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SMALL BUSINESS, BIG TAXES: ARE TAXES HOLDING BACK SMALL BUSINESS GROWTH?

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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SMALL BUSINESS, BIG TAXES: ARE TAXES HOLDING BACK SMALL BUSINESS GROWTH?

WEDNESDAY, APRIL 15, 2015

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to call, at 2:31 p.m. in room G–50 of the Dirksen Senate Office Building, the Honorable Daniel Coats, Chairman, presiding.

Representatives present: Paulsen, Hanna, Delaney, Maloney, Brady, Schweikert, Grothman, and Beyer.

Senators Present: Coats, Klobuchar, Lee, Sasse, and Cassidy.

Staff present: Barry Dexter, Cary Elliott, Connie Foster, Harry Gural, Colleen Healy, Karin Hope, Jason Kanter, Christina King, Kristine Michalson, Viraj Mirani, Andrew Nielsen, Barry Nolan, Robert O'Quinn, Brian Phillips, Leslie Phillips, and Aaron Smith.

OPENING STATEMENT OF HON. DANIEL COATS, CHAIRMAN, A U.S. SENATOR FROM INDIANA

Chairman Coats. We want to welcome our witnesses today. It's no serendipity that this particular hearing has been scheduled on tax day, April 15th, and we are talking about taxes. We have some witnesses here who are experts in the field and have experienced a real-life experience in terms of dealing with our tax code from the small business owner's standpoint and so we are looking forward to that testimony.

There are vexing challenges facing us with our tax code that is burdensome on business, individuals and others and complex beyond their ability to fully understand it. The small business owners that I have met throughout Indiana have been patient, persistent and overcomers. Despite the obstacles that small businesses face, they are responsible for two-thirds of the net new private sector jobs created in the United States so it is important that we listen to you and understand the challenges that you have.

Our role as legislators should be to ensure that the tax code is no longer a major obstacle to growth and jobs for these businesses. Against the headwinds of the slowest recovery since 1960, small business owners have to deal with a tax system that is hopelessly complex, full of provisions that expire every one or two years, riddled with special exemptions, deductions and preferences and filled with new penalties.

The Small Business Administration lists the tax paperwork as the most costly paperwork burden the Federal Government imposes on small businesses, adding up to about $1,500.00 per employee. It is not surprising that 9 out of 10 small business owners have turned to an outside paid professional to figure out their taxes as I have to do. Even though I took three tax courses in law school I can't begin to plow my way through the complexity of our tax code.

Today we will hear from witnesses who can discuss how tax policy is affecting the broad landscape of small businesses. We will also hear two stories of real businesses that will bring home how taxes affect companies on the ground.

Tax day is a perfect time to commit to not let another April 15th pass before we finally tackle comprehensive pro-growth tax reform. And while it is urgent and essential to lower our corporate rate tax, which is the highest in the developed world, we must not forget the millions of small businesses that pay taxes at the individual level and have just experienced rate increases.

I look forward to hearing from our witnesses about how we can tear down barriers to growth in our broken tax code and now I want to recognize Ranking Member Maloney for her statement.

[The prepared statement of Chairman Coats appears in the Submissions for the Record on page 34.]

[The prepared statement of Vice Chairman Brady appears in the Submissions for the Record on page 34.]

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, RANKING MEMBER, A U.S. REPRESENTATIVE FROM NEW YORK

Representative Maloney. I want to thank very much Chairman Coats and all of our witnesses for being here today. There is broad agreement that small businesses are the backbone of our economy, the anchors of our communities and that they have played an important role in our current recovery.

When President Obama took over from former President Bush the economy was in a free fall and small businesses were bearing the brunt of the pain. Over the fourth quarter of 2008 and the first quarter of 2009 small businesses shed more than three million jobs.

President Obama and Democrats in Congress along with the Federal Reserve took bold actions to turn things around in the darkest days of the Great Recession. These actions included a number of efforts designed specifically to support small businesses. For example, the Recovery Act cut taxes for small businesses allowing them to immediately deduct up to $250,000 of investment, carry back losses for 5 years and exclude from taxation 75% of capital gains from small business investment.

Several small businesses in my district told me that this initiative alone helped them save their business. Today small businesses are leading the economic recovery. Small businesses have added more than 6 million jobs, over 17 straight quarters of small business job growth which we can see in this Chart Number 1. You can see where we have been growing with a solid blue rise of jobs for small businesses.

We have come a long way in the past 6 years. The share of small businesses planning to add jobs is back near the pre-recession average as we can see here in this Chart 2. While this reflects major progress I believe that we need to do much more to support small business growth.

The Administration's tax reform plan, for example, would simplify and cut taxes for America's small businesses. President Obama's revenue proposal includes expanding and permanently extending increased Section 179 expensing for small businesses. The proposal would also increase the number of small businesses that take advantage of simpler cash accounting rules.

The Administration's approach provides tax cuts for small businesses in a fiscally responsible way and in the context of broader business tax reform. By contrast, the Republicans in the House have passed bills without offsets which would blow holes in the budget. Some of my Republican colleagues would have us believe that small businesses are up in arms about President Obama's proposals. But this chart, based on a survey and data provided by the NFIB, a very respected organization and one of our witnesses today, shows that the share of small businesses listing taxes as their top concern is no greater today than it was when former President Ronald Reagan left office, as we see in Chart Number 3.

One of our principal goals today should be to decide what a small business is for tax purposes. Most of the 95% of businesses that are organized as pass-throughs are small, but many are extremely large. Numerous large law firms, accounting firms, hedge funds and other businesses are pass-throughs. The tax code treats these large businesses the same as "mom and pop" stores down the street and one of my questions today will be should we treat them the same?

When designing tax policy, fairness should be a principal concern. Some large multinationals pay less than small businesses and some extremely large companies don't pay any federal income taxes at all. In other words the corner store likely pays more in federal income taxes than some of our country's largest corporations. Those who are critical of our tax system should save some of their outrage for this.

Before taking on tax reform, Republicans have proposed repealing the estate tax and they plan to vote on it in the House later today or possibly tomorrow. Let's be clear: repealing the estate tax would be a major windfall for some of our most privileged and wealthiest citizens. With the current exemption of over 5 million per person and 10 million per couple, the estate tax affects only 2 out of 1,000 estates. In other words, 99.8% of Americans do not pay any estate tax at all as we see in Chart 4.

Republicans say they are motivated by a desire to protect small businesses but that is something of a Trojan horse I believe. Only about 20 small businesses and small farm estates owed any estate tax in 2013 according to the Tax Policy Center. Only 20. Repealing the estate tax is also very expensive. The Joint Committee on Taxation found that repealing the estate tax would increase the deficit by $269 billion over 10 years.

1986 was a massive overall and simplification of our tax code. The minute the ink was dry we began to undo it and trust me, it wasn't small businesses that were at that tax table. We must make sure that any tax reform benefits the small firms, not just the big multinationals gaming the system to further limit their tax obligations.

Tax reform is hard. That is why there hasn't been a major rewrite of the code in about 30 years. For it to work it must be comprehensive and it must be bipartisan. I have always said the best legislation is always bipartisan and I look forward to hearing the perspective of our witnesses today on this important subject. Small businesses create massive amounts of jobs in our great country. Thank you for coming here today, thank you for appearing before our Committee.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 35.]

Chairman Coats. Well, thank you Ranking Member Maloney, and I will now introduce our witnesses. I think we could put on a pretty good show here if I turned it right over to my colleague Congressman Brady to talk about estate taxes which the House will be voting on I think at 4 o'clock or so. So we are going to try to move through this fairly quickly so our House members in particular have an opportunity to speak and ask questions.

But with the joint chambers and two parties we have somewhat of a byzantine balancing act here in terms of making sure that everybody gets an opportunity in a fair way. Let me quickly introduce our witnesses.

Brian Reardon is President of the S Corporation Association and a Principal at Venn Strategies. From 2003 to 2005, Mr. Reardon was special assistant to the President for economic policy, working within the President's National Economic Council. He has also worked on Capitol Hill and for the National Federation of Independent Business.

Jody Fledderman is President and CEO of Batesville Tool and Die in Batesville, Indiana, a company that supplies precision metal stamping components for the automotive and appliance industries, among others. He is also past Chairman of the Precision Metalforming Association and serves on the boards of New Horizons Rehabilitation, the Indiana Manufacturers Association and the State of Indiana's Chamber of Commerce.

Ms. Holly Wade is the Director of Research and Policy Analysis for the National Federation of Independent Businesses. In addition to providing analysis to small businesses on public policy, she helps produce NFIB's monthly small business economic trends survey. She also serves on the Department of Commerce Industry Trade Advisory Committee on Small and Minority Business.

Martin Sullivan. Dr. Sullivan is Chief Economist for Tax Analysts, writing frequently in tax publications. Previously he taught economics at Rutgers University and served as a staff economist at the U.S. Department of Treasury and later at the Joint Committee on Taxation. He graduated from Harvard and has a PhD from Northwestern University.

And finally, our witness from Minnesota who I am going to let Congressman Paulsen introduce, Senator Klobuchar sent her regrets she will be arriving late. So Congressman Paulsen I would love to have you introduce our witness from Minnesota.

Representative Paulsen. Well thank you Mr. Chairman, and it is my pleasure to welcome Mr. Thomas Hoghaug. He has a long and accomplished career in the medical device industry and is currently CEO of both Signus Medical as well as LockDown Surgical in Chanhassen, Minnesota, which is my home town.

I would like to thank Mr. Hoghaug for his participation in today's hearing and his willingness to discuss some of the challenges, the very real challenges medical device tax presents to his companies and so many others like them in Minnesota and around the country. I expect, Mr. Chairman, his testimony will prove very valuable to members of the Committee, seek ways to ease the tax burden faced by America's small businesses today.

Chairman Coats. Thank you Congressman. We will go in order that I just read, starting with you Mr. Reardon and then followed by Mr. Fledderman and Holly Wade, Mr. Hoghaug and Dr. Sullivan.

STATEMENT OF MR. BRIAN REARDON, PRESIDENT, S CORPORATION ASSOCIATION, AND PRINCIPAL, VENN STRATEGIES, LLC, WASHINGTON, DC

Mr. Reardon. Chairman Coats, Vice-Chairman Mr. Brady and Ranking Member Maloney I appreciate the opportunity to testify before the Committee today. The S Corp Association and its' allies have been active on business tax reform efforts for about 5 years now and in that time we developed a number of themes that I would like to emphasize today. They are explained more fully in my written testimony.

First, if Congress were starting from scratch it would use S Corp as the model for taxing business income. The basic principles are that income is taxed once and only once. It is taxed when the income is earned and regardless of whether the income is distributed to the shareholders and its taxes at progressive rights. High income shareholders pay high rates low income shareholders pay lower rates. That's the correct way to tax business income.

Second, S Corp's are doing exactly what Congress intended them to do when they were created 50 years ago. The S Corp was created to incent private and family-owned businesses and it has worked. Today there are 4.6 million S Corps and they are in every community and every industry.

While Congress has acted over the last 50 years on numerous occasions to improve the rules and to enhance the ability of families and entrepreneurs to use the S Corp model to structure their businesses.

Third, you hear lots of talk about the erosion of the corporate tax base. What you don't hear is that the business tax base, that is pass-through businesses plus C corporations, has actually grown over the last 30 years since the 1986 Tax Reform Act. Prior to 1986 the business tax base was about 9% almost wholly made up of C corporations, 9% of the GDP. Today it's 11% of GDP, 6% pass-through, 5% C Corp, so it's grown and it's grown wholly because of the growth and progress of the pass-through community.

Fourth, pass-through businesses employ mostly private sector workers out there. Every day 55% of private sector workers get up and they go to work at a pass-through business. In some states, nearly 7 out of 10 workers work at pass-through businesses.

Fifth, pass-through businesses pay taxes and they pay lots of them. There is this theme out there that if you are not paying the corporate tax you are not paying taxes at a reasonable rate. That's been something that we have been concerned about for a long time. Back in 2013 we asked an economic firm to study how much do businesses pay, and what is their effective rate by business structure. I think that's the only time anybody's ever done that kind of study.

And what we found was that S Corps have the highest effective tax rate, about 32%. Big S Corps, the large ones that people want to make pay taxes like C Corps they pay an effective rate of 35% so they are paying lots of taxes right as they are right now as S Corps.

If you look on this thing you can see the C Corp number is 27%. An important point is that of that 27% dividends makes up 2 percentage points so there is a second layer of tax on C Corps. Here dividends are represented, capital gains are not, so you have to add that in. We were unable to calculate the capital gains rate. But the bottom line is that pass-through businesses are paying a lot of tax.

Sixth, the tax rates on pass-through businesses just went up and they went up a lot. This is a result of the fiscal cliff and the Affordable Care Act taxes. The top rates on pass-through businesses increased from a marginal rate of 35% to almost 44%, you can see the components up here. The main rate went up to 39.6. There's the new Affordable Care Act tax of 3.8% and then the reinstatement of the Pease limitation on itemized deductions, that's about 1.2%.

When you combine that with state and local taxes, some pass-through businesses are paying more than 50% marginal rates on their income.

I mention all of these points to set the table to talk about tax reform. Back in 2011 the Treasury Department floated a proposal to broaden the tax base by limiting business deductions to credits and to use the revenue to lower the corporate rate.

The challenge for S Corps and other pass-throughs of this plan is obvious. They use the same deductions and credits but they pay individual rates not corporate rates. What might this look like? I think we have a new slide here. Yeah, here it is—so here's some companies they both have $20 million in revenues they both use the same deductions and credits. You can see right now the S Corp or the pass-through is paying the higher top rate than the C Corporation.

Now if you try to a tax reform and I am not advocating this but if you go to the next slide and you eliminated those credits and deductions you can see that under the Administration's plan the C Corp would get a 25% rate. While the S Corp is still paying 44.6. That's simply unsustainable.

So pass-through businesses oppose corporate only tax reform. What do we support? Since 2011 we have advocated the following three principles for tax reform. One it should be comprehensive. Two it should lower rates for pass-throughs and C Corporations alike. And, three, it should reduce or eliminate the double corporate tax. The double tax on corporations is the reason U.S. businesses are uncompetitive. We are one of only a few countries to actually impose a double tax on our corporate businesses. We should simply get rid of it.

So what are the takeaways? One, S Corporations are the correct way to tax business income. Two, pass-through businesses are a significant part of the economy. Three, the top rates on these employers just went up significantly and 4, tax reform done right should be comprehensive, it should lower rates on pass-throughs and C Corps alike and it should reduce or eliminate the double tax on corporations.

I appreciate the opportunity to testify and I look forward to answering any questions.

[The prepared statement of Mr. Brian Reardon appears in the Submissions for the Record on page 42.]

Chairman Coats. Mr. Reardon, thank you very much. I appreciate you staying close to the five-minute rule that helps give us time to have a good interaction with the witnesses. Thank you. Mr. Fledderman, you're on.

STATEMENT OF MR. JODY FLEDDERMAN, PRESIDENT AND CEO, BATESVILLE TOOL AND DIE, INC., BATESVILLE, IN

Mr. Fledderman. First of all thank you for the opportunity to testify here today before you. My name is Jody Fledderman, I'm the President and CEO of Batesville Tool and Die in Batesville, Indiana. I have been the president of that company since 1989. We provide metal stamping assemblies mostly for the automotive industry. I am here to talk to you guys today a little bit about our business and what the taxes do to us.

We have 395 employees at this facility and we would actually hire more if we could find enough qualified workers. I am not a tax expert but I am here to tell my story from a business owner perspective and how these tax laws are affecting us. We have a lot of obstacles that we have to deal with as manufacturers. The single biggest obstacle for us to deal with right now is the uncertainty in our tax code.

It's very difficult for us to plan the future when we don't know the rules for today. It feels as if people in Washington are so insulated from what's going on in these small businesses that they don't realize not doing something can affect us as much as doing something. That's why I believe we also need comprehensive tax reform. Not just to lower our rates to globally competitive levels, but also to provide stability and predictability for us.

Washington should develop tax policy that encourages investment and manufacturing in America, not penalize companies and their owners for doing business in the U.S. But we need tax reform for all businesses not just C Corporations. A January 2015 industry survey showed 61% of metalworking companies are pass-through businesses. Sector-wide 81% of all manufacturing companies are pass-throughs and pay much higher taxes as you saw from the previous slides. This means C Corporation only reform leaves behind 8 out of every 10 manufacturers, mostly small and medium sized family-owned businesses.

We are one of those millions of manufacturers that corporate only reform would leave behind. Our company is structured as an S Corporation. We are a multi-generational manufacturing business with very strong ties in the community and we have awarded shares and opportunity for ownership to a lot of our key employees that are key to our success. Because of that we are now at 72 shareholders so we are a little unusual for an S Corporation. We are not a 1 or 2 owner company.

A main reason most family-owned or tightly held manufacturers structure themselves as pass-throughs is to make it easier to transition the business to your family when you retire. Some of our shareholders are high school students, some of them are retirees in their 80s, there is no way they could cover the tax penalties of a sale or buy-back if we were a C Corp so that is one of the main reasons that the structure of the S Corporation is so important for us.

The main drawback to being a pass-through structure is the most obvious. As you saw on the slides before publically most people believe the top rate is 39.6. In reality we are paying it at 43.4% for our federal income taxes, when you calculate in the surcharges and some of the other additions. Now keep in mind that we have got 72 shareholders and we also have one that is a fully passive income shareholder which is why we pay the extra 3.8% tax.

We have to pay that extra tax for everybody so we pay it at the 43.4% for all of our shareholders and even if that's not what their tax liability is and then it is up to them to try to get those refunds on their own. Now because we are not a one or two owner company that money doesn't come back to the company, it ends up with our shareholders if they can claim it or if they had tax attorneys that can do that for them.

We have looked at several different scenarios. Our tax rates—had our tax rates not increased to 44% we would have had an additional $500,000 for our manufacturing operations. If Congress were to lower the effective tax rate to even 28% it would reduce our tax liability by $700,000 obviously more if lowered to 25%.

The public perception plays a big role in this. The average person assumes that the owner takes that $700,000 and puts it in their pocket when obviously they don't, that's re-invested back in the business. Profit margins in our industry are usually less than 3% so all the investment back in the business comes from any profitability that we are able to generate.

While tax rates receive the most attention, nothing frustrates us more in manufacturing than the constantly expiring tax credits and deductions, that's really the biggest problem for us. We feel like Congress takes too casual of an approach to the tax extenders, you know that we will get to them eventually. What Washington doesn't understand I believe is that we rely on those provisions to plan our investments and expansion years in advance.

Right now we are mulling the purchase of a $3 million machine that would probably add 15 to 18 jobs to our business but it would take 16 months to get that machine in service and we have no idea if we will be able to use Section 179 or Bonus Depreciation to apply to that investment.

I'll wrap up here of what happened to us in 2014. I told the story in Senator Coats' office and I think it is one of the reasons why I was asked to come here and talk today. We pay the taxes on behalf of our shareholders every quarter, we make quarterly estimate payments and by the end of the third quarter we were paying at our

43 or our nearly 44% and so the week before Christmas we find out what credits will be extended.

Well we found out that the taxes that we had paid in the third quarter was already $600,000 more than what our tax was supposed to be, so that's tax that now we have paid into the Federal Government that we shouldn't have and that we will end up coming back to our shareholders in some form or another, some of it will if our shareholders' tax accountants are savvy enough to get it back but that's $600,000 that we will never see back in our business as cash flow.

