TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

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Senate Committee on Finance
on the date of February 23, 2010
on the subject of

Trade and Tax Issues Relating to Small Business Job Creation

Good morning, Chairman Baucus, Ranking Member Grassley, and members of the Committee. I am pleased to be here on behalf of the National Federation of Independent Business (NFIB) as the Committee discusses small business, taxes, and job creation. The NFIB is the nation's leading small business advocacy organization representing over 350,000 small business owners across the country. We represent businesses in a number of industries and of various sizes, with the average member employing between 8 and 10 employees.

Small businesses are a major source of job growth accounting for 2/3 of the net new jobs created.[1] To grow the economy out of the current recession, it is important that the Committee focus on supporting small businesses.

The State of the Small Business Economy

Small businesses continue to struggle through the economic recession. The NFIB conducts a monthly Small Business Economic Trends (SBET) survey, which provides the most regular set of data regarding the state of the small business economy. In March of 2009, the survey's optimism indicator reached its second lowest reading in the 35-year history of the survey. While up slightly from the all-time low, the optimism indicator has been below 90 for 7 quarters (100 is average), indicative of the severity of this recession.

The biggest problem facing small business owners in this recession has consistently been sales. They don't have customers coming in the door. In June and July of 2009, the number of businesses reporting lower net sales hit an all-time low in the SBET survey. For most of last year and into 2010, the problem of "poor sales" has been and continues to be the number one problem indicated by business owners in the survey.

Less sales and demand means less investment in small businesses. Again, we are seeing this trend in the survey. Capital expenditures are at historic lows in the survey and fewer small business owners plan to hire. The outlook for business expansion is also grim with only 5 percent saying it's a good time to expand.

When asked why they believe it's not a good time to expand, economic conditions is the number one reason, followed by the political climate, meaning they are concerned about what policies are on the horizon and what they might mean for their business.

Small business owners are uncertain not only about the economic future, but how policy changes may impact their business. When Washington talks about health care mandates, expiring tax rates, card check, cap and trade – small business hears cost increases. At a time when small businesses lack the capital they need to operate, the threat of higher costs imposed from Washington makes them less certain about their future costs and less likely to invest in their business.

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[1] U.S. Dept. of Commerce, Bureau of the Census and International Trade Admin.; Advocacy-funded research by Kathryn Kobe, 2007 (www.sba.gov/advo/research/rs299tot.pdf) and CHI Research, 2003 (www.sba.gov/advo/research/rs225tot.pdf); U.S. Dept. of Labor, Bureau of Labor Statistics.

Until this cycle ends and the economy is back on its feet, it is unlikely that small business will add many new employees.

Job Creation Legislation

With unemployment hovering around 10 percent, policymakers in Washington are looking at ways to create jobs. Washington can support policies that will create an environment that encourages job growth, but it can also advocate for policies that will threaten job growth. So, the first item on Washington's agenda should be - do no harm.

Tax policy is an important issue to focus on relative to small business and job creation, because taxes are a major concern for small business owners. In fact, in the NFIB Research Foundation's Small Business Problems and Priorities consistently ranks tax issues, whether tax rates or complexity, at the top of the list.[2] Taxes are a concern because they increase the cost of doing business and reduce the amount of capital that a small business has to spend on its business activities.

Extend the 2001 and 2003 Tax Rates

With that in mind, Washington should send an immediate signal to small business owners that their taxes will not be raised. About 75 percent of small business owners are pass through businesses and pay their business tax at the individual level, so with the 2001 rates sets to expire they are facing a tax increasing if Congress fails to act by the end of this year.[3] If a business is struggling to make ends meet, why would Washington take any money out of those businesses at the same times they are asking them to hire new workers?

The current tax rates should be kept in place for all small businesses. Some propose raising taxes on those businesses that report more than $250,000 in income. The owner of a pass through business may report a higher amount of income on their return than they actually take home, but that income is the money invested back into the business. This is the capital they use to purchase new equipment, pay the salary and benefits of workers, and meet day-to-day expenses.

