recent years few have understood the needs of dynamic small business and as a result the tax code has often discriminated against growing a small business, most recently in 1986.[2] At that time liberals were upset to discover that owners of successful small businesses were likely to be high net worth individuals. Evidently the lower tax rate for very low profitability bothered them so that they wanted to retrieve the money lost from that tax break. Thus liberal's desires to avoid rewarding these individuals meshed with the conservatives' desire to allow small business owners to avoid corporate taxes altogether. The result was a greatly expanded opportunity for small businesses to become S corporations but to mollify liberals; small businesses that remained C corporations were subject to a surtax. This 39% marginal tax rate on income between $100,000 and $335,000, "the Nasty Notch", [3] has the unintended consequences of not only discouraging C corporation formation, but also causing existing, small C corporations to switch to S corporations or LLCs. In so doing, small businesses have successfully avoided the corporate tax, but at the same time, missed the opportunity to retain the earnings critical to grow successful businesses. Neither liberals nor conservatives seem to have understood the economic implications of this change. Now there is momentum to revise the corporate income tax by removing various tax expenditures and loopholes. An important revision would be to encourage the formation of C corporations by reducing the tax rate for small business up to $1,000,000 and removing the surtax to reclaim the lower tax rate paid on lower earnings.

Don't Eat the Marshmallow

Research shows that some children have more patience than others and that those with more patience have improved their life's outcomes in many ways. The way that the child research was done was for the researcher to tell the child that he or she could have one treat now or if they waited until the researcher returned—two treats. A child that waited generally had a more successful life measured in many ways: did better in school, less likely to get divorced, higher lifetime income, Etc.

We would be horrified to learn that there had been a concerted effort over almost thirty years to convince children that it was better by far to go for the immediate reward. But what if this was done with the best of intentions by people that thought they were doing the child a favor?

Training children to chose the immediate reward would be considered at best unethical and if applied widely to harm society. And yet the federal tax system is set up to entice budding entrepreneurs to "Eat the marshmallow now".

The lesson is we won't give you the second marshmallow because you are likely to grow up to be a high net worth individual. The government will penalize you if you try to wait for the second

[1] President's Deficit Commission, Co-Chairs' Proposal, draft 11.1.10 page 22
[2] Representative Camp proposed, though most likely inadvertently, to continue to discourage the formation of C corporations.
[3] The "Nasty Notch" refers to the increase to 39% for income between $100,000 and $355,000.

marshmallow. Yet, we know that those that wait are more successful. Furthermore, the economy benefits when children AND entrepreneurs delay gratification.

How can it be that entrepreneurs are penalized for success and that it is not by accident? Since the Stone Age we have known "Don't eat the seed corn". Many companies are not started with the intent to create an opportunity for growth but to provide a job for the owner. For these companies S corporation, and particularly the LLC, statuses are the perfect vehicle for business because they provide the protection of limited liability without the extra tax burden. These businesses generally have little need for business investment and the profits are used for personal uses, not business saving.

Well meaning people decided in 1986 to increase the small business tax rate so that successful small business would pay more taxes to make up for the initial lower rate. Others were intent on shielding small business from corporate taxes altogether. This devil's bargain between the left and the right ensured that even exceptionally motivated entrepreneurs would choose to flow-through earnings to avoid paying high marginal corporate tax rates. It will take a massive incentive to entice certain small businesses to choose to be taxed as corporations. Liberals fear that the very rich will incorporate themselves and avoid even more taxes. [4] But it is vitally important that those small businesses with growth potential retain the earnings necessary for that growth.

Graduating corporate taxes up to at least one million dollars would provide a powerful incentive for small businesses to become C corporations and concentrate on retaining earnings once again. Indeed, tax experts and economists seem unaware that the Tax Reform Act of 1986 caused many small businesses to avoid reinvesting the earnings necessary for growth. They think that venture capital and other outside funding sources fill small business' investment needs. [5] Industries such as high tech do depend on outside capital, but many owners wouldn't want outside investors even in the unlikely event they were available. Self-financing is the norm for small business, and second mortgages, home equity loans and even credit cards are the methods. Why does this matter? It matters because once a business reaches a certain size, these methods are inadequate and a business is likely to become chronically underfinanced. Businesses with the most growth potential are the most likely to be stymied by a lack of funds.

Recent legislation helps small business by increasing the amount of investment that may be written off immediately instead of through depreciation.[6] For many rapidly growing firms, however, the greater need is to finance the growth in inventory and accounts receivable. Without

[4] For those concerned that lowered corporate income tax rates would cause high income tax payers to turn themselves into corporations, they should note that the Tax Reform Act of 1986 repealed the General Utilities Doctrine, "that permitted a firm to liquidate its assets at more than book value and to pass the proceeds of the liquidation through to stockholders without making the firm pay income taxes on the gains." "As a result of the repeal, any gain from liquidation is taxed twice: once to the liquidating firm (C corporation) and again to the stockholders."