So in summary the real—my real feeling is that you know people are never really going to be happy with the tax code no matter what it is. They're always going to think it is too much but the real problem is that we can't plan our future. We are being asked to compete globally and compete with people all around the world. We already have one of the highest tax codes of all the countries in the world and then not knowing what the rules are makes it almost impossible for us to plan a future, thank you again for your time.

[The prepared statement of Mr. Jody Fledderman appears in the Submissions for the Record on page 51.]

Chairman Coats. Mr. Fledderman, thank you very much for your testimony.

Ms. Wade.

STATEMENT OF MS. HOLLY S. WADE, DIRECTOR OF RESEARCH AND POLICY ANALYSIS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

Ms. Wade. Good afternoon Chairman Coats, Ranking Member, Maloney, Members of the Joint Economic Committee. Thank you for the opportunity to testify today. I am pleased to be here on behalf of the National Federation of Independent Business as the Committee discusses small business tax policy and the economic growth in the small business sector.

The small business economy is slowly emerging from one of the worst recessions in U.S. history and if I base small business economic trend survey data it shows the dramatic change in consumer spending employment, employer's confidence and business investments throughout the recession and subsequent recovery.

While some business activities have made significant improvements over the past 4 years, capital expenditures and outlook on business conditions and expansion remain at historically low levels due to economic conditions and the political climate. The threat of higher taxes whether in the form of income taxes, the healthcare law, the estate tax, Section 179 expensing limits or others, create enormous uncertainty among small business owners worried about the impact of policy changes on future business costs.

The survey also tracks which problems most affect owners in operating their small business. From mid-2008 through mid-2012 poor sales was their number one problem as consumer spending declined sharply, but now taxes is often the number one concern for small business owners, a problem that moderates the economic recovery in the small business sector.

The identified small business problems and priorities survey highlights three main areas of tax policy that are of great concern to small business owners. With the cost of health insurance leading as the most severe problem for small business owners, 5 of the top 10 problems are all tax related. These tax problems fall into 3 categories, cost, complexity and frequent changes.

The cost of tax obligations is three-fold. The amount paid to federal, state and local tax agencies, the cost of hiring a CPA or a tax advisor to navigate complex tax codes and the owner's time in providing the required paperwork and/or filing themselves. Eighty-eight percent of small employers use the tax preparer and most use one to either insure compliance or because the requirements are too complex.

Tax related regulations cause the greatest difficulties for 40% of small employers, more than environmental, health and safety or employee regulated regulations. And compliance costs are especially problematic because they are 76% higher for small businesses than for their larger counterparts, costing them $18 to $19 billion a year or about $74 per hour.

Tax related costs compete with the owner's ability to use limited profits for primary business activities. Profits are the main funding mechanism for owners purchasing new equipment, expanding facilities, hiring and stocking inventory. Tax related costs pressures are especially problematic for newer firms that almost solely rely on profits for operation and expansions costs as they are generally not able to access traditional vending sources.

But regardless of the firm's age, the tax burdens take a heavy toll on the owner's ability to operate their business. One example that encapsulates all three categories of tax related problems for small business owners is the Affordable Care Act. The employer mandate, small business tax credit and the termination of employer reimbursement plans are just a few of the many tax related costs and complications small business owners face in complying with the new law.

The ACA though is just one example of how excessive tax burdens affect small business owners. And the federal tax code is only one layer of tax obligations owner's face in operating their business. They must also comply with state and local taxes adding to the overall compliance burden. Unfortunately only the owner experiences the cumulative effect of all the required taxes and regulations placed on their business.

Federal, state and local lawmakers and government agencies only see them in isolation giving a false perception of their true impact.

In conclusion small business owners continue to be accessibly burdened by direct indirect complicated and ever-changing taxes related to operating their business. Alleviating the excessive tax burden on small businesses is an essential component to creating a strong and healthy environment for owner's to operate and grow their business.

I appreciate the opportunity to present NFIB's views and data on the effects of tax policy on small business and I look forward to answering any questions you may have.

[The prepared statement of Ms. Holly S. Wade appears in the Submissions for the Record on page 53.]

Chairman Coats. Thank you, thank you very much.

Mr. Hoghaug.

STATEMENT OF MR. THOMAS A. HOGHAUG, CEO, SIGNUS MEDICAL, LLC, AND CEO, LOCKDOWN SURGICAL, INC, CHANHASSEN, MN

Mr. Hoghaug. Chairman Coats, Vice Chairman Brady, Ranking Member Maloney, Representative Paulsen I thank you for the opportunity to testify. My name is Thomas Hoghaug I currently hold the position of CEO for Signus Medical LLC and LockDown Surgical, Inc. It is an honor for me to be able to address this Committee today and personally shed some light on an extremely negative impact the medical device tax has had on both of my companies and on similar small medical device firms.

The issues and examples I will share are personal examples that are in no way unique to Signus Medical and LockDown Surgical, they are common experiences shared by a multitude of device firms and have been conveyed, confirmed to major meetings, committees and gatherings of medical device executives.

Small device firms are primarily responsible for the majority of innovation and development of better and more cost effective treatment modalities for patients in the United States. I have worked in the orthopedic medical device arena for over 27 years, including as a founder of over 10 companies.

Signus Medical is a master importer developer and distributor of spinal implants, while LockDown Surgical is an extremity company focused on joint ligament repair. Both teams are focused on improving the quality of life and reducing human suffering. LockDown Surgical was founded in February of 2012 with a single FDA cleared product for shoulder repair. It has been operating at an annual financial loss and expects to reach breakeven finally and begin to turn a small, modest profit in the fourth quarter of this year. It would have been sooner if it was not for the medical device tax.

With the introduction and the implementation of the Affordable Care Act's medical device tax, companies have experienced a multitude of unforeseen and crippling consequences of the tax including layoffs, non-replacement of lost employees, disrupted and negative cash flow, curtailing or elimination of R&D projects, reduced inventory expansion and effective tax rates which can exceed 100% of profits.

Money that was once used to grow and re-invest in the expansion of the companies is now sent to the IRS every two weeks. Another perhaps unforeseen but very significant impact of the medical device tax is disruption of both of my company's cash flow. As mentioned earlier payments are made within two weeks of posting sales, but the collections are running upwards of 70 days.

These payments strip both firms of ready cash which was previously used for day-to-day operations, payroll, payments to vendors. Since 2012 our monthly cash flow has been negative due to the device tax. As of last year I shelved two major R&D projects because of the device tax.

Instead of investing in innovation we are looking at how we will simply manage due to the cost of introducing several new products in 2015 which would under pre-tax condition expectations return

Signus Medical to nominal profitability and expand LockDown's surgical products into other areas of the body where there is a very real and significant patient need.

Most difficult for me I had to personally lay-off a number of team members, specifically to pay this medical device tax. I am very proud to be actively involved in the medical device arena. It has historically been a shining star in the U.S. economy and has boasted some of the highest paying jobs when compared to all other business sectors and average wages. The advancements in treatments and improved patient outcomes is commonly a direct result of the smaller and more nimble device companies such as Signus Medical and LockDown Surgical who reinvest profits and resources into the development of new and lower cost-effective surgical and non-surgical solutions.

Simply put the device tax is destroying our ability to deliver on the promise to improve patient care. This is something I will not compromise on. With the inclusion of the medical device tax in the 2014 operational budgets, both Signus Medical and LockDown Surgical posted effective tax rates in excess of 110%. This is not sustainable for any business, large or small. I feel once again I will be facing employee down-sizing and further elimination of development projects and thus new clinical therapies to patients in the United States in order just to remain in business to pay the device tax.

Money required for re-investing to expand infrastructure including employees, of inventory and product and R&D project is no longer available. Again these problems are not unique to my two companies and are clearly felt across the entire medical device industry. I do believe however that smaller and start-up companies are more severely impacted by the device tags given their inherent size and the inability to spread or defer the cost over non-device products being sold by larger, more vertically integrated companies.

In conclusion I would like to thank the Committee members for this opportunity to testify. I sincerely hope that the information and personal experiences I shared helped to enlighten you as to the true negative impact the medical device taxes have had on the medical device industry as a whole and smaller and start-up companies in general.

Growth, innovation and new job creation come from small medical device firms. The medical device tax threatens to kill off or at the very least curtail this segment of our industry, thank you.

Chairman Coats. Mr. Hoghaug, thank you very much for your testimony. And now Dr. Sullivan.

[The prepared statement of Mr. Thomas A. Hoghaug appears in the Submissions for the Record on page 55.]

STATEMENT OF DR. MARTIN A. SULLIVAN, CHIEF ECONOMIST, TAX ANALYSTS, FALLS CHURCH, VA

Dr. Sullivan. Chairman Coats, Vice Chairman Brady, Ranking Member Maloney, Members of the Committee thank you for this opportunity to testify. Two recent developments have heightened interest in tax relief for small business. First, in 2012 Congress allowed the top individual rate to rise from 35 to 39.6%. Second, there is concern that Congress will pursue corporate only tax reform that would cut the corporate rate and to pay for that lower rate cut, reduce tax deductions and credits for all businesses.

This would hurt small business that would lose tax breaks but get no relief from the rate cut. In my remarks today I will briefly comment on five options for small business tax relief.

Option 1—Congress could reduce the top individual rate to 35% or lower. We should always strive to keep tax rates as low as possible but the case for lowering the top tax rate should not pivot on the effect that it would have on small business but on larger issues such as the need for deficit reduction, the effective rate cuts on tax fairness and the effect of a rate cut on the overall economy.

The figure on the screen shows a box. The box represents all the income affected by a change in the top individual rate. Only 30% of pass-through income is in this box, only 21% of it is related to pass-through employers and only 8% is related to small business employers. The bottom line—most of the benefit of cutting the top rate would not go to small business.

Option number 2—Congress could cut the top individual rate but limit that rate cut only to pass-through businesses and several states have adopted this approach most notably in 2013 Kansas completely exempted all pass-through income. One problem with this approach is that it opens the door to aggressive tax avoidance. Secondly, much of the benefit would not go to small business, but go to large businesses, some of them very large.

Here are the facts. In 2011 there were 15,000 S Corporations with more than 15 million in sales. They accounted for 27% of all S Corporation profits. And there were 22,000 partnerships with more than 100 million in assets, they accounted for 64% of partnership profits. Clearly we should not equate pass-through business with small business.

Option 3—Congress could limit any rate cuts for pass-through business to certain industries. Dave Camp's tax reform provided a 25% rate for manufacturing and construction pass-through business. This target approach is a lot less expensive, only about a quarter of the cost of an across-the-board pass-through tax relief like they had in Kansas. But why should we pay for some industries over others and why if we want to create jobs should we exclude labor intensive service and retail businesses.

Another problem is the complexity. It is hard to figure out exactly which business lines qualify for these benefits as demonstrated by our current difficulties with the Section 199 deduction for domestic manufacturing.

Option number 4—Instead of providing back-end tax relief for small business income, Congress could provide front-end relief for business costs such as capital spending, wages and research. This approach has several advantages. It is far easier to measure qualified costs than it is to isolate income that is qualified for these benefits.

Second, there is far less opportunity for tax planning and third, this approach can target activities that promote economic growth. So for example, if Congress wants to create jobs it can do this more effectively with a wage credit than with a cut—a rate cut of equal revenue cost.

Deducting the full cost of capital equipment when purchased is called expensing. As tax breaks go expensing for small business is one of the most meritorious. It is an incentive for capital spending, it's better than a rate cut, it increases cash flow and it simplifies record-keeping.

Besides a wage credit or expensing, Congress could make the research credit more attractive to small business by making it refundable as several states have done.

And Option number 5—Simplification. Of course everybody wants simpler taxes but simplification is especially important to small business. Compliance costs per employee are much higher for small firms than for large firms, yet it is the economic equivalent of a tax surcharge just for being small.

One particularly promising approach for small business tax simplification would be the expansion of the cash method of accounting.

So in conclusion to help small business we should avoid rate cuts that are poorly targeted, complex and spur costly and unproductive tax planning. Instead we should provide tax relief tied directly to investment and employment and most of all we should simplify.

Simplifications are a sure-fire way to reduce costs for business, to promote growth with minimal impact on the deficit, thank you.

[The prepared statement of Dr. Martin A. Sullivan appears in the Submissions for the Record on page 59.]

Chairman Coats. I want to thank our witnesses for their testimony and I look forward now to the interaction between the Members. I want to turn this over now; I'm going to defer my time. My House colleagues I know have an important vote on taxes, interestingly enough, coming up at 4 o'clock. So let's see if we can get as many of them some time here as we can. I do want to turn to our Ranking Member Mrs. Maloney and then we will hear from Mr. Brady.

Representative Maloney. I want to thank you all for your testimony and thank you for being sensitive to our time. One of the biggest challenges in crafting tax policy for small businesses is deciding what counts as a small business. Many Americans when they think of a small business think of a corner grocery store but clearly small businesses are much more than that and there are dozens of possible definitions based on revenues, number of employees, average revenue per employee, industry classifications or other characteristics.

And defining what a small business is is critical to the success of our hearing today and I would like to ask Ms. Wade from the NFIB can you tell me in two or three sentences for the purpose of tax policy what is a small business, how would you define it?

Ms. Wade. For NFIB members, most of our members are under 40 employees however they span all industries and all size groups so for tax policy the policy that would benefit most of them would be lower rates and simplification and reducing the changes in the tax code. There isn't a strict definition because there are many firms that are labor intensive versus capital intensive so it is a broad spectrum that we represent.

Representative Maloney. Okay, is a global law firm with dozens of offices around the world a small business Ms. Wade?

Ms. Wade. It depends. It depends what the composition of the firm here. We have you know, we have manufacturers who export, we have members who span every industry so tax policy that can cover most of them would be our choice for pro-growth, supporting most small businesses.

Representative Maloney. Is a hedge fund with billions in assets a small business Dr. Sullivan would you say?

Dr. Sullivan. I think it is just common sense that that is not a small business.

Representative Maloney. What about a global law firm?

Dr. Sullivan. Well as we know they can have thousands and thousands of partners. They are considered a pass-through business, they are taxed as a partnership, but they are certainly not a small firm.

Representative Maloney. Mr. Fledderman you run a successful tool and die company and you have an I would say a personal stake in this issue. Do you think, for example, that a global law firm or a hedge fund should be classified as small business?

Mr. Fledderman. I don't really know if it should be classified as a small business.

Representative Maloney. For purposes of the tax code?

Mr. Fledderman. No I don't. I think that manufacturers and people that make things obviously more on that side since that is what we do, but that is what really generates the jobs in this country we all know that and I believe that that's what we should be concentrating on.

Representative Maloney. Dr. Sullivan could you please tell me very briefly what is a pass-through? Is a pass-through the same thing as a small business?

Dr. Sullivan. A pass-through business is one of three classifications under the tax code, either a sole proprietorship, a partnership or an S Corporation, they are called pass-throughs because as all of these folks here know the income is not taxed at the entity level it is taxed on the individual level.

However it is not the same thing as a small business. Most small businesses are pass-throughs but most pass-through not all pass-throughs are small businesses. There are many very large pass-through businesses.

Representative Maloney. Should these large entities with hundreds of millions and even billions of revenue be treated the same and face the same tax structure as the local laundromat and the neighborhood deli, Dr. Sullivan?

Dr. Sullivan. It depends. I can use a real live one in Kansas where the Governor Brownback put in legislation to exempt all pass-through business from all income tax in Kansas. It was discussed as a small business tax relief which it was but it also provided tax relief for the largest businesses in the state.

Representative Maloney. And are there steps that we could take to better differentiate in the tax code between traditional small business employers and huge companies organized as pass-throughs? What steps would you recommend Dr. Sullivan since you have written about and studied this?

Dr. Sullivan. Well I think ultimately we are talking about job creation so I would suggest targeting the tax benefits to those businesses that have lots of employees rather than just lots of assets.

Representative Maloney. Thank you my time has expired.

Chairman Coats. Thank you.

Congressman Brady.

Vice Chairman Brady. Thank you Chairman for calling this important meeting I do have a statement I would like to submit for the record.

Chairman Coats. We will accept that.

Vice Chairman Brady. The gist of the statement is to lay out the economic benefits of repealing the estate tax and the harm it does to our economy and family-owned farms and businesses, especially a growing group for women and minority-owned businesses, building wealth for the first time in America. We think that's a good thing and it also lays out the need for tax reform, corresponding to the fact that in a recent poll 80% of Americans believe Congress ought to act now to fix this broken tax code.

A quick question for you Mrs. Wade and then a tax question for the others. On the estate tax, we are told that this is just tax cuts for the wealthy, that your members are the Paris Hilton's of the world, the robber barons of the Teddy Roosevelt day, that this doesn't benefit average Americans. But my understanding from NFIB and other groups is that this death tax is the number 1 reason family-owned farms and businesses aren't passed down to the next generation.

It is hurtful to the economy. It harms jobs, it is the wrong tax, the wrong time or it is the wrong people and studies show that repealing the estate tax would actually create more revenue for the Federal Government than keeping the tax in place. And part of the damage is that the businesses use so much time, devote so much time and money to planning to survive the death tax rather than investing in their companies.

So for your member's small businesses, would repealing the death tax help them spend more money and time on growing their business and jobs and less time on just doing the tax planning that they have to do today?

Ms. Wade. Certainly, we've produced a number of studies looking into succession planning for small business owners and small employers and how they are trying to work through the estate planning phase of about 30% are their business. So looking to pass their business on to family members and while the estate tax you know affects a number of them, more of them are spending resources in trying to plan for this, it is that uncertainty of where their business is headed in the future, it is the uncertainty of what thresholds the estate tax will be in the future.

So in our latest survey, tax survey 34% in the last five years of small business owners have paid for trying to plan for an estate tax so 35% probably many or fewer will pay this estate tax but it is a misallocation of resources.

Vice Chairman Brady. That's a good point, the claim is just a very small number paid the tax. You are saying 1 out of 3 of your members have to engage in tax planning and to divert resources from productive investments to avoid or minimize estate taxes.

There is often in tax reform a trade-off between lowering rates and reducing depreciation or increasing depreciation so my view is that corporate rates are extremely important, but so is cost recovery. The ability to fully cover the cost of those investments is a big driver of main street jobs. So I wanted to ask the other witnesses today, do you have any advice to us as we look at this issue of capital cost recover, and whether it is equally important to rates when it comes to business growth Mr. Reardon?

Mr. Reardon. I think it's incredibly important. You know there are a couple of plans out there, including one put forward by Senator Lee, to allow full expensing and it effectively shifts the taxation of business income from an income base to a consumption base approach which I think most economists agree is the correct way to go. It also has the benefit of being incredibly simple.

I mean you go out and you buy a piece of equipment and you write it off. You don't have to keep track of depreciation schedules, you don't have recapture, you don't have all that so it benefits on both sides, it reduces the cost of capital and it increases simplicity.

Vice Chairman Brady. Thank you Mr. Reardon.

Mr. Fledderman.

Mr. Fledderman. Oh yeah I agree 100%. It would be very beneficial but again I will stress that it's really important for two things. Number one that we know what the rules will be and then if this is an expense, it is some type of expense it is made permanent so many of the pieces of equipment that we have take months to put into service and when we are informed that the third week of December what is going to be allowable we have got a week left to purchase something over Christmas, again it makes sense.