No small business owner should see their taxes increased, especially in the current economic environment. An NFIB Research Foundation poll, combined with U.S. Census Bureau statistics, indicates that the businesses most likely to face tax increases are businesses that account for a substantial portion of the workforce. The NFIB survey shows that about 10% of small business owners report more than $250,000. However, the businesses most likely to pay more taxes are firms with 20 to 250 employees. In fact, over 30 percent of firms with between 20 to 250 employees would see their taxes

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[2] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC.

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

increase if the $250,000 threshold expires.[4] In 2006, these businesses accounted for over one-quarter of the U.S. workforce, employing about 33.5 million workers.[5]

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

In addition, to the current individual rates, Congress should also extend the lower capital gains rate passed in the 2003. If a business has to sell an asset, now is not a good time to increase the tax paid on the disposition of that asset. Keeping the rate lower should also be an incentive to invest in capital assets with the certainty that any gain later realized on that investment will be subject to a lower rate of tax.

Tax increases are directly related to less business investment. As one study notes, a 5 percent increase in the individual tax rate, reduces by 10 percent the number of entrepreneurs making new capital investments and reduces the likelihood of hiring workers.[6] At a time when we are trying to promote business investment and job creation, why would we also be pushing policies that reduce investments and hiring?

Extend the current tax rates and let all small business owners know that their taxes will not go up next year.

Hiring Tax Credits

A number of proposals have been offered to provide a tax credit to a business that hires or retains employees. These are well intentioned proposals, but will probably do little to spur significant new hiring. Proving a tax break for a business that adds a new employee during difficult economic times can help to defer some of the cost associated with adding a new worker and may move a business that is on the edge about hiring, but a tax credit is not going to be a big incentive to add a new employee.

Demand is the major incentive to hire workers. A business is only going to add a worker if they have work for the employee to do. Until demand picks up and small business owners know what their business costs will be, they are not going to add substantial workers. A hiring tax credit is not going to solve the underlying problem.

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

In fact, the NFIB surveyed our membership about the effectiveness of the New Jobs Tax Credit passed in 1977.[7] The NFIB survey of member's reaction to the credit found it to be ineffective as an incentive to hire.

The first problem identified in the NFIB survey was that few businesses – only 42-percent - even knew about the credit. (The larger the firm, the more likely it was that they new about it.) Of the 42-percent that new about it, only 8-percent stated that it was an incentive to create a job. Ten-percent of the members surveyed stated that the credit was too complex. Complexities included determining the amount of the credit available and whether a new hire was eligible for the tax credit. One in five members in the survey stated that the incentive was not big enough to incentivize hiring a new worker. Finally, the survey found that the credit had a windfall effect in the Fourth Quarter with more than 50-percent of the firms collecting the credit in the Fourth Quarter most noting that they would have hired the worker regardless of the credit.

If the Senate is going to move ahead with a hiring tax credit, the New Jobs Tax Credit provides some insight on how to make such a proposal most effective. A tax credit to incentivize hiring will be more effective if four key elements are met – (1) timing, meaning when does the business claim the credit, (2) amount, is the credit rich enough to incentivize a business to hire, (3) complexity, is the credit easy enough to qualify for so that a business will be interested in taking advantage of it, and (4) awareness, does the business know about the credit.

In terms of timing, S. 2983, introduced by Senators Schumer and Hatch, is correctly focused on payroll tax liabilities. Cash flow is a major problem for most small businesses and during tough economic times this is even more of a problem.[8] Payroll tax relief eliminates a regular expense that a small business has to make throughout the year, regardless of their profitability or cash flow position.

The other conditions are less clear. How large a tax credit has to be to incentivize a business owner to hire a worker will fluctuate from business to business and with little demand for workers, no amount may be enough. A tax credit, like the hiring tax credit, must include sufficient means to reduce fraud, which ultimately could make the credit more complicated and less effective. The more conditions placed on the credit, the less likely it is that a business can or will claim it. Finally, if passed, awareness is something we will have to work on and the NFIB will certainly inform our members.