[5] Few realize that reduced capital gains rates reward investors for taking their money out of the business. The need is to give incentives for investors to leave money in the business. Applied to marriage, our tax law would reward marriages by offering free divorces. Perhaps not the best way to encourage a stable society!

[6] Such government incentives may cause businesses to overinvest in fixed assets to reduce their taxes. There is a December rush by local small businesses to purchase high end pickups to reduce their tax liability. Though reducing their current taxes, they now may owe $50,000 or more for the purchase with payments over the next five years and no depreciation to offset that cash outflow.

a strong balance sheet, financing is often not available or only available on very expensive terms. Lenders today are more likely to look beyond the collateral to the overall health of the firm as evidenced by a strong balance sheet.

History

Why does our tax code discriminate against small business despite many earlier attempts to foster small business growth by graduating corporate taxes?[7] For instance, "This interest (in fostering small business growth) brought forth five similar proposals in 1956 to modify the corporate income tax"[8].Those included HR 9067 introduced by Wright Patman, HR 10727, by John Dingel, and S 3128 by Senator Fulbright. Big business reacted decisively and the Chairman of General Motors was particularly aggressive in his protests. Little came of these bills and the 1980 White House Conference on Small Business (WHCSB) adopted as their highest priority: "*Legislate a more graduated corporate income tax, reducing taxes at the low end of the rate schedule by pushing the top of the tax-rate stepladder from $100,000 to at least $500,000 of earnings."* (Italics in original) (Over $1,400,000 in today's dollars) The WHCSB made this recommendation even though it would affect only a minority of small businesses. To quote the report:

"…The more earnings that small companies retain, the more they can expand, develop new products and services, and create new jobs. At the White House Conference, the subject of retained earnings was the delegates' chief concern. They overwhelmingly endorsed a recommendation for a more graduated corporate income tax as their top-priority item. Likewise, the Commission believes that a more gradual rise in the tax rate is the single measure that would most benefit all small corporations."

Instead of adopting graduation, badly informed economists and legislators thought that easing restrictions on S corporations would achieve the same end. And therefore the Tax Reform Act (TRA) of 1986 was enacted during the year I was a delegate to the White House Conference on Small Business (WHCSB). As a delegate to the 1986 convention, I lobbied to adopt the 1980 WHCSB recommendations

Although these reduced taxes advocated by the 1980 Conference would have been vital to the development of small manufacturing firms, the 1986 Conference was in no mood to consider any economic arguments. It confined its interest to reducing business taxes. Expanding eligibility for S corporation status had already met most of their needs. Though some small business organizations, particularly manufacturers, strongly supported graduation, others refused to support graduation because "Many of their members weren't corporations and if they were, they could elect to be taxed as a pass through or S corporation." In 1986, Congress ignored the economic implications of graduated corporate taxes and passed the Tax Reform Act with its notorious notch. Looking back, we can see that C corporations have decreased at approximately 1.5% per year for almost 30 years. On the other hand, S corporations have increased at approximately 7% a year during the same time period. The number of LLCs (Limited Liability Companies) has increased exponentially.

[7] Over 75 years ago Franklin Roosevelt asked Congress to graduate the corporate income tax and Congress agreed.
[8] Clifford D. Clark, A Note on Investment Activities and the Graduated Corporate Tax, *Journal of Finance*, March, 1957 pp 44-50.

Proposal

The tax situation is backwards from what it should be to encourage small business growth. To encourage new C corporation formation, the corporate tax rate should be significantly below individual tax rates, up to perhaps one million dollars. Updating the 1980 recommendations to account for inflation and the change in individual rates could create the following corporate tax schedule.

10% up to $250,000, 15% from $250,000 to $500,000, 25% from $500,000 to $1,000,000 and the normal rate above $1,000,000.[9]

It makes economic sense to lower the rate for small firms because the lower rates would promote economic growth, and ultimately create a stronger economy. In concert with the changes in the corporate tax schedule listed above, congress could consider giving an immediate economic boost to these small businesses by allowing small businesses to elect to be taxed as C corporations at any time. (Presently one must make the election during the first 75 days of the tax year.) This liberalized election would give immediate tax relief and extra cash to small businesses at a time when small business needs this incentive

With this corporate tax schedule, hundreds of thousands or even millions of S corporations and LLCs would choose to grow by being taxed as corporations as soon as they were profitable. The 1980 White House Conference's corporate tax recommendations are even more valid today, and this would be an excellent time to adopt them and permanently *Nix the Notch*. While it wouldn't solve all the present economic problems, this proposal encourages small businesses to become taxed as corporations, giving them an incentive for business growth through earnings reinvestment, creating a stronger small business community that would greatly strengthen the American economy.

[9] In the relevant ranges, the present rates are: $0-50,000 15%, $50-75,000 25%, $75-100,000 34%, $100-335,000 39%, $335,000-10,000,000 34%.