Vice Chairman Brady. No, thanks for that point, Mr. Hoghaug and then Dr. Sullivan?

Mr. Hoghaug. No I would agree that estate planning is something that I used to actually consider and look at for succession to my children and all. Right now given the medical device tax it's negative impact and this I am just worried about being in business in a few years.

Vice Chairman Brady. Having an estate.

Mr. Hoghaug. So you know right now that planning has been set aside in lieu of planning on the day-to-day business.

Vice Chairman Brady. Thanks, Dr. Sullivan briefly I'm out of time.

Dr. Sullivan. Sure. Capital expensing and bonus depreciation are very important and effective incentives for capital investment, especially for small business because they give the additional benefit of cash flow. The problem is it is such a good incentive that it might be better than a rate cut and so when you are looking at trade-offs when you have limited budget it makes it very difficult to talk about lowering the rate and doing a capital recovery at the same time.

Vice Chairman Brady. Thank you sir, thank you again Chairman.

Chairman Coats. Senator Klobuchar.

Senator Klobuchar. Did you want to let some House members go first, I understand they have a vote I can wait 20 minutes.

Chairman Coats. I do have some concerns, I have just been told it has been pushed back a little bit, but if you are willing to——

Senator Klobuchar. Yes, I just have to leave in 20 minutes, I'm fine.

Chairman Coats. Well, let's see who would be the next House member up.

Mr. Hanna.

Representative Hanna. Thank you Chairman. Mr. Hoghaug people would believe that the medical device tax 2.3% shouldn't be relevant it doesn't sound like a big number to anybody. Listening to your statement and incidentally I agree with you but I would like you to do a little bit deeper dive in explaining to this community why it is that—and we know it is on your gross receipts, why it is that that percentage could have such a tremendously negative impact through ObamaCare on your bottom line and on your company?

Mr. Hoghaug. Thank you for the question. First of all it's an excise tax which even though theoretically people say will be passed on to the consumer. In reality we cannot pass it on, capitated pricing and hospitals, 70% decrease in actual pricing since 2008 has completely eliminated the ability to raise prices.

Secondly it comes out of our weekly or bi-weekly cash flow and is paid ahead of collections or profitability. Irrespective of how a company is doing, including being a start-up as one of my firms is, in the end the Device Tax is not tax deductible. There are a few opinions out there but there are no IRS mandates that say where it can or cannot be deducted. Perhaps at the state and local level but certainly not on the federal, so if you were to take an 8 million dollar company with roughly a 6 million dollar profit, $480,000 it is about $248,000 in tax.

If you were losing money that $248,000 is still owed to the government irrespective of when you collect it or how you collect it and it just restricts the day-to-day basic cash flow for reinvestment in the firm.

Representative Hanna. Thank you very much. Miss Wade you know government sets all kinds of problems up for small business. It almost feels—and I'm from New York, one of the highest taxed states—as if it is a war of attrition. People think that businesses will stay in business, people and individuals don't get frustrated, don't quit, don't make enough money in their lives so that it just becomes marginally not worth it.

I think you and I know that people do quit, people do give up and the energy that it takes to create and grow and stick with a small business through your lifetime regardless of awful things like inheritance taxes as it may suck the life blood out of your business just when the next generation needs it the most. The raw costs, the psychological cost in addition to just the specific costs, you talked about the 179 deduction and the fact that Congress—and Mr. Fledderman did also so in a couple of minutes can you explain to me and I am sure I already agree with you.

But you notice there is nobody here in defense of this tax code today. The true meaning of not knowing the direction of your life, your business, your—this sustenance for your family in the way

Congress handled this this last time, literally in the last moment and how important and why the 179 deduction is important.

Ms. Wade. Sure so small businesses one of their major complaints is uncertainty over government policies and frequent changes in the tax code and 179 expensing covers both of those unfortunately so in our survey of small business economic trends monthly survey we asked a few questions on capital expenditures.

While capital expenditures are historically low since the recession the December 2013 when the expensing when it was going to be lowered from 500,000 to 25,000 we saw a huge spike in the number of small business owners purchasing capital expenditures, planning that it would be lowered to 25 and not retroactive. So these fluctuations in tax policies certainly affect small business owners and how they conduct their business and we think it should be better served that they conduct their business on what's best for their business and not driven by uncertainties.

Representative Hanna. Do you think all of this causes a misallocation of resources in many different ways for everyone?

Ms. Wade. Absolutely uncertainty is one of the huge problems they face.

Representative Hanna. My time is expired, yield back. Thank you Chairman.

Chairman Coats. Well, thank you for this explanation. To my colleagues and the witnesses and those watching here, we have summed it up. As I said, a byzantine system is in place in terms of who goes when. The rule is that those who are here at the start of the Committee hearing are listed and then they are ranked in terms of House, Senate, Republican, Democrat. We try to be fair to both chambers and to both parties.

Then those who come and go fit in so we almost need to hire a staffer just to provide me a note which gets revised about every 3 minutes and then we have the question of votes over in the House so we are trying. If I overlooked somebody or missed somebody or they are out of order, I apologize. We are trying to do the best that we can. The way I have it on the list is Senator Klobuchar has yielded her time, not yielded, but deferred her time, to the point where she looks over and tugs at my sleeve and says I need it now. So you are welcome to do that, but if we stay with our agreed on procedures it will be Congressman Paulsen, followed by Senator Lee, followed by Congressman Delaney, and then we'll go from there if that is all right with everybody. So Congressman Paulsen, you are on.

Representative Paulsen. Well first of all thank you Mr. Chairman, and the testimony was very good today. You know we spent a lot of time in this Committee gathering data over the last few years about how we are experiencing a growth gap. The economy is under-performing. It is the slowest economic recovery ever and wages are flat, small businesses have really struggled. For the first time in 35 years, more businesses have failed than have started. On top of that, we have got the medical device tax and very powerful testimony that we have heard today.

It is hurting one of our best American success stories. I think one thing to reflect on is that 80% of medical device companies are small businesses, 50 employees or less. Sadly some of the stories that I have heard match the story, Mr. Hoghaug, that you mentioned of the impact on these device manufacturers I talked to a company in Texas. They had never laid off an employee in 22 years, but they laid off 25 people and then they deferred hiring another 15 people simply because of the device tax.

I hear other stories all the time in my home State of Minnesota, and Senator Klobuchar knows and Mr. Hoghaug you mentioned that in your written testimony and you have kind of got this a little bit of cash flow issues. In your written testimony it mentions your effective tax rate as a company at Signus Medical is nearly 79%. You face one of the highest tax rates of any industry now in the world.

I mean it is surprising to me that you are still in business and how can any of us sitting in front of you expect that you can continue running your business like that. Now the Congressional Research Service and other supporters of the tax claim there's no impact on jobs, it's not real. It's not really happening. As someone who is actually running a small business, Mr. Hoghaug, and understands what is happening on the ground how do you respond to those critics?

Mr. Hoghaug. What a great question. In theory most of the studies that I have seen or read it is all based on the fact that you can pass on this 2.3% to the actual end user that is not my experience. We have not been able to—I haven't seen anything but a decrease in the actual pricing since 2008, prices are down about 70% thus profits are down. You tack on the 2.3% on top of that and the cash has to come from somewhere and as I mentioned in my testimony one of the hardest things that I ever had to do is walk up and lay off two people for the sole reason that I had to make my tax payment, not because they were doing anything wrong, they were exemplary employees but I had to lay them off otherwise I would be in default and that's very real and I haven't been able to hire them back because we are paying 50, 60 days in advance of collecting the actual money on the sale so you are always playing catch up with the cash, but the bills always come in on time.

Representative Paulsen. You mentioned also that you deferred or had to shelve some research and development products. The surveys we have gotten back from the device industry says the exact same thing. This is the life blood of the industry right, I mean, it feeds into the supply chain of where we have seen all the success.

Can you tell us a little bit about some of the patients that your devices have helped, and what is the impact of the device tax now on them?

Mr. Hoghaug. Well I have hundreds of stories of benefiting. One that actually has stuck with me for many years is a father bringing in a 16 month old small child who was quadriplegic due to Down's Syndrome and a congenital defect at the base of the skull and carrying his small daughter into the neurosurgeon I worked with in Children's Minneapolis saying please, please bring my daughter back to me.

And through the course of the surgery an implantation of our device I was witness to the fact that she could move her fingers and her legs again and while still has many challenges ahead she was functional and you know there wasn't a dry eye in the house. But those are the types of implants and the next generation implant that could be out there to help more people, a greater number of patients.

The research and development dollars just aren't there to take it to the next generation to supply it.

Representative Paulsen. Well, I think that illustrates how this is really a tax on innovation and as the Chairman knows coming from a state with a high number of medical device companies, and Senator Klobuchar knows we need to keep this industry alive. Thankfully, this is one of those issues that has gathered bipartisan support for repeal, and I hope that we will continue to be able to move this issue forward. I yield back.

Chairman Coats. Thank you.

Senator Lee.

Senator Lee. Thank you Mr. Chairman and thanks to all of you for your testimony it has been very informative today. Mr. Reardon in your testimony you mentioned that back in 2003 full integration of the corporate taxation system came within just a few votes of becoming law, finally becoming reality and you made a convincing argument that businesses should choose their form, their corporate form based on the type of business they have, the type of business strategy they have rather than having to game out the tax code.

Can you discuss with us just a few potential ways in which full integration of business taxation might occur today or ways in which the tax burden of C Corporations and pass-through entities might be kept in balance so that the decision of how to organize a business is driven by business considerations rather than by the tax code?

Mr. Reardon. Sure, I would be happy to. Thank you. I think the Committee has discussed a little bit, sort of this dilemma of that you have big S Corps and you have similar sized C Corps and they are taxed differently and you know how do you reconcile that and my argument is that the S Corp is taxed correctly so you should move the tax code towards that single layer of tax.

One of the ways to do that is to integrate the corporate code with the individual code so that if you are paying taxes at the corporate level then there is no shareholder level tax or vice versa. If you don't pay tax at the corporate level then you have a shareholder level tax of an appropriate amount and then that's the tax that the company pays.

I guess one of the other concerns is that well we can't quite get there, there's no way to do that. Well we came really close in 2003.

The President's original proposal was full integration of the corporate code where if a corporation paid a tax on the dollar that it made then there would be no subsequent tax, either as a dividend or when the shareholder sold the stock as a capital gain. That plan passed the Senate, it came very close to passing the House. The compromise was that we ended up with a 15% raid on cap gains and dividends which got us pretty close to the idea of you know a single layer of tax, certainly much closer than we have been since World War II.

I think that there is two ways to do it. My understanding with your plan is that you have if the corporation pays a tax there is no subsequent shareholder level tax. The challenge with that is the optics, that it looks like that shareholders aren't paying taxes when in fact they are carrying the burden of the tax paid by the business. I think you get around that by having a notice sent out to the shareholder that this much tax was paid by the business on their behalf.

The other way to do it would be to allow the corporate to have a dividend's paid deduction so that the corporation when they kick out a dividend to the shareholders they don't pay a tax at the corporate level, but that the shareholder pays that tax.

I like that because it makes the tax explicit at the shareholder level. The challenge with that is you know there's I think 40% of C Corp equity right now is owned by tax exempt taxpayers, IRA's, trust funds, college funds et cetera so how you deal with those shareholders is difficult.

Senator Lee. There's probably not an easy fix to that.

Mr. Reardon. There's not an easy fix to that so I think your solution is probably the most elegant but the bottom line is that if you want to make U.S. businesses more competitive, the double tax is the big challenge. Our competitors don't have double taxes. Most of our countries that we compete with have integrated their corporate code with their individual codes so we are an outlier there and we should fix that.

Senator Lee. And once you have double taxation in place that therefore makes it a lot more difficult to design a fair tax code, a fair business tax code.

Mr. Reardon. Well I think you have two challenges one it drives up the cost of capital because you have got the two layers of tax and that means that you are driving investment out of the U.S. and into foreign markets and two you have a huge behavioral issue which is you know one of our members testified before the House Small Business Committee earlier today and in his testimony he talked about when they were a C Corp they didn't want to pay dividends because they didn't want to face that second layer of tax. But if they have shareholders who rely on those dividends then what is the point of being the shareholder of a company where you are not benefiting from the success of the company?

That endangers the future of the company because the shareholders say no let's sell the business, let's sell it to that big C Corp down the street. And so the challenge is that you know if you are going to you know move the tax code in the correct way you want to move away from the double tax, you want to make sure that business income, a single layer is taxes at a reasonable rate and then that's it and then you get away from both the cost of capital and the behavior challenges.

Senator Lee. Was this by the way the single biggest argument that sunk the 2003 plan that would have fixed it, was it the argument that you are somehow helping——

Mr. Reardon. I think there was opposition by some important people on the House side but you will have to talk to them I don't know exactly why they didn't like the idea.

Senator Lee. Okay well said. I see my time has expired, thank you very much, thank you, Mr. Chairman.

Chairman Coats. Senator Lee, thank you.

Senator Klobuchar.

Senator Klobuchar. Well thank you very much. We are left to wonder who these important people are but thank you very much.

Mr. Reardon. It might have been the Chairman of the Ways and Means.

Senator Klobuchar. Oh okay well I wanted to first acknowledge Mr. Hoghaug thank you so much for being here and the jobs you create in our State and Representative Paulsen has already mentioned how difficult this situation is with the medical device tax. He and I both have been working together to try to get this repealed along with Senator Hatch and others and we are hopeful that this may be the year we can get this done just because of the changing of politics and people understanding and also a GAO report that came out showing how difficult it is to assess this tax.

Just one other follow-up I had was just the R&D tax credit if that's helpful that's something else that expires at the end of every year and it has been a big frustration and if you find that helpful Mr. Hoghaug?

Mr. Hoghaug. Well, on the surface it seems to be helpful. It hasn't due to the length and kind of the uncertainty of the R&D projects with medical devices not one outstanding being the FDA—as it changes every year you can't get the entire project in under the deduction and I don't know if it is going to be there next year.

So we are planning as if it is not going to be there and then we just have to look at cash flow and how much you can afford.

Senator Klobuchar. Exactly and then it doesn't serve its purpose of creating incentive which is one of the reasons we would love to see longer term comprehensive reform as well as international tax reform and I know in this part of this but we know a little bit about that from having Medtronic and all the trillions of dollars that are overseas.

I was just talking to Senator Schumer about that if we are not going to get comprehensive done this year it would be nice to get that done. Another thing that I have found to be really helpful to our company's manufacturing companies is something you mentioned is the section 179 depreciation tax credit expensing provision and Mr. Fledderman as part of the comprehensive tax reform do you think we should be looking at the depreciation tables or some updates?

It is the number one thing that is mentioned to me and I think it was the head of the Federal Reserve Yellen who also mentioned that it was a very helpful way if we could make that longer and clearer and make any improvements to it it's one of our better tax incentives.

Mr. Fledderman. Yes and thanks for the question. It definitely would help tremendously especially if we can count on it. You know I listened to all of this and one of the things that I think I would like to say is we are talking about the tax incentives that there are and it seems to me like we really don't have tax incentives. We have tax rewards for something you did because we don't know whether we are going to have it.

Senator Klobuchar. Especially when they are retroactive.

Mr. Fledderman. That's right if you know at the beginning that you are going to have it then it really is an incentive to do something versus you might get a reward for doing it. It's a whole different thought process when you are a business owner when you have to make a decision on an investment or something like that. You know I am as patriotic as the next guy but I have got to admit you know when we were getting ready to invest another 4, 5, 10 million dollars in our business I'm questioning is this the best place to do it.

Does it really make sense to put that kind of money here and you don't really know what the return is going to be and I don't like thinking like that and I don't think that's the way we want business owners in this country to think.

Senator Klobuchar. Great thank you. Mr. Reardon, many small businesses in Minnesota actually are ESOPS and I think you know they provide several tax benefits under the law. Can you talk about the benefits of ESOPS for small businesses. We sometimes have tax changes that we are very concerned could affect them and there are some other issues, we got a ruling today out of the Department of Labor that we are concerned about on fiduciary duty but ESOPS actually are exempt from it.

Could you talk about the value of ESOPS?

Mr. Reardon. Yeah that was a real helpful ruling.

Senator Klobuchar. Yes.

Mr. Reardon. The you know, several of our board members are actually S Corp ESOPS and I think one of the primary values aside from the fact that when you have an ESOP structure it changes the whole culture of the business that people take a much higher level of ownership over both their jobs and sort of accomplishing the tasks that are within their responsibilities.

But it also eases the transition of business ownership. One of the biggest challenges for businesses like Mr. Fledderman's and Mr. McGregor's is how do you transition from one generation to the next or if there is no other generation what do you do with that business?

Usually for closely owned businesses, the people who have the best chance of succeeding with it after the first generation goes away are the people who are working there and so that's where an ESOP really comes in handy because it eases that transition it shifts the ownership to the people who are best able to keep that business successful and then it creates a great return and retirement opportunity for them.

Senator Klobuchar. Okay thank you very much.

Chairman Coats. Thank you. Let's see, my list has Congressman Delaney.

Representative Delaney. Thank you Mr. Chairman and I want to thank all of our witnesses for being here today. Prior to coming to Congress I ran a commercial finance company that I started that across 11 years we financed 5,000 small to mid-size businesses and made about $30 billion of loans and I can say every single one of the businesses that I ever financed always thought that they were paying too much tax.

And they are right about that to some extent because let's face it you know earnings would be more productively invested in the business than they are paid to the government but we do need tax revenues for the government to pay our obligations and that's our principal responsibility as fiduciaries.

And so when we think about these changes we have to be smart about them and we have to do things that you know unlike the medical device tax which I don't like because it's an excise tax and the reason I think the witness had the problem with his business is because it was income tax, you would only pay it if you are actually making money so you wouldn't have the cash flow problems.

But I think there are two things, the first is that I think we have to stop with the false choices between small and big businesses because A it is hard to find those lines and Mr. Fledderman it sounds like your business does a lot of work for the auto industry, those are big companies they are your clients. And so the fact that we have a bad tax system for them affects you too and I think it's true for most small to mid-size businesses in this country a lot of their clients at least of the 5,000 companies I financed a lot of their clients were big businesses so the fact that we keep their cash overseas because we have a bad international tax system hurts small businesses.

The fact that they have all the same problems that you do hurts small businesses so these false choices because small businesses employ a lot of people but there is a lot of data that suggests that it is actually fast growing mid-size businesses that create all the jobs so I just think it is important for us not to have this false narrative. We have a bad tax code and it is hurting all American businesses full stop and they are all interrelated.

But my question is to you Mr. Reardon, let's assume for a second because there is a fair amount of momentum at least I feel to do business only tax reform and I think the reason for that is that the ideological divide on the individual tax reform is very wide at this point.

So there is momentum to do business only so let's assume we are doing that for a second and let's assume that we don't do what you would like which is to eliminate the double tax and I understand all the reasons for it but let's assume for a second we don't do that, how do you—how would you propose that we deal with all of the unincorporated businesses of which probably 90% of businesses I don't know what the stats are all probably incorporated being one of our witnesses here Mr. Hoghaug you run a C Corp and you run an LLC right so there's you know these things are somewhat interchangeable.

How do you think we can if we were to eliminate deductions and lower the rates for C Corps and we were not to do individual tax reform at the same time, how could we actually do something to address an incorporated business at the same time?

Mr. Reardon. Just for the record we have always argued for comprehensive reform that addresses individual——

Representative Delaney. My hypothetical assumes that.