Increasing Section 179 Expensing

Extending the higher section 179 expensing amounts of $250,000 is important for businesses that may be purchasing equipment this year. Providing additional tax relief

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[7] Testimony of James D. "Mike" McKevitt, Washington Counsel, National Federation of Independent Business; before the House Ways and Means Committee, *The Impact of the Tax System and the President's Tax Proposals on Small Business*, March 7, 1978.

[8] One in five small businesses experiences a continuing cash flow problem and one in two businesses face regular cash flow problems. This is a problem common to all small businesses and is just as true for a larger small business as it is for the smallest business. *The Cash Flow Problem – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 1; Issue 3; 2001.

will help these businesses making an investment in 2010 and Congress should extend this higher amount. In general, section 179 is an important tax provision for small business owners. First, the immediate deduction for qualified investments in the business puts money back into the business faster, which helps to address the cash flow problem. Second, deducting the full value of the investment in one year also simplifies the tax code, since the business does not have to track the value of the asset and the amounts deducted over the life of the asset as under normal depreciation rules.

Similar to the hiring tax credit, extending section 179 will not have much impact if businesses have little reason or do not have the immediate capital to invest in their business. Even though section 179 was increased to $250,000 in 2008 and 2009, capital expenditures in the SBET survey hit a 35-year low. The problem is cash and demand, no targeted tax break is going to replace those key elements to making an investment.

There are ways to make the current deduction more effective. First, make the higher limits permanent. Senator Grassley's bill, S. 1381, the Small Business Tax Relief Act of 2009, does just that. The higher expensing threshold passed in 2007 expire at the end of this year, so making it permanent now will provide more certainty in the future. As the economy begins to recover, more small businesses will look to make new investments so keeping the incentives in place for a longer period of time will ensure that the tax relief is available through any recovery period.

Second, only equipment can currently be expensed under section 179, but expanding section 179 to include real property – such as new windows or a new roof – would increase the number of businesses that could claim the deduction. In addition, the expansion to real property could benefit the struggling construction industry, which would be hired to do this work.

Zero Capital Gains on Qualified Small Business Stock
The Administration and others have proposed eliminating capital gains on the sale of qualified small business stock. Eliminating tax on an asset is a good approach to incentivizing investment in small firms, this proposal is just extremely narrow.

Current law - Section 1202 - excludes 50 percent of the gain on qualified small business stock.[9] A "qualified small business" is defined as a business organized as a C Corp and having less than $50 million in gross assets.[10] Only 25 percent of small businesses are organized as C corps, so the proposal immediately excludes 75 percent of small businesses.

Certainty for Small Businesses

With the Senate preparing to act on a number of these proposals, many of them will provide some tax relief to small business. That is a step in the right direction. In some cases – such as with a hiring tax credit and increasing section 179 – a business must make

[9] 26 U.S.C. 1202(a).
[10] 26 U.S.C. 1202(d).

an investment of capital before receiving the relief. This will help some small businesses to cover costs and take risks as the economy attempts to grow out of the current recession. Businesses that lack the capital or demand to make those investments will not see this relief.

We are hearing regularly from our members that they are concerned about uncertainty, whether it's the expiring individual tax rates, the unresolved estate tax, or tax extenders. Congress should act on these issues quickly - providing relief to small businesses - so that small business owners know what the laws are relative to the business decisions they have to make. It is counter productive in the current economic climate for a business owner to keep capital locked-up until they wait to see what Congress does

The continued lost sales, lack of demand and capital that comes from business activity, and uncertainty are the main problems plaguing small businesses today. This is why keeping the current tax rates in place is so important. Let all small business owners keep the money they earn to invest in and grow their business. As business activity picks up, they will use that money to hire new workers, expand facilities, or invest in new equipment. Entrepreneurs take the risk to start their business, they have the know-how to grow their business, and they know best what's needed to keep the business operating successfully.

Allow America's small businesses to manage the day-to-day operations in their business and grow out of the current recession. It has happened before and small businesses can get through this again, but they need some stability and certainty to do it.

I appreciate the opportunity to present the NFIB's views on these important issues and look forward to continuing to work with the Committee to support small businesses and strengthen our economy.