



January 28, 2011

Honorable Dave Camp  
Chairman  
Committee on Ways and Means  
United States House of Representatives  
Washington DC 20515

Honorable Max Baucus  
Chairman  
Committee on Finance  
United State Senate  
Washington, DC 20510

Honorable Sander Levin  
Ranking Member  
Committee on Ways and Means  
United States House of Representatives  
Washington DC 20515

Honorable Orrin Hatch  
Ranking Member  
Committee on Finance  
United States Senate  
Washington, DC 20510

Honorable Timothy Geithner  
Secretary  
United States Department of Treasury  
Washington, DC 20220

Dear Chairmen, Ranking Members and Mr. Secretary:

As Congress and the Administration contemplate tax reform, we believe it is important to fully understand the ramifications for small business. Let us make no mistake about it: While small business has complained as much as anyone about “life” under the current tax code, small business has also been a significant beneficiary.

We have always held to the premise that the tax code can be a powerful economic policy tool. Indeed, from a graduated corporate rate structure to direct expensing to the mortgage deduction and countless other provisions, small business has benefited from the bias built into the code. We make no apologies for that reality. We are absolutely certain the economy and the nation are better off for it.

Small businesses depend on their retained earnings. The history of our small business economy demonstrates that small businesses are not able to routinely raise capital or secure funds from alternative sources, as big businesses can. Small business requires patient capital, and even then, the financial return on investment can be modest. Yet, in terms of job creation, innovation and economic diversity, the return on the investment by us, as taxpayers, is well worth it. That is why we believe the current code allows small business to be taxed less and retain earnings, and includes economic incentives to encourage investment in small businesses.

We expressed similar concerns during the debate regarding the Tax Reform Act of 1986. Under the guise of lowering and flattening the rates, some incentives and beneficial provisions were washed out of the code. In today’s terminology, these are often referred to as “tax expenditures.” Based on our 1986 experience, we are particularly leery of the trade-offs involved in lowering the corporate rate by broadening the base. How many of the deductions and credits that are

“candidates” for elimination are used by small businesses doing business as sole proprietorships, partnerships and S Corporations? We are all familiar with the adage, “Be careful of what you wish for, you might get it.” It is tempting to overlook the value of the current code to small business and the inherent flaws of the proposed alternatives, when faced with the massive evidence of complexity and flaws in the current system and the allure of simplicity, but we must tread carefully.

We have identified two general problem themes regarding the current system: the overall complexity of the code and the problems of a blended business/personal tax system. Admittedly, some of the provisions of the code most beneficial to small business are ones that contribute to those problems--hence our dilemma.

By a blended system, we mean that the code allows for the taxation of wages and business income under one structure for wage earners, sole proprietors, partners, and S corporation shareholders. We point to the debacle of the 1993 increase in the personal rate structure as an example of the problems that resulted from this design feature. By increasing the tax on the wealthy, we increased the tax on the incomes of operating S corporations. It pulled small business into a debate it did not need to be in, and the end result had an unintended but negative impact on the retained earnings of small businesses.

Therefore, it would seem that any alternative to the current system should “wall-off” the taxation of personal income from operating business income. This, unfortunately, leads us down the road of double taxation of business income, a policy the code currently imposes on C Corporations and their shareholders. This, in turn, will lead to the hypothetical question, “We can eliminate some of the complexity of the code, but the price will be the elimination of the single taxation status so many small businesses enjoy. Can small business survive the trade-off?” The benefits of a lower graduated corporate rate would have to be quite extraordinary to make the migration to C Corporation status worthwhile. Otherwise, it is a “lose-lose” situation for small businesses; their tax liability goes up either way to pay for big business’ tax relief, whether they remain a “pass-through” entity or convert to C Corporation status.

As to the code's overall complexity, this is a result of many factors, not the least of which is that the code has just been around too long and is a 1950's car (notwithstanding the Tax Reform Act of 1986) in a 2000's race. Again, the question is how do you retain the bias of the old system for small business, if you change to a different system?

A major contributor to complexity have been the frequent changes made to the tax code in the 1980's, 1990's and 2000's under a “revenue neutral” policy that has undermined tax policy development during this period. We operated, and for the most part still do, on the “morsels and crumbs” theory of tax policy. Instead of making tax policy because it is the right thing to do, we are forced to ensure all actions are revenue neutral, and therefore we never fix anything straight out--we “do a little of this, and a little of that.” Look no further than the saga of estate tax relief as exhibit one. What a mess! This is not to suggest we should not be mindful of deficit ramifications, but perhaps, make fewer changes and do them right.

A fundamental question that must be answered before undertaking any analysis of a tax system change is, “What is your effective rate of taxation?” There is a huge difference between the marginal rate that may appear on a tax liability schedule and the rate of taxation a small business pays after all deductions and credits are taken.

We look forward to the opportunity to participate in the dialogue to make certain we fully understand the ramifications of tax reform for small business. Thank you.

*The Small Business Legislative Council is a permanent, independent coalition of over 50 trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. Our policies are developed through a consensus among our membership. Individual associations may express their own views.*