Mr. Reardon. Plan B is out there which I think it is sort of encompassed on what Senator Lee has in his plan. There's a Grant Thornton business equivalency plan out there which would effectively cap the tax on pass-throughs at whatever the top C Corporate is so that you would divorce a little bit the individual rate from the pass-through rate.

Basically treat it like capital gains so when you have active pass-through income it shows up in the shareholder's income taxes and then it is treated to a different rate schedule than their other wage and salary income. I think that's probably the most fair way to treat the difference between C Corps and pass-throughs.

Martin has mentioned a number of other options out there, all of them would benefit certain pass-throughs but the challenge is that none of them, unlike rates, affect all pass-throughs the same way and so if you do broader expensing you are helping companies that have more capital expenditures but there is lots of S Corps and pass-throughs out there, retail and others that don't have a lot of capital expenditures so they won't benefit at all.

So they will still be stuck with that higher rate. We have explored this as I said for 5 years and we keep coming back to the rates.

Representative Delaney. What do you think the apples to apples differential is right now between a C Corp counting its double tax and a pass-through?

Mr. Reardon. It depends on——

Representative Delaney. Who is paying more and by how much? I know it's hard but generalize it.

Mr. Reardon. Well the effective rate study that we did looking at domestic only because once you get into international it gets really complicated with all the credits in there. S Corps are at 32%, C Corps were at 27% that does include dividends but it doesn't include the capital gains rate so you should probably adjust the C Corp up a little bit. But I think you know they are sort of in that range where they are at right now.

Representative Delaney. So if you did the proposal that you are talking about the spread would probably be similar because if you lowered the rate?

Mr. Reardon. Yes, I think it would be fairly comparable.

Representative Delaney. Thank you sir.

Chairman Coats. Congressman Beyer.

Representative Beyer. Thank you Mr. Chairman and thanks all of you for coming and this fascinating—I've been running a small business for 41 years and very much identify with so much of what you say the incredible difficulty of accumulating capital just because of the tax.

So Dr. Sullivan is a Harvard trained economist. We heard early on and I think Mr. Reardon's presentation about that when you add up the medical device tax, rather the Affordable Care Act Tax and the like you get to 44%, 43.4% when you add Virginia's 5.75% personal state tax you are over 50 and then if you look at the part that we take out for ourselves for social security that's another 15.4% so it's you know 65% or something on the first $107,000 and then drops down.

Is there any theoretical economic research that shows where that ideal theoretical tax break should be where you start to get the disincentive of not to work which just doesn't make any sense to try as hard as it does when you are a small business?

At what point do we say if 53% is perfect or 40% or 60% or 29?

Dr. Sullivan. Well I think there's no magic number out there. It certainly is subject to a lot of controversy. You should keep the rates certainly as low as possible. I think the question that we are talking about is there are a lot of individuals who are not involved in small business who are subject to these high tax rates and so when we talk about lowering the rates it is not just affecting the small business. If we want to help small business it doesn't make a lot of sense just to focus on the rates because then you are helping all individuals who have very high incomes. So if we want to promote job creation we should give tax breaks to the individuals who are actually creating jobs. And so I wouldn't focus so much on the rates as to focus on the job creation part of the equation.

Representative Beyer. I was impressed with options 4 and 5, option 4 being the upfront tax benefits like the costing, expensing and option 5 being you know the tax simplification, the huge tax burden years ago when Bill Clinton was first elected President I talked to one of his chief economists about one of my great frustrations which is I don't mind paying 39.6% tax on the income I take out of the business, you know to buy my big house, to pay the country club bills, it drives me crazy to pay it on the money that I want to leave in the business to grow more jobs, to expand it.

Is there not an option 7 here or an option 6 that says you can do the same tax rates on the money that is taken out but a much, much lower rate on the money that is left to grow the business and to grow jobs?

Dr. Sullivan. I was just at Harvard last week talking to the law school professors there and Professor Halperin was suggesting that there should be tax relief for money that is kept inside the corporation and so I think there are options like that that people are interested in.

Representative Beyer. Maybe we can ask our Chair and Ranking Member if we can pursue that together which would be excellent, thank you and I'm hoping Mr. Reardon can help us think about that also.

Mr. Hoghaug, you know one of the arguments made about the medical device tax was that you were going to sell somebody more artificial hips and pacemakers and the like that would offset it. Do you see any uptick in demand from ACA?

Mr. Hoghaug. Great question, no. We have seen zero uptick. Most of the devices, spine in particular, but I am also involved with the shoulder and other joints, are diseases of the aging and elderly. Those people either have insurance or covered by Medicare so we have seen no appreciable rise at all. You know a trauma patient that goes in with a broken neck is going to get treated whether or not they had insurance so those numbers really haven't changed at all.

Representative Beyer. Would deductibility and alignment of the cash flow make a meaningful difference for you in the medical device tax?

Mr. Hoghaug. I just think it's an entirely bad idea to be taxing in any way this—the innovation. I'm not sure how one could reconcile that. I mean it seems that the majority of the House and Senate are in favor of repealing this tax as it really is a tax on innovation and you know by not being able to reinvest within the company and on the next new generation product the patients are suffering.

Representative Beyer. Thank you Mr. Chair.

Chairman Coats. Terrific questions. I mean you got our attention on those couple of items there. Thank you, Congressman Schweikert?

Representative Schweikert. Thank you Mr. Chairman. Is it Congressman Beyer? If you are paying your country club fees, you belong on this side right? So if I turned to this panel and said, all right, optimal tax system? And from a personal perspective, and it would be a good time for the doctor, in a moment, to share his philosophical vision. What is a tax code that maximizes economic growth, economic stability but minimizes decision making directed from the tax code itself; because I believe as a regulatory policy when it is outside certain realms but also tax policy we distort price effects, we distort allocations.

Mr. Reardon, describe to me what the optimal tax code is?

Mr. Reardon. If I were writing the tax code in the current environment I would shoot for a rate that is sustainable, 28–30% range and then I would tax all income at that rate. As I said earlier incorporate or integrate the corporate code so you can have the 30% rate on C Corps, 30% rate on pass-throughs and 30%——

Representative Schweikert. And you would create equalization or deal with the differential on the C Corp and its dividends?

Mr. Reardon. And on the individual rates as well, you know I disagree sort of a little bit with what Marty is saying about what rate should be applied to wage and salary income simply because capital has to come from somewhere and the only way that you are going to get capital for people to borrow or invest is for people to be able to earn money and then save it and then invest it in those enterprises.

Representative Schweikert. Mr. Fledderman does that accomplish what you need?

Mr. Fledderman. Absolutely I agree 100% I think the simplification of tax code helps both the business as we can plan and I think it helps the Federal Government because they can plan. Right now the government doesn't know what kind of credits I am going to submit for at the end of the year so they really don't know what kind of returns are to be necessary. It would be a lot easier for us to calculate what our tax burden is going to be and for the government to calculate what the tax take is going to be.

I'm all for paying my fair share of taxes and a flat tax would be simplified would make it the same for everybody.

Representative Schweikert. Miss Wade what would be the optimum tax code?

Ms. Wade. For NFIB members they have told us time and time again that lowering the rates that's for all demographics of small businesses, regardless of industry or their growth potential. Lowering the tax rate but then also permanency of the Estate tax repeal and 179 expensing so that the frequent changes in the tax code isn't driving their business decisions.

Representative Schweikert. What is you lowered rates to the point that you remove things like 179?

Ms. Wade. We've surveyed our members and there is a little bit of negotiation but it all comes down to what their paying and bottom line on tax costs.

Representative Schweikert. That's what it is always about right?

Ms. Wade. Yes.

Mr. Sullivan. It's always about trade-offs. I mean NFIB members want lower rates and they want expensing but you are asking the question. If we have to raise a certain amount of revenue what's the best way to do it.

Representative Schweikert. In the most—my proposition is based on the concept what maximizes economic growth and minimizes economic distortion by tax policy.

Mr. Sullivan. And the answer is that under tax reform in the classic sense we want a single layer of tax on all businesses and we want rates as low as possible and there is going to be some very painful loophole closing that is going to have to take place for that to happen. When I was on staff I was always lobbied, I'm sure you are lobbied and you are told that if you take away this tax break it is going to hurt jobs but ultimately all of those tax breaks are really hurting jobs and you need to lower the rates and sort of ignore that pattern about "oh you are going to kill jobs by taking away my tax break."

Representative Schweikert. In a world like you have where you are putting money into R&D for medical devices what is optimal for you?

Mr. Hoghaug. Well two-fold once I agree—but I would agree that a lower flatter tax, corporate tax would certainly induce re-investment within the company and with R&D. The elimination of the medical device tax which is punitive on my start-up company, which has yet to turn a profit and yet it still pays medical device taxes, so I am actually borrowing money and financing the tax.

But I would agree just some extension of the R&D tax credit or something, just something that we could plan for the future.

Representative Schweikert. All right thank you Mr. Chairman. There is one comment I wanted to make we need to be a little careful earlier we threw out what if you were an investment company or a hedge fund or this and that and the title or the structure we should probably be concerned about what is the profitability, what's the actual income from it because there was a time when I ran a fairly large investment fund and make no money from it but I had a really big title so we have got to be very careful about stereotyping because it sort of distorts, you know when we get down to the sort of what's the actual—that's for the economy and best for the country that I yield back Mr. Chairman.

Chairman Coats. Well, thank you, Congressman. The Senate has called a vote so I am going to have to leave shortly, I would be happy to turn this over to the Ranking Member, Congresswoman Maloney if you want to continue with some additional questions or if you have any additional questions.

It seems to me, and I am not trying to categorize everything into a conclusion here, but what I have heard today is that tax reform is a necessity if we are going to promote economic growth for the future.

Comprehensive tax reform seems to be the best way to go. Piecemeal continues the complexity and some unfairness. Making it fair is simplifying our tax code, lowering rates to the extent that we can. Particularly dealing with the question relative to business income, where is that sweet spot where you can lower the rate and eliminate the exemptions or the trade-offs? Because if you want to achieve fairness you want to achieve simplicity.

It seems to me that to get that fairness, you have to give that consideration. Is there a level at which you could say give me that level, that provides the certainty that I need, so that I know exactly what I am going to have to pay on the income that I earn and the profits that we achieve and I don't have to hire attorneys and CPA's to figure out how I qualify for certain exemptions, certain deductions? I think that's a challenge that is going to hit all of us here in Congress, and we are going to have to address the need through comprehensive tax reform that very question.

We have talked about the right level as you have gone through this I don't think we need to report that. And then locking in certainty seems to be the key component of getting a pro-growth dynamic economic tax code. We talked about what I would think are two confiscatory, egregious taxes and one is the medical device tax, which I think our witness here from Minnesota knows, and I have experienced the same thing in Indiana. We are a medical device state also.

I have seen and heard from those who own the companies who have not yet, but have potentially innovated breakthroughs that can substantially improve health and save lives, but simply aren't going to be able to get there or pursue their technology or their innovation because they are forced to pay tax on their sales, an excise tax and not on their profits.

They are not making a profit, they have to borrow money to pay the tax or they lay-off people. We have had companies that have planned expansion, planned new hiring and canceled as a result of this tax. It's egregious to take this type,—particularly this type of innovative industry that has so much promise for future health benefits to slap on an excise tax. And it was all based on the fact that you would have a surge of business from the Affordable Care Act, which you have indicated has not been the case. And that's true with many of our smaller companies in particular.

And then the estate tax. I know the House will be voting on this. I am not sure if the Senate has the votes to address this. But in many instances, not in every because there is some inherited money passed down, clearly, but this is money that has been earned, money that has been taxed. And then you get to do it all over again—almost half of everything that you have saved, and give it back to the government the second time.

I think it's been a very constructive hearing. I thank our witnesses for being here, with some terrific questions that have been asked, and some very good answers that have been given. I think this will play an important role in terms of how we determine how we move forward with achieving the goal I think we all want to have and that is taking a very complex, out of whack, desperately needed, tax code reform piece and make it sensible. Accomplishment here is relative to what is necessary for us to get our economy not hindered by the complexity and the unfairness of this particular code. And so thanks to all of our witnesses, thanks to my colleagues here. With that, this meeting is adjourned.

(Whereupon the meeting adjourned at 4:06 p.m.)

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF HON. DAN COATS, CHAIRMAN, JOINT ECONOMIC COMMITTEE

It is fitting that on Tax Day, April 15, we are examining one of the most vexing challenges for small business—our burdensome and incomprehensible tax code.

A quote by an unknown source represents the entrepreneurial spirit I have witnessed representing Hoosiers in Washington: "Small business isn't for the faint of heart. It's for the brave, the patient and the persistent. It's for the overcomer."

The small business owners I have met are brave, patient, and persistent. They are indeed overcomers. Despite the obstacles small businesses face, they are responsible for two-thirds of the net new private-sector jobs created in the United States. Our role as legislators should be to ensure that the tax code is no longer a major obstacle to growth and jobs for these businesses.

Against the headwinds of the slowest recovery since 1960, small business owners have to deal with a tax system that is hopelessly complex, full of provisions that expire every one or two years, riddled with special exemptions, deductions, and preferences, and filled with new penalties.

The Small Business Administration lists tax paperwork as the most costly paperwork burden the Federal Government imposes on small businesses at $74 per hour or $1,500 per employee. It is not surprising that nine out of 10 small business owners have to turn to an outside paid professional to figure out their taxes.

Today we will hear from witnesses who can discuss how tax policy is affecting the broad landscape of small businesses. We will also hear two stories of real businesses that will bring home how taxes affect companies on the ground.

We hear these stories every day:

- Stories of complexity. I can sympathize with business owners because I took two tax law courses in law school and am still baffled by the tax code.
- Stories of uncertainty, like the farm family unable to replace outdated equipment because they are unsure whether small business expensing or bonus depreciation will be in effect for the year, and at what level.
- Stories of manufacturers hit with higher tax bills because the top individual tax rate rose, but without extra cash in the business to pay the tax.
- Stories of small businesses struggling under the weight of ObamaCare's taxes and mandates, wondering if they can afford to add more workers or whether they should move employees to part-time status.
- Stories of medical device makers, like one in Warsaw, Indiana, that develops orthopedic implants for children and had to shelve two important projects because of the medical device tax.
- And stories of family-owned businesses with land, buildings, equipment or inventory but without cash to pay the estate tax, worried the business won't survive to the next generation.

Tax Day is a perfect time to commit to not let another April 15 pass before we finally tackle comprehensive, pro-growth tax reform. And while it is urgent and essential to lower our corporate tax rate, which is the highest in the developed world, we must not forget the millions of small businesses that pay taxes at the individual level and have just experienced rate increases of their own.

I look forward to hearing from our witnesses about how we can tear down barriers to growth in our broken tax code.

PREPARED STATEMENT OF HON. KEVIN BRADY, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

Chairman Coats, Ranking Member Maloney, Members, and Distinguished Witnesses:

Even though the United States has technically been in a recovery for more than five-and-half years, our economy remains stuck in second gear. Last year, our economy grew by 2.4 percent—that is barely above the average annual growth .rate of 2.3 percent for this entire disappointing recovery.

In this recovery, the rate of new business formation has lagged. New and expanding small businesses have historically accounted for a large share of new jobs during expansions. Regrettably, this fountain of job creation has slowed significantly during this recovery compared with past recoveries.

Our broken U.S. tax code is a major cause for this weak recovery:

- Our tax code is too costly, complex and unfair—but mostly unfair. Especially to hardworking taxpayers, small businesses and America's economy.

- A national survey by Texas-based polling firm Baselice & Associates shows 80 percent of voters support Congress "acting now to fix the tax code by making it fairer, flatter and simpler." Eighty-six percent of Republicans support reform, followed by 79 percent of Democrats and 76 percent of independent voters.
- Americans agree: We need a simpler, fairer tax code that's built for growth and makes our economy healthier. It should close loopholes and limit deductions to lower tax rates for everybody. Small businesses shouldn't pay higher tax rates than big businesses, and real reform should stop encouraging companies to shift jobs overseas.
- I believe a 21st century tax code shouldn't raise taxes to bail out Washington's spending problem. It should limit spending, rein in the IRS and strengthen America's economy to begin paying down our national debt.

Today, I want to focus on a particular challenge confronting farmers, ranchers, and small business owners—the death tax. All too often, families must sell their farms, ranches, and small businesses to pay Uncle Sam's death tax. One fifth-generation Texas ranch I know-which started back in the 1800s—had to sell 2/3 of that historic land to pay the death tax. That's just wrong.

What is worse—if you can imagine it—is that the death tax is especially destructive for women- and minority owned small businesses. They're the fastest growing sector of small businesses and start-ups in this country.

Bob Johnson, the founder of BET television, observed the death tax "continues to pose a serious threat to the likelihood that present-day African American-owned businesses can be preserved as part of a family's long-term legacy."

President Obama insists that the death tax is necessary to remedy income inequality. Yet, that just isn't so. Former Vice Chairman of the Federal Reserve Board Alan Blinder found that only two percent of income inequality can be explained by inherited wealth.

The death tax motivates the wealthy to reduce their savings and increase their consumption spending now rather than pass their wealth on to the next generation. The death tax actually increases the consumption gap between the wealthy and the poor in America. Moreover, the death tax leaves all Americans poorer as the productive investment in new buildings, equipment, and intellectual property—which those savings would have funded—does not occur and the jobs that such investment would have generated are not created.

This reminds me of President Reagan's aphorism about our friends' knowing so much that isn't so.

Democrats claim that "special use valuation" is an alternative way to exempt farms, ranches, and small businesses from the death tax. We've tried these gimmicks before. They don't work. They just throw additional burdens and complexity on family businesses and tie them up in red tape for years after death.

Enough with the gimmicks and complicated workarounds. They don't work. Right now, our country is facing a $1.5 trillion Growth Gap compared with an average recovery since 1960. That means we're missing 5.5 million private-sector jobs. The average family of four is missing almost a thousand dollars a month. Our recovery is so bad, we're going to need 7.4 percent growth in real GDP each and every quarter just to catch up to the average recovery by the time President Obama leaves the White House.

We need American entrepreneurs and family businesses to close that gap. They're the backbone, the engine of our economy. But the death tax has robbed them of $1.1 trillion in capital stock. The Tax Foundation estimated that in 2005 the death tax cost American taxpayers $88.2 million and 2.3 million hours of effort just in compliance. Imagine if all of that could have been invested in new jobs and business opportunities. I don't think I need to stress to anyone here how desperately we need that.

The Treasury collected $19.5 billion in estate and gift taxes over the last 12 months. In contrast, the Treasury spends $9.9 billion per day. The death tax generates less than two days of federal spending.

This week, the House of Representatives will vote to repeal the death tax once and for all. I hope the Senate will join the House and approve this truly progressive legislation and send it to President Obama.

I look forward to today's discussion with our witnesses.

PREPARED STATEMENT OF CAROLYN B. MALONEY, RANKING MEMBER, JOINT ECONOMIC COMMITTEE

Thank you Chairman Coats for holding today's hearing. I also want to thank all of the witnesses for being here today.

There is broad agreement that small businesses are the backbone of the economy, the anchors of our communities, and that they have played an important role in the current recovery.

ACTIONS BY DEMOCRATS

When President Obama took over from George W. Bush, the economy was in free fall and small businesses were bearing the brunt of the pain. Over the fourth quarter of 2008 and the first quarter of 2009, small businesses shed more than three million jobs.

President Obama and Democrats in Congress, along with the Federal Reserve, took bold action to turn things around in the darkest days of the Great Recession. These actions included a number of efforts to support small businesses.

For example, the Recovery Act cut taxes for small businesses, allowing them to immediately deduct up to $250,000 of investment, carry back losses for five years, and exclude from taxation 75% of capital gains from small business investment.

SMALL BUSINESS JOB GROWTH

Today, small businesses are leading the economic recovery. Small businesses have added more than six million jobs over 17 straight quarters of small business job growth (see chart #1).

We have come a long ways in the past six years. The share of small businesses planning to add jobs is back near its pre-recession average (see chart #2).

While this reflects major progress, I believe we need to do more to support small business growth.

The Administration's tax reform plan, for example, would simplify and cut taxes for America's small businesses. President Obama's revenue proposal includes expanding and permanently extending increased section 179 expensing for small businesses. The proposal would also increase the number of small businesses that can take advantage of simpler cash accounting rules.

The Administration's approach provides tax cuts for small businesses in a fiscally responsible way and in the context of broader business tax reform. By contrast, the Republicans in the House have passed bills without offsets—which would blow massive holes in the budget.

SMALL BUSINESS ATTITUDES

Some of my Republican colleagues would have us believe that small businesses are up in arms about the Obama Administration's policies. But this chart—based on survey data provided by the NFIB, one of our witnesses today—shows that the share of small businesses listing taxes as their top concern is no greater today than when Ronald Reagan left office (see chart # 3).

Ronald Reagan!

SOME "SMALL" BUSINESSES ARE QUITE LARGE

One of our principal goals today should be to decide what a small business is for tax purposes.

While most of the 95 percent of businesses that are organized as pass-throughs are small—many are extremely large. Numerous large law firms, accounting firms, hedge funds and other businesses are pass-throughs.

The tax code treats these large businesses the same as "mom and pop" stores down the street. But, should it?

When designing tax policy, fairness should be a principal concern. Some large multinationals pay less than small businesses and some extremely large companies don't pay any federal income taxes at all.

In other words, the corner store likely pays more in federal income taxes than some of our country's largest corporations. Those who are critical of our tax system should save some of their outrage for this.

ESTATE TAX

Before taking on tax reform, Republicans have proposed repealing the estate tax and they plan to vote on it in the House later today or tomorrow.

Let's be clear: repealing the estate tax would be a major windfall for the wealthiest Americans. With the current exemption amounts of over $5 million per person and more than $10 million per couple, the estate tax affects only two out of 1,000 estates. In other words, 99.8 percent of Americans do not pay any estate tax (see chart #4).

Republicans say they are motivated by a desire to protect small businesses. But that's something of a Trojan horse. Only about 20 small business and small farm estates owed any estate tax in 2013, according to the Tax Policy Center. Twenty!

Repealing the estate tax is also very expensive. The Joint Committee on Taxation found that repealing the estate tax would increase the deficit by $269 billion over 10 years.

NEED FOR BIPARTISAN TAX REFORM

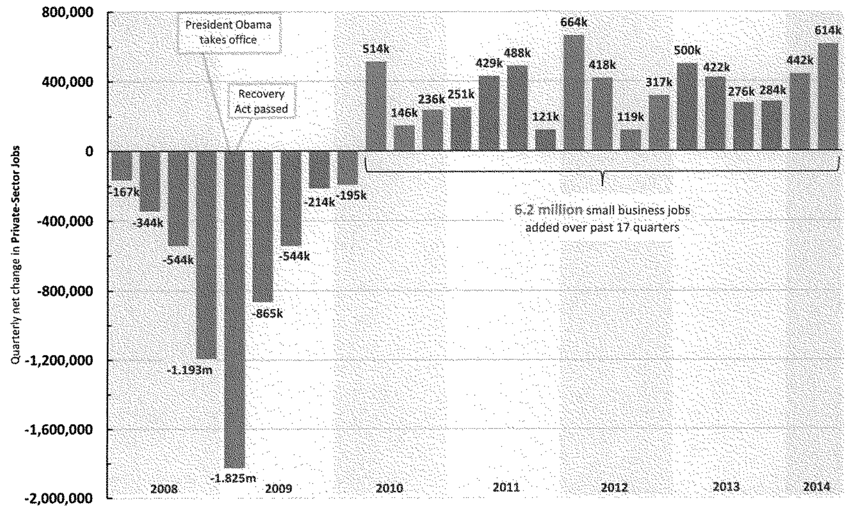
1986 was a massive overhaul and simplification of the tax code. The minute the ink was dry, work began to undo it. And trust me, it wasn't small businesses at the table.

We must make sure that any tax reform benefits the small firms, not just the big multinationals gaming the system to further limit their tax obligations.

Tax reform is hard. That's why there hasn't been a major rewrite of the code in about 30 years. For it to work, it must be comprehensive and it must be bipartisan. There is no other path forward.

I look forward to hearing the perspective of our witnesses this afternoon. Thank you for appearing before the Committee.

Small Businesses Have Added Jobs for 17 Straight Quarters



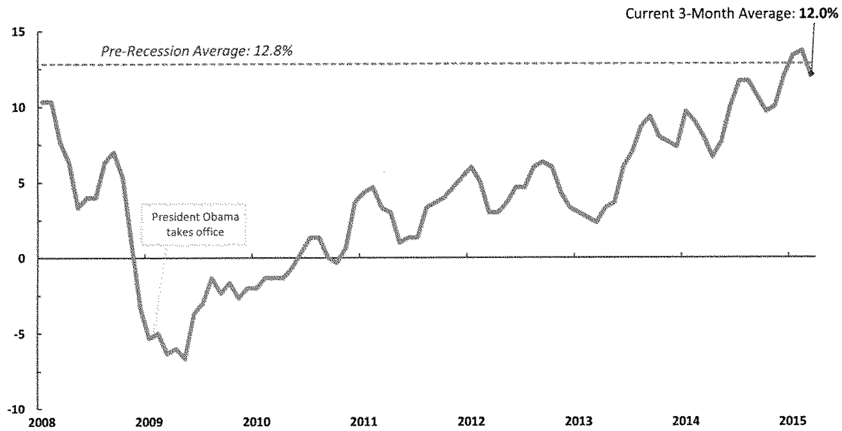
Notes: Small business defined as a firm with fewer than 500 employees; data through Q2 2014
Source: Bureau of Labor Statistics, Business Employment Dynamics (Updated April 14, 2015)

Slide 1

JOINT ECONOMIC COMMITTEE
RANKING DEMOCRAT CAROLYN B. MALONEY

Share of Small Businesses Planning to Increase Employment Is Near Pre-Recession Average

3-Month Moving Average, January 2008 to March 2015



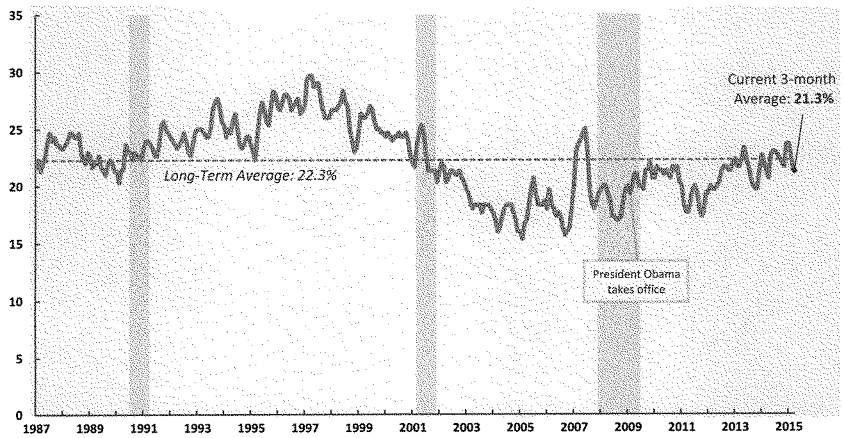
Notes: Dashed line represents the average from January 2001 through December 2007; data represent share of small businesses planning to increase employment in the next 3 months net of those planning to reduce employment
Source: JEC staff calculations using data from the National Federation of Independent Business (Updated April 14, 2015)

JOINT ECONOMIC COMMITTEE
RANKING DEMOCRAT CAROLYN B. MALONEY

Slide 2

Share of Small Businesses Listing Taxes As Top Business Concern Effectively Unchanged Over Time

3-Month Moving Average, January 1987 to March 2015



Notes: Dashed line represents the average from January 1986 through March 2015; grey areas represent periods of recession as determined by the National Bureau of Economic Research
Source: JEC staff calculations using data from the National Federation of Independent Business (Updated April 14, 2015)

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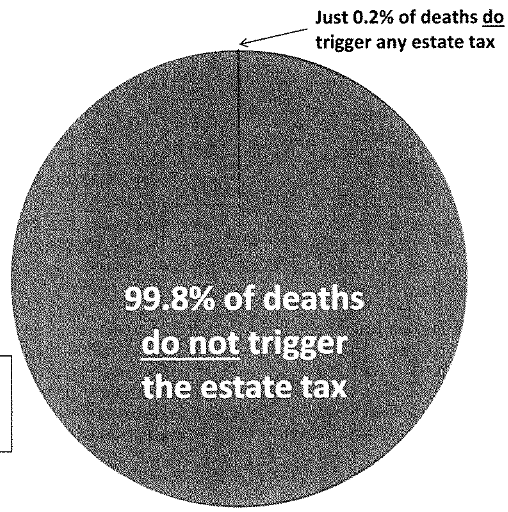
Slide 3

Only 2/1,000 Estates Are Subject to the Estate Tax



No one pays estate tax on the first $5.43 million of their wealth (2015)

Just 20 small businesses owed any estate tax at all in 2013 -- and those that did owed less than 5% of their value

Source: Joint Committee on Taxation and the Urban-Brookings Tax Policy Center

Slide 4

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TESTIMONY BEFORE THE JOINT ECONOMIC COMMITTEE

Hearing On:
Small Business, Big Taxes: Are Taxes Holding Back Small Business Growth

Brian Reardon, President, S Corporation Association

April 15, 2015

History of the S Corporation

Before Congress created S corporations, entrepreneurs had two choices. They could form a traditional C corporation and enjoy liability protection, but they would face two layers of federal tax at the corporate and individual level. Or they could choose a partnership or sole proprietorship and enjoy a single layer of taxation at the individual level, but sacrifice the umbrella of liability protection.

Neither choice was optimal for closely-held and family owned businesses. In 1946, the Department of Treasury suggested a third option – merging a single layer of federal tax with comprehensive liability protection. President Eisenhower embraced the Treasury proposal and in 1958, led by Democratic Finance Chairman Harry Byrd, Congress acted to create subchapter S of the tax code.

Creation of the S corporation was a huge step forward in reducing the harmful effects of the double corporate tax and encouraging closely-held and family business creation in the United States. Reducing an oppressive level of tax was an essential part of the legislation. As the Finance Committee noted at the time of passage, "permitting shareholders to report their proportionate share of the corporate income, in lieu of a corporate tax, will be a substantial aid to small business."

Over a half century later, policies embraced by Democratic and Republican Congresses alike have made the S corporation rules more flexible while also reducing the marginal tax rates these businesses pay. In return, S corporations have made the American economy more flexible, dynamic, and diverse, helping to create much needed jobs while providing an essential economic anchor to communities around the country.

Despite this success, the recent debate over reforming business taxation has almost exclusively focused on C corporations and their challenges. This narrow focus has persisted even though S corporations and the larger pass through business community employ the majority of workers, contribute more to our national economy, and face exactly the same pressures and challenges as C corporations.

The rate on C corporations should come down as part of a larger package of tax reforms, but so shouldn't the top tax rate on pass through businesses, including S corporations. This is an argument we have been making for more than four years now, and during that time we have developed a number of

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themes that help explain both the importance of the pass through community to investment and jobs here in the United States, and the reasons why Congress should enact comprehensive tax reform that reduces rates for pass through businesses and C corporations alike.

Use S Corporations as the Model

Simply put, the S corporation structure is the correct way to tax business income. If Congress were starting its tax policy from scratch, it would start with the S corporation model to tax business income. There are three key reasons why this is true.

First, S Corporation income is taxed once, and only once. Everybody knows multiple layers of tax raise the total effective rate paid by businesses, but the double corporate tax also has the effect of distorting business behavior. There is a reason why only a small minority of C corporations pay dividends – they are adjusting their behavior to avoid that second layer of tax. Business income should be taxed once at a reasonable rate and then that's it.

Second, S corporation income is taxed when the business earns the income, and it is taxed regardless of whether the income is "distributed" to shareholders. There is no election or deferral in paying tax on S corporation income.

Finally, S corporation income is taxed at progressive rates tied to the shareholder's income. Wealthy S corporation shareholders pay high marginal rates while lower income shareholders pay lower rates. This contrasts with the C corporation model, where with few exceptions most C corporation shareholders shoulder the same tax burden, regardless of their income.

S Corporations are Doing What Congress Intended

Congress created S corporations to encourage private enterprise and it worked. Today there are 4.6 million S corporations.[1] They are in every community and they are engaged in every type of industry.

Since their inception, Congress has proactively amended S corporation rules to make them more attractive to entrepreneurs. Reforms enacted in 1982, 1986, 1996, 2001, 2003, 2004, and since have made the S corporation structure more flexible and competitive with C corporations and the newer LLC's. Of these changes, the two that stand out are the broad tax reforms of 1986 and the Jobs and Growth tax package of 2003.

The 1986 tax reform opened the door to the broad growth of the pass through business sector. Prior to 1986, the top rate on corporate income was 46 percent, while the top rate on individual income was 70 percent. As a result, the vast majority of business activity was done under the C corporation umbrella and tax planning, avoidance and gaming was rampant as business owners attempted to avoid the higher

[1] Internal Revenue Service Data Book, 2014

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individual rates. As S Corporation Association Advisor Tom Nichols testified before the Ways and Means Committee in 2013[2]:

> *When I first started practicing law in 1979, the top individual income tax rate was 70 percent, whereas the top income tax rate for corporations taxed at the entity level ("C corporations") was only 46 percent. This rate differential obviously provided a tremendous incentive for successful business owners to have as much of their income as possible taxed, at least initially, at the C corporation tax rates, rather than at the individual tax rates, which were more than 50 percent higher.*
>
> *This tax dynamic set up a cat and mouse game between Congress, the Department of the Treasury and the Internal Revenue Service (the "Service") on the one hand and taxpayers and their advisors on the other, whereby C corporation shareholders sought to pull money out of their corporations in transactions that would subject them to the more favorable capital gains rates that were prevalent during this period or to accumulate wealth inside the corporations. Congress reacted by enacting numerous provisions that were intended to force C corporation shareholders to pay the full double tax, efforts that were only partially successful.*

The second major event in pass through taxation was the adoption of the Jobs and Growth tax package in 2003. This package included two major improvements in business taxation. First, it significantly reduced the double tax on corporate income, moving corporate taxation closer than ever to the pass through structure we should adopt.

The President's initial proposal was for full integration of the corporate code so that, like S corporations, C corporation income would have faced a single layer of tax. Far from being unachievable as some have argued, that proposal came within a few votes of becoming law. As it was, Congress adopted a plan that significantly reduced the double tax by cutting dividend and capital gains taxes to 15 percent.

Second, the 2003 reforms resulted in rate parity among C corporations, pass through businesses, and individuals. This meant that a business making a dollar faced the same 35 percent rate, regardless of how it was structured, on its initial earnings.

In return for these reforms, S corporations have rewarded Congress by making the US economy larger and more flexible than if all business activity were conducted under the C corporation structure. As Ernst & Young noted in 2011:

> "In addition, the flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment embodied in the income tax system leads to a bias in firms' financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and

[2] Statement of Tom Nichols before the Ways and Means Select Revenue Measures Subcommittee (May 15, 2013)

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> consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation throughout the entire economy."[3]

There is more employment and capital investment in the United States than if all businesses were organized as C corporations because of the existence and success of pass through businesses.

Pass Through Business Employ Most Workers

The higher growth rates resulting from pass through taxation includes employment. Both Ernst & Young[4] and, more recently, the Tax Foundation[5] have found that more than half of private sector workers are employed at pass through businesses, while S corporations employ nearly one in four. According to the Tax Foundation numbers:

- Pass Through Businesses – 66 million (55 percent)
- S corporations – 29 million
- Partnerships – 13 million
- Sole Proprietorships – 23 million
- C Corporations – 52 million (45 percent)

States with the highest levels of pass through employment include Montana, South Dakota, Maine, Rhode Island, New York, Idaho and Wyoming. Only Hawaii and Delaware have pass through employment levels below 50 percent.

The Tax Foundation reports that large pass through businesses also are a significant source of employment. According to their analysis, more than 10 million people work at pass through businesses with more than 500 employees.

The Business Tax Base is Growing, Not Shrinking

Moreover, while observers frequently note that the corporate tax base has shrunk since 1986, it's rarely pointed out that the business tax base overall has grown in that time. Business plays a bigger role in the American economy today than it did prior to 1986, entirely due to the growth of pass through businesses, including S corporations.

According to the Tax Foundation[6], in the decades prior to 1986, traditional C corporation income made up approximately 8 percent of GDP while pass through income, including S corporations, made up just one percent, for a total of 9 percent. Today, following the 1986 reforms and subsequent improvements in business taxation, C corporations contribute 5 percent of GDP while pass through businesses add 6 percentage points – a total of 11 percent of GDP

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[3] Robert Carroll and Gerald Prante, The Flow-Through Business Sector and Tax Reform (Ernst & Young, 2011)
[4] Ibid., 4.
[5] Kyle Pomerleau, An Overview of Pass-through Businesses in the United States (Tax Foundation, 2015)
[6] William McBride, "America's Shrinking Corporate Sector," Tax Foundation, last modified January 6, 2015

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Instead of decrying the "erosion" of the corporation tax base, policymakers should be celebrating the growth of the business tax base. The pass through approach to business taxation is superior in many respects, and businesses are making that clear by migrating, when they are able, into the more efficient structure.

S Corporations Pay Their Fair Share of Tax

Another critique of S corporations is that they "avoid" the corporate tax, with the implication being that they either don't pay taxes or pay insufficient levels of tax. This is simply untrue. While it's correct that S corporations do not pay the corporate tax rates, as noted above they do pay taxes on their business income when it is earned, and often at higher rates than C corporations.

To get a better sense of how much tax S corporations pay, two years ago we asked the econometric firm Quantria[7] to measure the effective tax rates of businesses by type – C corporation, S corporation, partnership, and sole proprietorship. They found that S corporations, and particularly large S corporations, pay the highest effective federal tax rate:

- Sole Proprietorships: 15 percent
- C corporations: 27 percent
- Partnerships: 29 percent
- S corporations: 32 percent
- Large S corporations: 35 percent

For pass through businesses, these results show what you might expect. Sole proprietorships are generally informal smaller enterprises with lower incomes while partnerships and S corporations tend to be larger and more formal, so they have higher effective tax rates. And while effective rates on C corporations have been studied extensively, with results sometimes varying from the level found by Quantria, the key point here is that pass through businesses, and in particular S corporations, pay significant amounts of tax. Policymakers should keep this in mind as they seek to reform how businesses pay tax.

Rates on Pass Through Businesses Just Went Up

Finally, it is important to point out that, as a result of the resolution of the fiscal cliff and the implementation of a new Affordable Care Act tax, marginal tax rates on pass through businesses went up sharply beginning in 2013.

First, top marginal rates on pass through businesses rose from 35 to 39.6 percent. Second, the restoration of the Pease limitation on itemized deductions has the effect of increasing marginal rates by another 1.2 percent.[8] And finally, the implementation of the new ACA Investment Surtax adds another 3.8 percent on S corporation shareholders who do not work at the business. The cumulative effect of

[7] Entity Choice and Effective Tax Rates. Quantria Strategies, LLC, 2013

[8] Kyle Pomerleau, " The Pease Limitation on Itemized Deductions Is Really a Surtax," Tax Foundation, last modified October 6, 2014

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these changes, all talking effect beginning in 2013, raised the top marginal rate on S corporation shareholders and other pass through business owners from 35 to more than 44 percent.

The effective of this increase is to drain working capital from these businesses. The Chairman of McGregor Metalworking, an S Corporation Association member testified earlier today[9] that the combined local, state, and federal tax distributions he makes to his shareholders increased from 34 percent in 2012 to 42 percent in 2013. Prior to 2013 he was able to retain up to 66 cents of every dollar his business made for working capital and hiring new workers. Post 2013, he only is able to retain up to 58 cents.

Pass Through Businesses and Tax Reform

Beginning four years ago, we became aware of a move by the Treasury Department to push for reforming the business tax code, but for corporations only. Under this plan, the business tax base would be broadened by eliminating certain deductions and tax credits and then the revenue raised from that base broadening would be used, at least in part, to pay for lower rates for C corporations.

The challenge of this approach to pass through businesses is obvious. Pass through businesses use the same deductions and credits as C corporations to determine their taxable income, but unlike C corporations, their rates just went up, not down. The result would be C corporations facing an initial layer of tax 15 to 20 percentage points less than the pass through business they compete against. This disparity in rates is simply unsustainable.

To assess how harmful this approach would be to pass through businesses, in 2011 we asked Ernst & Young to study[10] the effect of corporate-only tax reform. They found that corporate-only reform would increase the tax burden on pass through businesses by 8 percent, or about $27 billion per year. Industries most affected include agriculture, construction, and retail. This estimate was done prior to the rate hike starting in 2013, so the impact on pass through businesses today would likely be higher.

For a company specific example, consider again McGregor Metal Working. As noted previously, their effective tax rate (including federal, state and local) increased from 34 to 42 percent as a result of the fiscal cliff and the implementation of the ACA investment surtax. According to McGregor, if Congress enacted corporate-only reform that lowered the corporate rate while eliminating McGregor's access to LIFO, section 199, and the R&E tax credit, their effective rate would rise to over 46 percent.

Pass Through Principles for Tax Reform

So the pass through community opposes corporate-only tax reform. What do we support? Two years ago, dozens of trade groups representing hundreds of thousands of pass through employers signed a letter articulating the following three principles for tax reform:

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[9] Statement of Dan McGregor before the Small Business Committee (April 15, 2015)

[10] Carroll and Prante, The Flow-Through Business Sector and Tax Reform, Ernst & Young, 2011.

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1. Reform needs to be comprehensive and reform the code for individuals, pass through businesses, and corporations alike;
2. Reform should reduce rates on individuals, pass through businesses, and corporations and seek to restore the rate parity that existed from 2003 to 2013; and
3. Reform should continue to reduce or eliminate the double tax on corporate income.

This week, we released an updated version of this letter with more than 100 trade groups signing on, including the National Federation of Independent Business, the National Restaurant Association, and the American Farm Bureau.

The message is simple – when it comes to reforming the tax code to make American businesses more competitive, the difference between a "corporate only" approach that treats pass through businesses as an afterthought and true comprehensive reform that treats them as an equal partner is rate reduction. Tax reform needs to reduce rates on corporations and pass through businesses alike and seek to restore the rate parity that existed prior to 2013.

Why Can't They Just Convert?

One question that gets asked repeatedly is why S corporations who oppose corporate only reform don't simply convert to C corporation status to access the lower rates. If the Administration's approach to reform were adopted, the short answer is that many would convert, but they wouldn't be better off, and neither would the tax code or the economy. The result would be a step backwards for business taxation, not an improvement.

Here are three reasons policymakers should reject the "they can just convert" argument:

1. Anti-Tax Reform: The 1986 Tax Reform Act ended the decades-long era of taxing corporate income at lower rates than individuals and pass through businesses. As noted above, that approach discouraged the creation and growth of closely-held and family businesses while encouraging gaming and tax sheltering. Corporate-only reform would effectively return us to the pre-1986 world where most businesses were structured as C corporations and business decisions were driven by tax considerations, not business considerations.

2. Strengthens the Double Tax: Most observers agree that the double tax on corporate income retards investment and jobs creation, yet those arguing that S corporations can just "convert" are suggesting that we should increase the reach of the double tax to include family businesses currently structured as S corporations. That makes no sense. Tax reform should move business taxation away from the double tax, not towards it.

3. Penalizes Business Sales: For many business owners, the sale of their business is their retirement plan. The tax code recognizes this reality by taxing any gain from the sale of a pass-through business at the capital gains rate of 24 percent. The sale of a closely-held C corporation, on the other hand, is taxed twice at a combined rate of 50 percent. This double tax punishes entrepreneurs who have spent a lifetime building their businesses.

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The goal of tax reform should be to promote closely-held and family-owned businesses, not punish them.

Conclusion

Congress has a unique opportunity to dramatically improve how we tax all businesses. This reform effort should build on the remarkable success of the experiment begun 50 years ago when Congress created the S corporation. With that legislation, Congress sought to improve the American economy by encouraging the creation of closely-held and family owned businesses and to diversify economic decision making across the country.

Today, America's 4.6 million S corporations come in every size imaginable and are in every industry, every state and every community. Combined with partnerships and sole proprietorships, the pass-through community employs the majority of American workers and generates more than half of all business income. This diversity of industry, size and location strengthens our economy by spreading out economic power and decision making away from the financial centers and into the local communities where the business resides.

By adopting reforms that fit within the three pass through principles articulated above, Congress can help Main Street businesses succeed by continuing to shift business activity away from the harmful, less competitive double corporate tax and towards the more efficient, competitive pass through model. These businesses have been at the forefront of America's economic growth since their inception, and have acted as a backstop for economic insecurity, most recently during the 2008 financial crisis. The resiliency of S corporations and other pass-through businesses is vital to our nation's economy, and Congress should make them a centerpiece of any tax reform effort.

Comparison of effective Tax Rates on a profitable company

Effect of Device Tax on a startup or loss Company

These two fields may be changed, they are variables		Former Law - no Device Tax	Device Tax is not Deductible for State or Federal Tax Purposes		Former Law - no Device Tax	Device Tax is not Deductible for State or Federal Tax Purposes	
		Actual Invoiced Sales	Actual Invoiced Sales		Actual Invoiced Sales	Actual Invoiced Sales	
Sales		$8,000,000	$8,000,000		$8,000,000	$8,000,000	
Pre-Tax Income (% of Sales)	6.00%	$480,000	$480,000	-2.00%	-$160,000	-$160,000	
Device Tax	2.30%		$184,000	2.30%		$184,000	
Adjusted Pre-Tax Income State		$480,000	$480,000		-$160,000	-$160,000	
Adjusted Pre-Tax Income Federal		$480,000	$480,000		-$160,000	-$160,000	
State Tax Effective Rate	8.50%	$40,800	$40,800	-1.50%	$2,400	$2,400	State minimum taxes
Adjusted Federal Taxable Income		$439,200	$439,200		-$162,400	-$162,400	
Federal Tax Rate	35%	$153,720	$153,720	0%	$0	$0	
Total Taxes		$194,520	$378,520		$2,400	$186,400	
Net Income After Tax		$285,480	$101,480		-$162,400	-$346,400	<<<<< Has to finance device tax!!!!
Effective tax rate on Pre-Tax Income		**40.5%**	**78.9%**		**-1.5%**	**-116.5%**	
% Tax Increase to Effective Rate			94.6%			-387.5%	

PREPARED STATEMENT OF JODY FLEDDERMAN, PRESIDENT & CEO, BATESVILLE TOOL & DIE

Thank you for the opportunity to testify before you today about the impact of taxes on small and medium- sized manufacturing businesses. My name is Jody Fledderman; I have been President and CEO of Batesville Tool and Die in Batesville, Indiana since 1989. For over 30 years, Batesville Tool & Die has been providing quality metal stamping and stamping assemblies for our automotive, appliance, industrial and other industry customers. We currently have 395 employees and would hire more if we could find qualified workers.

In addition, I was the 2014 Chairman of the Precision Metalforming Association and serve on Board of Directors for both the Indiana Manufacturers Association and the Indiana Chamber of Commerce. I think my positions on state and national boards and running my own business, provide me a unique perspective of the challenges facing manufacturers in Indiana and across the country.

The single greatest obstacle to growing my business in the long term is the uncertainty surrounding our tax code. How can Congress expect us to plan when we do not know what the rates will be in the future?

How can lawmakers carelessly continue putting off their responsibilities until the last hour? Too often it feels as if people in Washington are so insulated from the real world they do not recognize their inaction has significant consequences for families and businesses throughout the country. It is very difficult to plan for the future when you don't even know the rules for today.

I truly believe our economy would have recovered more quickly if businesses felt comfortable that Washington would set the rules and stop meddling for a while. This is why we need comprehensive tax reform. Not just to lower our rates to globally competitive levels but also to provide stability and predictability in the Internal Revenue Code. Washington should develop tax policy that encourages investment and manufacturing in America—not penalize companies and their owners for doing business.

TAX REFORM FOR ALL BUSINESSES

A January 2015 industry survey by the Precision Metalforming Association and National Tooling and Machining Association showed that 61% of companies are structured as a pass-through business, often paying income taxes at the higher individual rates. Sector-wide, 81% of all manufacturing companies are structured as pass-throughs, meaning C–Corporation only reform would leave behind eight in ten manufacturers, most small and medium-sized family-owned businesses. We are one of those millions of manufacturers Corporate-only reform would leave behind.

Batesville Tool and Die is structured as an S–Corporation. As a multi-generational manufacturing company with strong ties to the community, over the years our company has awarded shares to certain employees and family members. Maybe we've been overly generous in the past, but we now have 72 shareholders. We are not your typical manufacturing pass-through, which in our industry tends to average 3–5 shareholders. However, being a pass-through allows us to reward employees with shares in the company without the penalty of double taxation that a C–Corporation structure brings.

The main reason most family-owned or tightly held manufacturers structure themselves as pass-throughs is so they can keep the company within the family. Underscoring this point is that many in our industry are nearing their retirement and planning to pass the business along to the third or fourth generation of manufacturers. If our company was a C–Corporation, when I'm set to retire, the tax penalties just on my portion alone would mean I'd have to plan years ahead how to cover the dividend tax rate – even if I knew what it was ahead of time.

Unfortunately, I'm still a ways away from retiring, but think what would happen to these 72 small shareholders if we sold the company—some of them are retirees in their eighties while others are high school students. How would they come up with the resources to pay the income and dividend taxes were we structured as a C–Corporation?

While there are many benefits to our pass-through structure, the main drawback is the most obvious—Congress raised our rates a few years ago. While publicly most believe the top rate is 39.6%, in reality we pay roughly 43.4% in federal income taxes when you calculate the surcharges and other additions. Keep in mind we have 72 shareholders, with one drawing fully passive income. This means we are withholding 43.4% from all of their taxes and leaving it up to the individual shareholder to seek a refund if their overall income levels do not reach the highest brackets. More importantly, that is money taken out of the business to pay taxes on their behalf and even if the individual receives a refund, the company will never see any of that money again—valuable resources we could have used to invest in the business.

As Washington contemplates tax reform, I asked our CFO to explore how various scenarios affect our company. Based on current tax law and after deductions and credits, Batesville Tool and Die paid roughly $1.6 million in taxes. Had the individual tax rate not increased to 39.6%, we would have paid $1.1 million in taxes using the same figures. If the rate is reduced to 28% and the key investment provisions are kept in place, our tax liability drops to $928,000, freeing up $700,000 to invest in the business, more if lowered to 25%.

This is where public perception plays a big role. The average person and politician would assume the owners pocket that $700,000. In reality, that is not the way small and medium-sized manufacturers operate. In the metalworking industry, our profit margins are typically 1–3%. The cost of manufacturing in America is not cheap and we use every resource available to make ourselves more globally competitive through investing in new technologies and hiring skilled workers.

Furthermore, what many people do not know is most small business owners have to personally guarantee loans for the company when buying equipment that can cost in the millions. The fewer resources our lenders see in the business, combined with the higher personal tax liability for each shareholder, often leads to increased borrowing rates and stricter terms. Small and medium-sized manufacturing businesses rarely self-finance, and with a 1–3% profit margin we are not the most attractive borrower in the best of circumstances.

TAX CREDITS AND DEDUCTIONS USED BY MANUFACTURERS

Every manufacturing business is different and each company serves a variety of industries which have varying needs requiring specialty equipment. Some of our equipment can cost $2–10 million, much of which we could not afford without Bonus Depreciation. For others the R&D Tax Credit is worth hundreds of thousands as opposed to general deductions.

While traveling the country as Chairman of the PMA last year, I heard from countless manufacturers that they are holding back investments because they do not know whether Congress will extend critical tax provisions. The recent association survey of our industry showed that 91% of metalworking manufacturers claimed Section 179 Equipment Expensing in 2014. An equally impressive 89% used Bonus Depreciation while roughly half claimed the R&D Tax Credit. This January, Congress allowed the R&D credit to lapse for the sixteenth time, Bonus Depreciation to expire, and 179 to revert to $25,000, rendering it completely useless for manufacturers like us.

To our company, the R&D and Bonus are by far the most important. We claimed $544,000 in R&D and while that was among a peak year for us, we see this provision as one of the few in our tax code that actually incentivizes manufacturing in America. I know many smaller companies shy away from the R&D as not being worth their time to defend in an audit. Some will say they cannot substantiate the $20,000 in expenses to claim $40,000 in R&D credits. But at Batesville, our exposure to the R&D is significant, so I guess we will just have to keep the faith in Congress that you will extend or make permanent the R&D, I just ask that you don't wait until the eleventh hour this time.

Bonus Depreciation really is a game changer for manufacturers who invest heavily in equipment and talented people to run them. Had Congress not extended Bonus Depreciation in December of last year, countless manufacturers in the metalworking industry would have faced an average $400,000 tax liability due in 2015. The typical small manufacturer does not have that kind of cash on hand and would eliminate 2015 purchases and hiring to pay the added tax liability.

However, before Congress pats themselves on the back for a job well done, extending expired provisions in November and December each year clearly stunts economic growth. Machines in our industry take eight weeks to eighteen months to place into service. This makes it impossible for the average manufacturer to benefit from Bonus Depreciation or Section 179 Equipment Expensing extended on December 11 with only three weeks to finance, purchase, and place into service machinery weighing several thousand tons.

The other real world impact of Congressional inaction was witnessed firsthand at Batesville Tool and Die last year. Due to the uncertainty over whether Congress would extend the R&D, Bonus and other key tax provisions, we overpaid our quarterly estimates to account for a potential massive tax liability if the provisions remained expired for 2014. This meant we overpaid our taxes by $580,303 because lawmakers waited until a lame duck Congressional session before acting. While our employees and other shareholders benefit from this structure, it causes significant challenges for the business when we have to overpay based on which tax credits and provisions Congress keeps in place.

As a pass-through, we pay the taxes for our shareholders quarterly based on estimates of revenue and existing tax law. This meant that last year we withheld roughly 44% from each shareholder for income taxes and overpaid on their behalf based on not knowing which tax provisions Congress would put in place for the taxable year. The individual shareholders will receive a refund for the overpayments on their personal tax returns, but they will never give that money back to the business who overpaid on their behalf. This means, the company will never see that $580,000 again. With over half a million dollars I could hire seven or eight new employees or purchase a new machine that would have also required new workers. Instead, we sent that money to Washington, who will just turn it around and give to it the individuals, while the small business is left footing the bill.

Comprehensive tax reform would immediately fix this problem. Our company would know the rules at the beginning of the year and withhold or pay the appropriate estimate. But the current system is like shooting a moving target, but never giving you a chance to lock on. Absent comprehensive tax reform, we need Congress to make permanent these investment provisions or at least extend them for a significant number of years. As I mentioned earlier, some of our equipment takes eighteen months or longer to place into service and our planning process is often two to ten years as we anticipate future growth.

The Alternative Minimum Tax, or AMT, is another issue which receives attention from politicians when discussing tax reform. The reach of the AMT is much broader than just affecting the "middle class." When a business is captured under the AMT, they cannot claim the Research and Development Tax Credit, which would be available to them and is so popular among lawmakers. In addition, an AMT captured business could not benefit from the politically popular $1,000 credit for hiring the long-term unemployed. Again, this is why we need comprehensive reform, the Internal Revenue Code is riddled with outdated and conflicting provisions stifling U.S. companies and deterring foreign investment.

CONCLUSION

In towns such as Batesville, Indiana with a population of 6,500, the community needs employers like us but we need a partner in Washington that sets the rules and sticks with them. Manufacturers of all sizes need time to plan. We may not be a billion-dollar company but businesses in our industry routinely spend millions each year to remain competitive. Virtually every other industrialized nation has a tax code that fosters innovation and encourages investment. It is time the U.S. Government caught up to the rest of the world the way its manufacturers have.

Thank you for the opportunity to testify before you today on this important issue.

PREPARED STATEMENT OF MS. HOLLY WADE, DIRECTOR OF RESEARCH AND POLICY ANALYSIS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Good morning Chairman Coats, Vice Chairwoman Maloney and members of the Joint Economic Committee. Thank you for the opportunity to testify today. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee discusses small business, tax policy and economic growth in the small-business sector. NFIB is the nation's leading small business advocacy organization representing over 350,000 small-business owners across the country. NFIB represents businesses in most industries and of various sizes, with about 80 percent under 40 employees.

The small business economy is slowly emerging from one of the worst recessions in U.S. history. NFIB's monthly Small Business Economic Trends (SBET) survey data shows the dramatic change in consumer spending, employment, owner's confidence and business investments throughout the recession and subsequent recovery.[1] While some business activities have made significant improvement over the past four years, capital expenditures and outlook on business conditions and expansion remain at historically low levels due to economic conditions and the political climate. The threat of higher taxes whether in the form of income taxes, the healthcare law, the estate tax, section 179 expensing limits, or others creates enormous uncertainty among small-business owners worried about the impact of policy changes on future business costs.

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[1] Dunkelberg, William C., and Holly Wade, NFIB Small Business Economic Trends, NFIB Research Foundation, series.

The SBET survey also tracks which problems most affect owners in operating their small businesses. From mid-2008 through mid-2012, "poor sales" was their number one problem as consumer spending declined sharply. But now "taxes" is often the number one concern for small-business owners, a problem that moderates the economic recovery in the small-business sector.

The NFIB Small Business Problems and Priorities survey highlights three main areas of tax policy that are of great concern to small-business owners.[2] The survey is of a random sample of NFIB members asking them to evaluate 75 potential small-business problems and assess the severity of each. The problems are then ranked by their mean score. With the "Cost of Health Insurance" leading as the most severe problem for small-business owners, five of the top 10 problems are all tax-related. These tax problems fall into three categories: cost, complexity and frequent changes.

The cost of tax obligations is threefold; the amount paid to federal, state and local tax agencies, the cost of hiring a CPA or tax advisor to navigate complex tax codes, and the owner's time in providing the required paperwork and/or filing themselves. Eighty-eight percent of small employers use a tax preparer, and most use one to either ensure compliance or because the requirements are too complex. Tax-related regulations cause the greatest difficulties for 40 percent of small employers, more than environmental, health and safety, or employee-related regulations.[3] And compliance costs are especially problematic for small-business owners as they are 67 percent higher for small businesses than for their larger counterparts, costing them $18–19 billion per year, or about $74 per hour.[4]

Tax-related costs compete with owners' ability to use limited profits for primary business activities. Profits are the main funding mechanism for owners purchasing new equipment, expanding facilities, hiring and stocking inventory. Tax-related cost pressures are especially problematic for newer firms that almost solely rely on profits for operation and expansion costs as they are generally not able to access traditional lending sources. Banks almost exclusively lend to more established firms, not new ones due to higher failure rates. But regardless of the firm's age, tax burdens take a heavy toll on owners' ability to operate their businesses.

One example that encapsulates all three categories of tax-related problems for small-business owners is the Affordable Care Act (ACA). The employer mandate, small-business tax credit, and the termination of employer reimbursements are just a few of the many tax-related costs and complications small-business owners face in complying with the new law.

The cost of health insurance is the most critical issue facing small-business owners. It is the main reason owners do not offer employer-sponsored health insurance and the main reason owners discontinue providing the benefit.[5] But the employer mandate does not take into consideration the cost issue as it requires all employers with 50 or more full time equivalents to offer health insurance or pay a tax for not offering.

The employer mandate pressures offering firms to continue regardless of profitability and penalizes firms for not offering, regardless of their financial situation. Firms with high employee turnover, seasonal employment and lower profit margins are less likely to offer health insurance. But now, those with 50 or more full time equivalents must absorb an additional tax for not offering, offer increasingly expensive health insurance, or limit employment—all less than optimal options.

The employer mandate also contributes to increased tax complexity due to the often ambiguous and complicated aggregation rules associated with calculating the number of full time equivalent employees. The paperwork associated in calculating employee hours as they relate to the mandate reduces the most valuable asset of the owner, his or her time. And the aggregation rules will be most difficult for owners with seasonal employees, high employee turnover or own more than one employer firm. The IRS estimates that it will take over 4 hours to fill out the required forms, acknowledging that these estimates will vary due to individual circumstances. For firms with more complicated employment structures, the time commitment required will likely be far greater.[6]

Small-business owners have also encountered repeated delays and confusion over the ACA's small-business health insurance tax credit and financial reimbursement

[2] Wade, Holly, Small Business Problems and Priorities, NFIB Research Foundation, 2012.
[3] Dennis, William J., Tax Complexity and the IRS, NFIB Research Foundation, Volume 6, Issue 6, 2006.
[4] https://www.sba.gov/sites/default/files/advocacy/rs343.pdf
[5] Dennis, William J., Small Business's Introduction to the Affordable Care Act Part II, NFIB Research Foundation, December 2014.
[6] http://www.irs.gov/pub/irs-pdf/i109495c.pdf

options. The tax credit is a targeted approach to help curb health insurance costs for offering small employers and is intended to provide an incentive for those that do not, to start offering. However, the tax credit is largely ineffective on both fronts as its design is exceedingly restrictive, complicated, and only offers temporary relief to a larger small business cost problem. The tax credit now serves as a windfall for the few who qualify and take the time, or pay an accountant, to file for it. The IRS estimates that it will take over 15 hours to understand, complete and submit the appropriate forms.[7] The paperwork costs involved in filing for the tax credit will likely yield little benefit at the end of the day. These problems are not an uncommon fate for many tax credits including those trying to increase hiring and car sales. Generally these types of incentives only benefit those already committed to the activity and are willing fill out the required paperwork or pay someone to do it for them.

Another ACA tax burden that falls into the frequent changes category is the termination of employer reimbursements for individually purchased health insurance plans by their employees. A recent NFIB survey found that about 18 percent of small employers offered this benefit last year and are now in violation of the law. NFIB continues to receive calls from owners, generally after having talked to their CPA or insurance agent, confused about the new rules prohibiting the practice and the subsequent harsh tax penalties. It is very likely many small employers are still not aware of this change in policy and will be notified of its termination in the form of a letter from the IRS requiring payment of excessive penalties.

The ACA is just one example of how excessive tax burdens affect small-business owners. And the federal tax code is only one layer of tax obligations owners face in operating their business. They must also comply with state and local taxes adding to the overall compliance burden. Unfortunately, only the owner experiences the cumulative effect of all the required taxes and regulations places on their business. Federal, state and local lawmakers and government agencies only see them in isolation, giving a false perception of their true impact. But it's the responsibility of the business owner to manage them all while trying to operate a profitable, successful business.

In conclusion, small-business owners continue to be excessively burdened by direct, indirect, complicated and ever changing taxes related to operating their business. Alleviating the excessive tax burden on small businesses is an essential component in creating a strong, healthy environment for owners to operate and grow their business. I appreciate the opportunity to present NFIB's views and data on the effects of tax policies on small businesses. I look forward to answering any questions you might have.

PREPARED STATEMENT OF THOMAS A. HOGHAUG, CEO, SIGNUS MEDICAL, LLC, AND CEO, LOCKDOWN SURGICAL, INC.

Chairman Coats, Vice-Chairman Brady, Ranking Member Maloney, Senator Klobuchar and Representative Paulsen, I would like to thank you for this opportunity to testify. My name is Thomas Hoghaug and I currently hold the position of CEO for Signus Medical, LLC, and LockDown Surgical, Inc. It is an honor for me to be able to address this committee today and potentially shed some light on the extremely negative impact the Medical Device Tax has had on both of my companies and on similar small medical device firms. The issues and examples I will share are personal examples that are in no way unique to Signus Medical and LockDown Surgical. They are common experiences shared by a multitude of smaller device firms and have been conveyed and confirmed to me during meetings, committees and gatherings of medical device executives. Small device firms are primarily responsible for the majority of innovation and development of better and more cost effective treatment modalities for patient care in the U.S.

I have worked in the orthopedic medical device arena for over 27 years with extensive experience in both international and domestic product sales and distribution. Over the course of my career I have founded seven (7) medical device companies, the largest being California based Alphatec Inc., and assisted others in achieving critical sales mass in order to go public. The most notable being Minneapolis based Spine-Tech Inc. which is considered to be the most successful IPO and ultimate acquisition target in the orthopedic industry. In 2002, I acquired sole ownership of Signus Medical, LLC, a master importer, developer and distributor of spinal implants. In June of 2014 I accepted the concurrent position of CEO of LockDown Surgical Inc; an extremity company focused on joint ligament repair. LockDown Sur-

[7] http://www.irs.gov/pub/irs-pdf/i8941.pdf

gical was founded in February of 2012 with a single FDA cleared product for shoulder repair. It has been operating at an annual financial loss and expects to reach breakeven and finally begin to turn a modest profit in the fourth quarter of this year. It wound have been sooner if it were not for the device tax.

Since the economic disaster of 2008, the spinal implant industry has been one of the hardest hit in terms of downward pricing pressure, FDA clearance delays and regulatory scrutiny. We have seen end user pricing drop in excess of 70% , while the burden of compliance and reporting has increased dramatically. Signus Medical has managed to weather these storms but not without a negative impact on its top line sales and net profit.

With the introduction and implementation of the Affordable Care Act's Medical Device Tax, companies have experienced a multitude of unforeseen and crippling consequences of the tax including: layoffs, non-replacement of lost employees, disrupted or negative cash-flow, curtailing or elimination of R & D projects, reduced inventory expansion and effective tax rates which can exceed 100% of profit. Money that was once used to grow and reinvest in the expansion of the companies is now sent to the IRS every two (2) weeks. The AdvaMed response to the November 3, 2014 Congressional Research Service reports that these payments are in fact used in the Nation's general revenue stream and not used for healthcare reform under the ACA as was promised.

From the time of our first device tax payments the impact was felt immediately. We are required to pay the 2.3% tax on all invoiced sales approximately every two (2) weeks. This tax is assessed on all device sales billed within the previous two (2) weeks irrespective of profit, profitability, cash-flow or collections. At present, our collections average about 72 days from the date of surgery yet we are compelled to pay the IRS within 14 days or less. As a result, we are fronting the tax payment nearly 50 days in advance of actually collecting payment for our implanted devices. Representing two small device companies as I do, I was forced to lay off several employees in order to cover the initial shortfall and when several more key support personnel were lost through the course of normal job advancement, I no longer have the investment capital to re-hire those positions. Both Signus Medical and LockDown Surgical are privately held businesses with very close-knit groups of employees. One of the hardest tasks I have ever had to perform in my 27 year career is to personally layoff employees who have performed their jobs admirably, have families and homes of their own, employer paid healthcare, financial obligations and commitments based upon the strong wages and benefits we were able to provide. Solely and for no other reason but to pay for the Medical Device Tax. To date we have experienced a nearly 25% reduction in our staff and I see no near or long term opportunity to replace them while this tax is in effect. I have had to implement a wage freeze since 2012 as the device tax cut into the profits and ultimately took more than 100% of both company's profits in 2014.

The payment terms and concept of what is essentially a 2.3% excise tax was, in my opinion, ill-conceived. The tax is on gross sales, cannot be passed on to consumers, is non-deductible and does not take into consideration the profitability or financial status of the company. In respect to LockDown Surgical, being a startup company, we have had to actually finance the device tax in addition to financing all of the initial costs associated with setting up and rolling out a new company and product. Investors look at the negative impact of the device tax; see how it pushes out the point of breakeven by literally years and are extremely hesitant to invest capital knowing much of it will be siphoned off to pay for a tax instead of used to grow and develop a company and new treatment therapies. No other industry is burdened with this government imposed barrier to market. Make no mistake it is a very real impediment to investment as was highlighted by a number of surveys conducted by LifeScience Alley, the Medical Device Manufacturers Association (MDMA) and AdvaMed. While presenting to Minnesota Governor Mark Dayton's Economic Round Table Forum in 2013, I expressed real alarm that the then effective tax rate on Signus Medical due to the device tax was 82%. Governor Dayton's financial advisor addressed my concerns by asking me, "Why on earth would you want to be in any business with such a high tax rate? I would never be in one." My response after the incredulous shock of that comment was that I have been in the spinal market since 2001. Our company has made commitments to providing the best treatment options to surgeons and patient care, providing our employees and their families with well-paying jobs and benefits. This company is my investment in my own future as well. Prior to 2012, the corporate playing field was essentially even and all companies just had to deal with some of the highest corporate tax rates in the world. I certainly didn't chose to self- impose this excise tax on my companies.

To help put this in perspective, our CFO provided me with some very basic accounting examples of the impact of the tax. I am by no means a tax expert, but as

CEO I am legally liable for all financial reporting and tax submissions. As such, I can certainly navigate through corporate Profit and Loss Statements and can clearly assess the impact the Medical Device Tax has on corporate bottom lines. In former times, pre device tax, a small company with $8,000,000 in sales and an average 6% pre-tax income would show a modest $480,000 pre-tax profit. Using the National average state corporate tax rate of 8.5% or $40,800 combined with the Federal Tax Rate of 35% on the adjusted taxable income or $153,720 it would result in a total of $194,520 in taxes paid; the Net Income After Tax would be $285,480 which could be used to expand the business, service debt or develop new products. That represented a 40.5% effective tax rate. Now, add in the 2.3% Medical Device Tax on gross sales of $184,000 and the total taxes paid on the same revenue dollars jumps to $378,520 resulting in a Net Income After Tax of $101,480 or in other words a 78.9% effective tax rate, which is a 94.6% increase in taxes and far less capital to reinvest.

Next, extend this same scenario to a startup or loss company and the effects are even more dramatic. A pre-device tax company with the same $8.000,000 in sales and a modest −2% loss of −$160,000 would only be subject to the average 1.5% of various State minimum taxes of $2,400. Total Net Loss After Tax would be a −$162,400. With the addition of the Medical Device Tax, this startup or loss company is liable for the same $184,000 as the profitable company; its total tax liability is now $186,400 thus resulting in a Net −$346,400 loss. This loss, including the device tax, has to be financed somehow and pushes out breakeven and profitability. There is no return on investment when one is financing a government tax and fewer investors are willing to take on this financial burden. Furthermore, the Device Tax loss is not deductible and is therefore lost to any kind of recovery forever. The following page contains a simplistic visual example of the deleterious effect of this tax.

Another perhaps unforeseen but very significant impact of the Medical Device Tax is disruption of both of my companies' cash-flow. As mentioned earlier, payments are made within 2 weeks of posting sales but collections are running upwards of 70 days. These payments strip both firms of ready cash which was previously used for day to day operations, payroll and payments to vendors. Since 2012, our monthly cash-flow has been negative due to the tax and we have slowly used up all cash reserves and creative reductions of inventory to now find ourselves in arrears with suppliers. Banks and investors are clearly aware of the effects of this tax and are reluctant to extend lines of credit or further loans citing no desire to finance government taxes. As of last year, I shelved two major R&D projects because I could not guarantee that cash, which at one time was budgeted and deemed available, would in truth actually be available. Instead, we are looking at how we will simply manage through the cost of introducing several new products in 2015 which would, under pre-device tax conditions and expectations, return Signus Medical to nominal profitability and expand LockDown Surgical products into other areas of the body where there is a very real and significant patient need.

I am very proud to be actively involved in the medical device arena. It has historically been a shining star in the US economy and has supported some of the highest paying jobs when compared to all other business sectors and average wages. The advancements in treatment and improved patient outcomes is commonly a direct result of smaller and more nimble device companies, such as Signus Medical and LockDown Surgical, reinvesting profits and resources into the development of new and more cost effective surgical and non-surgical solutions. What many are unaware of, however, is the very high physical cost of supporting each and every case performed on a daily basis across this huge nation of ours. Using spinal surgery as an example, Signus Medical must supply the hospital and surgeon sufficient implants and redundant backup inventory to address every potential size and possible complication one might face in surgery. Literally dozens of implants, like shoes in a shoe store, must be provided in order to actually implant and sell only one device and the cost of this inventory is born by the company. Hospitals no longer purchase or stock specialty instruments and implants so they must be shipped in and tracked for every single case. The FDA and HIPAA compliance burden for the location of each and every implant, their corresponding lot numbers, all associated instrument sets and ultimately which implants are used is staggering for a company of any size. The costs associated with increasing even one surgical customer are so significant that it may take many months to upwards of a year just to recoup the investment of the supporting implants and instrumentation. We at Signus have become a model of "Just In Time" shipping and inventory control in order to work around the much needed expansion capital which has been used instead to pay the device tax. Efficiency alone has its limits and I have been faced with the unenviable choice of slowing or turning down business to ensure patient safety. Patients, their safety and surgical outcomes are a priority shared by all medical device companies. This is something I will not and cannot compromise on.

With the inclusion of the Medical Device Tax into the 2014 operational budgets, both Signus Medical and LockDown Surgical posted effective tax rates in excess of 110%. This is not sustainable for any business, large or small. I fear once again I will be facing employee downsizing and further elimination of development projects and thus new clinical therapies to patients in the United States in order to just remain in business and pay the device tax. Even as the business improves, so do the pre-payment of device taxes and it is extremely difficult to actually ever catch up. Money required for reinvesting in expanded infrastructure including employees, new inventory and promising R&D projects is no longer available. Again, these problems are not unique to my two companies and are clearly felt across the entire medical device industry. I do believe however that smaller and startup companies are more severely impacted by the device tax given their inherent size and inability to spread or defer to cost over non-device products being sold by larger and more vertically integrated companies.

In conclusion I would like to thank Chairman Coats, Vice-Chairman Brady, Ranking Member Maloney, Senator Klobuchar and Representative Paulsen for this opportunity to testify before this committee. I sincerely hope that the information and personal experiences I have shared help to enlighten you as to the true negative impact the ACA's Medical Device Tax has had on the Medical Device Industry as a whole and smaller and startup companies like Signus Medical LLC, and LockDown Surgical Inc in particular. Growth, innovation and new job creation come from small medical device firms. The Medical Device Tax threatens to kill off or at the very least considerably curtail this segment of our industry.

Testimony of Martin A. Sullivan, Ph.D.

Chief Economist
Tax Analysts[1]
www.tax.org

Before the Joint Economic Committee
U.S. Congress

April 15, 2015

Hearing Topic:
"Small Business, Big Taxes:
Are Taxes Holding Back Small Business Growth?"

Good afternoon Chairman Coats, Ranking Member Maloney and members of the Committee. Thank you for this opportunity to comment on the important topic of small business taxation.

The expiration of President Bush's tax cuts at the end of 2012 and the limited extension of those tax cuts in the American Taxpayer Relief Act of 2012 resulted in an increase in the top individual income tax rate from 35 to 39.6 percent and the reinstatement of the phase-out of itemized deductions for high-income taxpayers (popularly known as the "Pease limitation.") Also taking effect at the beginning of 2013 was the 3.8 percent tax on net investment income enacted into law as part of the Affordable Care Act.

These changes had an adverse impact of the profitability and cash flow of many of America's small businesses. Cash flow is particularly important to small business because it is often difficult for small businesses to obtain bank loans and, unlike large corporations, small businesses cannot borrow directly in bond and commercial paper markets at low interest rates.[2] In states with high income tax rates, some business owners can face effective marginal tax rates in excess of 50 percent.[3]

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[1] The views expressed here are solely the author's and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

[2] Moreover, the financial crisis has compounded the difficulties of small business gaining access to bank credit. One recent study concludes: "Small business lending continues to fall, while large business lending rises." Karen Gordon Mills and Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game," Harvard Business School Working Paper, July 22, 2014.

[3] Kyle Pomerleau and Richard Borean, "The Dual Tax Burden of S Corporations," Tax Foundation, February 19, 2015.

To add to their tax worries, there is concern that there will be further tax increases on small businesses if Congress pursues a "corporate only" approach to tax reform. Now that United States has highest statutory corporate tax rate of all developed countries, there is near universal agreement the rate should be lowered. The most common suggestion for offsetting the revenue loss from a lower rate is to scale back or completely eliminate business tax benefits, such as accelerated depreciation and the section 199 deduction for domestic manufacturing and production.

These tax benefits, however, are also utilized by businesses not subject to corporate tax. There are three major no-corporate-tax alternatives: S corporations, partnerships, or sole proprietorships. Collectively these three tax classifications are referred to as "passthrough" entities because the profits of these businesses are passed through immediately to owners who must report this income on their individual tax returns. Most small businesses are passthrough businesses, and therefore small business could be subject to a tax increase under corporate-only tax reform. According to one study, the resulting increase in taxes on passthrough businesses could increase by $27 billion annually.[4]

Understandably in these circumstances there is significant interest in the possibilities for extending tax relief to small business. This testimony provides a menu of options. Below are a description and a discussion of the pros and cons of five general approaches to reducing small business taxes.

Option 1. Reduce the Top Income Tax Rate from 39 Percent to its Pre-2013 Level or Lower.

It is reasonable to ask: If the individual income tax rate increases in 2013 have created an unacceptable burden on small business, why not repeal those rate increases to remove that burden?

To begin to answer this question, it is important to understand that only a small fraction of the income earned by high-bracket taxpayers is generated by small business. This fact is illustrated in Figure 1. The estimates in this figure are derived from a uniquely detailed data set developed by the Treasury Department in 2011.[5] The figure shows that of all the high-bracket income subject to regular tax rates (that is, excluding capital gains and qualified dividends) about 30 percent is related to passthroughs.[6] Seventy percent of high-bracket income is from wages and other forms of income unrelated to passthrough business. Only about 21 percent of ordinary high-bracket income is from passthrough employers. And only about 8 percent of ordinary high-bracket income is generated by *small* business employers.[7]

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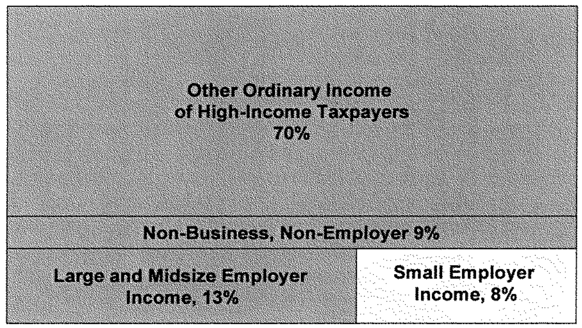
[4] Robert Carroll and Gerald Prante, "The Flow-Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform," April 2011.

[5] Matthew Knittel, Susan Nelson, Jason DeBacker, John Kitchen, James Pearce, and Richard Prisinzano, "Methodology to Identify Small Businesses and Their Owners," Office of Tax Analysis, Technical Paper 4, August 2011.

[6] In these calculations, high-income taxpayers are those who would be adversely affected by not extending the Bush tax cuts for taxpayers in the 33 and 35 percent brackets (in place in 2012)

[7] For details of these calculations, see Martin A. Sullivan, "The Myth of Mom-and-Pop Business," *Tax Notes*, September 12, 2011, p, 1085.

Figure 1. Composition of Income Affected by High-Bracket Rate Changes



The bottom line: most of the benefit of a cut in the top tax income tax rate would not be directed to small passthrough business. So, providing tax relief to *all* income in high brackets is an extremely inefficient way of achieving that objective. The merits of reducing the top income tax rate are better considered in relation to issues other than the impact on small business, such as the need for deficit reduction, the impact on fairness, and the impact on the *overall* economy.

Option 2. Reduce Income Tax Rates for Passthrough Businesses Only.

To preserve revenue and avoid some of the criticisms of the prior section, reduction of individual income tax rates could be targeted so that only passthrough business income is provided tax relief (for example, by excluding from the rate cut for the 70 percent of other income shown in Figure 1).

At the federal level, the most prominent example of across-the-board passthrough relief was the Small Business Tax Cut Act (H.R. 9) sponsored by former House Majority Leader Eric Cantor, R-Va., and passed by the House of Representatives on April 19, 2012. That bill would have provided passthrough businesses a deduction equal to 20 percent of income, subject to the limitation that the deduction does not exceed 50 percent of wages. In 2009 then-Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa, included a similar provision in his Small Business Tax Relief Act (S. 1381), which would have provided a 20 percent deduction for business income of passthrough entities with less than $50 million in annual gross receipts.

Several states have actually adopted variations on this approach. Beginning in 2013, Kansas has exempted all passthrough income from its state income tax. North Carolina had a similar measure in place since 2012, but it limited the deduction to $50,000 per taxpayer ($100,000 for couples). That provision has since been repealed for the years after 2013, a casualty of the state's latest tax reform legislation. In 2012 South Carolina approved an income tax rate cut on passthrough business income from 5 percent to 3 percent phased-in over three years. In 2013 Ohio enacted a tax deduction equal to 50 percent of the first $250,000 of business income earned by owners of passthrough businesses.

There are two major problems with a broad-based rate cuts for passthrough businesses. First, it encourages wasteful tax avoidance that reduces revenue but does little do create jobs (except for tax advisors).[8] Taxes can be reduced, for example, by business owners paying themselves smaller salaries and taking larger profit. Taxes can also be reduced by employees arranging for themselves to be classified as independent contractors who earn exempt business profits instead of taxable salaries.[9]

The second problem with this approach is that without limitations on the size of businesses that can qualify it is not well-targeted to providing tax benefits to small business. Many large businesses are limited liability companies (taxed as partnerships) and Subchapter S corporations. As shown in Table 1, there were nearly 15,000 S corporations with more than $50 million in receipts in 2011 (the latest year data are available). They accounted for 27 percent of all S corporation profit. Their average level of profit was $6.4 million. Other IRS data from 2012 (not shown in the table) indicate 17 percent ($89 billion) of Subchapter S profits were earned by 3,700 corporations that each had over $100 million in assets.

Table 1. Subchapter S Corporations with $50 Million or More in Receipts, 2011

	Number	Total Profit (billions)	Avg. Profit (millions)	% of Total (all size) S Corp. Profit
All Industries	**14,856**	**$102.2**	**$6.9**	**27%**
Agriculture, Forestry	323	$0.8	$2.5	14%
Mining	133	$4.0	$30.3	35%
Utilities	12	$0.2	$16.4	45%
Construction	1,578	$7.4	$4.7	29%
Manufacturing	2,301	$25.1	$10.9	49%
Wholesale, Retail Trade	7,967	$31.5	$4.0	42%
Transportation, Warehousing	503	$1.5	$3.0	20%
Information	186	$2.7	$14.7	28%
Finance and Insurance	188	$9.9	$52.9	33%
Real Estate, Rental, Leasing	90	$0.6	$6.7	4%
Professional, Technical Services	630	$5.5	$8.7	9%
Holding Companies	80	$5.4	$68.0	39%
Administrative, Support Services	361	$2.8	$7.7	20%
Educational Services	43	$0.5	$10.9	23%
Health Care, Social Assistance	216	$1.4	$6.4	4%
Arts, Entertainment, Recreation	71	$1.2	$17.3	17%
Accommodation, Food Services	118	$1.4	$11.6	19%
Other Services	57	$0.4	$6.3	5%

Table 2 looks at large partnerships. It presents 2012 data from income tax returns of 22,000 partnerships that had assets of $100 million or more. Even though these partnerships were less than

[8] Nicholas Johnson and Michael Mazerov, "Proposed Kansas Tax Break for 'Pass-Through' Profits Is Poorly Targeted and Will Not Create Jobs," March 26, 2012.

[9] A prominent expert from the Tax Foundation has called the Kansas exemption of passthrough income a "loophole." See, Joseph Henchman, "Kansas Income Tax Cuts: Boom, Bust, or Wash?" Tax Foundation, March 28, 20114.

one percent of the total number of partnerships, they accounted for 62 percent of the partnership profits. These partnerships on average had 461 partners and profits of $16.2 million.

Table 2. Partnerships with $100 Million or More in Assets, 2012					
	Number	**Avg. # of Partners**	**Total Profit (billions)**	**Avg. Profit (millions)**	**% of Total (all size) Partner-ship Profit**
All Types	22,174	461	$481.9	$21.7	62%
By Legal Form:					
LLC	8,406	127	$113.2	$13.5	47%
Other	13,768	665	$368.7	$26.8	69%
By Broad Industry Class:					
Finance	13,161	269	$248.5	$18.9	74%
Real Estate	4,545	44	$23.6	$5.2	35%
Other	4,468	1,449	$209.8	$47.0	56%

These data shows that it is a serious mistake to conflate the terms "passthrough" and "small business." Providing tax relief to all passthrough business is not an efficient method of providing tax relief to small business because many large businesses that compete with corporations subject to two levels of tax would benefit.

Option 3. Reduce the Income Tax Rate for Passthrough Business Income of Certain Industries.

As part of his sweeping proposal to overhaul the U.S. tax system, former Ways and Means Committee Chairman Dave Camp, R-Mich., proposed that qualified domestic manufacturing income (QDMI) of passthrough business be taxed at no more than a 25 percent rate.[10] (Under the Camp proposal, the top individual rate would be 35 percent and the corporate rate would be 25 percent.) QDMI generally would include net income from manufacturing, producing, or growing tangible goods in the United States or from construction in the United States. The proposal would include oil and gas income in QDMI, but it would exclude self-employment (i.e., sole proprietorship) income and income from the development of software.

In 2013 Rep. Ron Kind, D-Wis., introduced a bill (H.R.2940) that also would provide tax relief for passthrough businesses in manufacturing and other goods-producing industries. The effective rate of tax on income that qualified would be 20 percent and the amount of income qualified could not exceed 25 percent of the sum of Form W-2 wages paid, depreciation, and research expenditure.

A major difference between the Camp-Kind approach and the general passthrough relief provided in the House-approved Cantor bill is that manufacturing and other goods-producing industries account

[10] Chairman Camp originally released his tax reform plan as a discussion draft on February 26, 2014. He formally introduced it as the Tax Reform Act of 2014 (H.R.1) on December 11, 2014.

for only about one-quarter of all income of passthrough businesses. So the revenue loss from this more targeted passthrough relief is much less than across-the-board relief.[11]

This approach, however, gives rise to two major problems. First, for no economically justifiable reason, it violates the principle of tax neutrality. There is great sentiment in America to support manufacturing, but as stated in a recent Congressional Research Service report on manufacturing tax incentives: "Providing a tax break for certain industries can distort the allocation of capital in the economy, reducing economic efficiency and total economic output."[12]

Second, discerning which income is qualified for these special benefits creates massive administrative problems for the IRS. For taxpaying business it imposes significant compliance costs, and it creates opportunities for unproductive tax planning (for example, by shifting profits within a firm from unqualified to qualified lines of business). These are the same well-documented problems that stem from the enactment of income tax benefits for manufacturing and production income under section 199 of the Code.[13] Rate cuts targeted to specific industries would greatly increase compliance costs for small business.

Option 4. Provide Tax Benefits for the Cost of Inputs Used by Small Businesses.

Instead of providing "back-end" tax relief for income generated by small business, Congress could provide "front-end" relief in the form of tax benefits for business inputs, such as capital expenditure, employee compensation, and research spending. This approach has several advantages over the rate reductions described in the three previous sections. First, it is generally far easier to identify and measure the costs of qualified inputs than it is to identify and isolate income qualified for tax benefits.[14] Second, there is generally far less opportunity for costly and unproductive tax planning because no there are not major tax benefits from income shifting. Third, this approach allows Congress to target tax benefits to small businesses that promote particular policy goals. So, for example, if the goal of Congress is to promote job creation, it can better achieve this objective with a wage credit for small business than a small business rate cut of equal revenue cost.

By far the most popular and often cited tax benefit targeted to small business is the ability to write-off the entire cost of capital spending in the year of purchase. This is known as "expensing." As tax

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[11] For details of this estimate, see Martin A. Sullivan, "Kind's Manufacturing Bill Is a Perfect Fit for Tax Reform," *Tax Notes*, April 7, 2014, p. 22.

[12] Molly F. Sherlock, "The Section 199 Production Activities Deduction: Background and Analysis," Congressional Research Service, February 27, 2012.

[13] With enactment of the American Jobs Creation Act of 2004 Congress added the Section 199 domestic production activities deduction to the Internal Revenue Code. The Joint Committee explanation of the provision stated that Congress wanted to promote domestic manufacturing and "enable small businesses to maintain their position as the primary source of new jobs in this country." (Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted In the 108th Congress*, May 2005, JCS-5-05, p. 170.) The complexities of section 199 are numerous: "Congress introduced an alphabet soup of new acronyms (MPGE, DPGR, QPAI, etc.) as well as principles not found elsewhere in the tax code. This led to a great deal of computational complexity." (Andersen Tax, "Section 199 Domestic Production Deduction: Time for a Closer Look," September 2010.)

[14] Identifying property qualified for investment incentives or wages qualified for hiring incentives is relatively straight forward. Identifying research qualified for tax credits, however, can be complicated and controversial.

breaks go, expensing is one of the most meritorious. It provides an incentive for capital spending. It increases cash flow. And it simplifies recordkeeping.

In 2007 Congress increased the limit on amount of capital expenditure that can be expensed from $25,000 to $125,000. Subsequently the limit was increased to $250,000 for 2008 and 2009, and to $500,000 for expenditures incurred after 2010 and thereafter. All of these increases, however, were temporary. Under current law the $500,000 limit expired at the end of 2014.

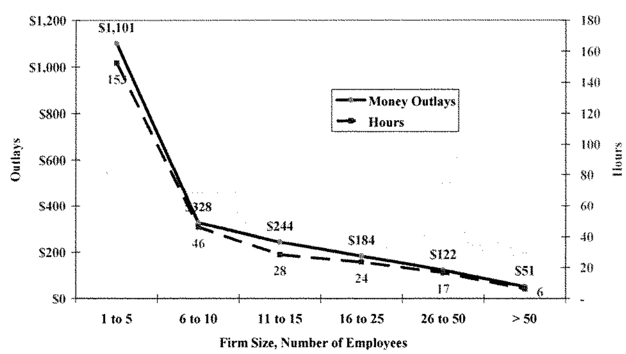
As in the past, it is likely Congress will provide retroactive relief. Small business expensing enjoys broad bipartisan support. On February 13 the House of Representatives passed by a 272-142 margin the America's Small Business Tax Relief Act of 2015 (H.R. 636) which included permanent extension of the $500,000 limit on small business expensing. And in its latest budget the Obama Administration has proposed raising the cap to $1 million on a permanent basis.

If Congress wants to provide small business with additional tax benefits for inputs beyond those provided by proposed extensions of expensing, it could consider provide a wage credit for small business hires. Alternatively, it could make the research credit more attractive to small, start up businesses by following the lead of several states that have made the credit refundable.[15]

Option 5. Reduce Small Business Compliance Costs Through Tax Simplification.

According to the latest estimates, small businesses spent about 1.75 billion hours and $15.5 billion on income tax compliance. Most of the time burden is for record keeping. And most of the financial burden is in paying for professional help. What about differences in cost by firm size? Estimates shown in the Figure 2 confirm what common sense would have us assume: small businesses face

Figure 2. Business Federal Tax Compliance Burden, Per Employee



[15] For example, Arizona, Iowa, and Minnesota have refundable research credits.

significant fixed compliance costs, and cost per employee decreases with firm size.[16]

The figure demonstrates the need for small business tax simplification. The inordinately large compliance costs faced by small businesses place a tax penalty on them that is the economic equivalent of a tax surcharge for being small. That distorts the allocation of capital away from small businesses and reduces economic growth.

Of course, everybody wants a simpler tax system. But tax simplification is especially important to small businesses. In particular, the instability of the code caused by frequent tax changes and expiring tax provisions is a drain on the limited resources of a small business.

One particularly promising approach for small business tax simplification would be expansion of cash accounting methods used to compute income tax. In an article for *Tax Notes*, David Kautter and Donald Williamson propose that small business recognize income and deductions only when cash is received or expenses are paid.[17] This proposal includes the elimination of calculations for depreciation and cost of goods sold, which the authors believe will not reduce government revenue and will increase compliance among small businesses and entrepreneurs. This is just one in a long line of proposals for simplified accounting for small business.[18] In its latest budget, the Obama Administration has proposed expanding the cash method of accounting by creating a uniform threshold of $25 million in average annual gross receipts for allowing exceptions from certain accounting rules.

In-depth examination of tax rules required to achieve small business tax simplification is neither easy nor glamorous. But it is one surefire way to reduce business costs and promote economic growth with minimal damage to the deficit.

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Thank you for this opportunity to comment on this important topic. All questions are welcome.

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[16] The data in this paragraph and in Figure 2 are from Donald DeLuca, Scott Stilmar, John Guyton, Wu-Lang Lee, and John O'Hare, "Aggregate Estimates of Small Business Taxpayer Compliance Burden," *IRS Research Bulletin--Proceedings of the 2007 IRS Research Conference*, p. 147.

[17] David Kautter and Donald Williamson, "A Simplified Cash Method of Accounting for Small Business," *Tax Notes*, February 13, 2012.

[18] President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," Nov. 2005; Treasury Department, "Approaches to Improve the Competitiveness of the U.S. Business Tax Systems for the 21st Century," Dec. 2007; President's Economic Recovery Advisory Board, "The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation," Aug. 2010; Nina E. Olson, "How Tax Complexity Hinders Small Business: The Impact on Job Creation and Economic Growth," (testimony of the national taxpayer advocate before the House Committee on Small Business), Apr. 13, 2011; and Testimony of Rick Endres, President, The Washington Network, Inc., before the U.S. House of Representatives House Committee on Small Business, April 9, 2014.

QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR MIKE LEE AND RESPONSES FROM HOLLY WADE, DIRECTOR OF RESEARCH AND POLICY ANALYSIS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC

What is the empirical evidence on how small, young, and growing businesses contribute to employment and to the economy generally?

Overall, the small business economy (those firm under 500 employees) contribute to almost half of private,non-farm,GDP,about half of private sector employment and 63 percent of net new private-sector jobs.[1]

However, a growing amount of attention on job creation has focused on the type of small business that most contributes to net new jobs per year. And important research has found that while small businesses are the engine of job creation, it is specifically new and young businesses that drive the process.[2] The latest research shows that while new firms only account for roughly percent of all jobs, these start-ups generate about 20 percent of gross job creation and the vast majority of net new jobs. The highly dynamic nature of new, young firms is an essential component to the economy as a whole, as employment in mature small and large firms tends to be more constant. However, that is not to discount the contribution of more mature firms. Most workers are employed in mature firms, those older than 5 years.

But one area of significant concern is the decline of net new firms and associated job creation. Census data shows that new firms accounted for about 16 percent of total firms in the late 1970s. However, that share had declined to 8 percent in 2011. And jobs created by those new firms are also on the decline. Therefore, a supportive pro-business environment is crucial in both attracting start-ups and maintaining a supportive and competitive environment for mature firm to be profitable.

How does the tax burden and tax complexity adversely and disproportionately impact small, young, and growing businesses?

NFIB's Small Business Problems and Priorities survey ranks the severity of 75 potential business issues. The survey is a random sample of NFIB members. While the headline result are of all respondents, we also looked at the severity of issues by the firm's age. "Federal Taxes on Business Income" ranked 5th for those businesses open less than 3 years and was ranked 6th for the overall population. Twenty-nine percent of this group found the problem a "critical" issue in operating their business. And "State Taxes on Business Income" while ranking lOth for the overall population, ranked 4th for the youngest category with 26 percent finding it a critical issue.

Other studies have found that regulatory cost burdens also disproportionately harm small firms and tax compliance certainly falls into this category.[3] Tax compliance costs are three times higher per employee for small firms than their larger counterparts, or about $1,600 per employee compared to just over $500, respectively. While most small employers hire an accountant for tax purposes,[4] the associated costs and paperwork burden are a challenge for small business owners.

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[1] Small Business Administration, Office of Advocacy, Frequently Asked Questions, March 2014.

[2] Haltiwanger, John, Ron S. Jarmin, and Javier Miranda, "Who Creates Jobs? Small vs. Large vs. Young," The Review of Economics and Statistics, May 2013.

[3] Crain, W. Mark & Crain, Nicole (2010). The Impact of Regulatory Costs on Small Firms. Washington, DC: U.S. Small Business Administration, Office of Advocacy.

[4] Dennis, William J., Tax Complexity and the IRS, Volume 6, Issue 6, NFIB Research Foundation, 2006.