

**TRADE AND TAX ISSUES RELATING TO
SMALL BUSINESS JOB CREATION**

HEARING

BEFORE THE

**COMMITTEE ON FINANCE
UNITED STATES SENATE**

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

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FEBRUARY 23, 2010
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TRADE AND TAX ISSUES RELATING TO SMALL BUSINESS JOB CREATION

TUESDAY, FEBRUARY 23, 2010

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:07 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Stabenow, Nelson, Menendez, Carper, Grassley, Snowe, Bunning, and Crapo.

Also present: Democratic Staff: Bill Dauster, Deputy Staff Director and General Counsel; Cathy Koch, Chief Tax Advisor; Amber Cottle, Chief International Trade Counsel; Michael Smart, International Trade Counsel; Hun Quach, International Trade Analyst; Tiffany Smith, Tax Counsel; and Joseph Adams, Economic Development Advisor. Republican Staff: Stephen Schaefer, Chief International Trade Counsel; Jim Lyons, Tax Counsel; and Nick Wyatt, Tax and Nominations Professional Staff Member.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Before I begin, I would just note that Senator Grassley will return very quickly. I have to leave to attend another meeting in about 10 or 15 minutes, and Senator Grassley will chair the rest of the hearing when he returns at about that time.

The Greek physician Galen once said, "Employment is nature's physician and is essential to human happiness." Over the course of this Great Recession, more than 8 million Americans have lost their employment. And along with their jobs, millions of Americans lost their well-being, their health, and their happiness.

Fortunately, the Recovery Act kept us from losing even more jobs. The nonpartisan Congressional Budget Office says that the Recovery Act lowered the unemployment rate by between 0.3 and 0.9 percentage points from where it otherwise would have been. But in the past 2 years, the unemployment rate more than doubled. It rose from 4.9 percent in December of 2007 to 10 percent in December of 2009.

Most economists do not expect significant improvement in unemployment any time soon. The Congressional Budget Office projects that the unemployment rate will not reach its natural state of 5 percent until 2016. Much work remains to be done. We cannot wait until 2016; we need to act now.

So, what can we do? First, we must remember that the private sector is the backbone of American innovation and job creation, and within the private sector small businesses are the principal engine of job creation. Over the past 15 years, small firms have generated two-thirds of new jobs. Small businesses are the leading source of employment in my State of Montana. In 2008, small businesses employed 325,000 Montanans. That is nearly three-quarters of the Montana workforce.

Small businesses have been hard hit by the Great Recession. The Small Business Administration reports that in 2008 alone, small businesses lost more than 3 million jobs. We know that small business and entrepreneurs play a very important role in recovery.

Take, for instance, BioScience Laboratories, Inc., a small testing laboratory based in Bozeman, MT. Bioscience Labs was hit hard by the recession, but they adapted, and they are growing. In 1991, one person started the company. One person. Today, Bioscience Labs employs 51 Montanans. They hired 10 of them in recent months, and they plan to hire 7 more by the end of the year.

We need to find ways to further support the creation and growth of small businesses like Bioscience Labs. Their flexibility and innovative solutions will be the key to economic recovery. The policies that we consider must provide immediate relief and must provide help when folks need it most, and we must be fiscally responsible. Creating jobs today should not come at the expense of fiscal stability tomorrow. We must create the most jobs at the least cost to the taxpayer.

U.S. export promotion programs fit the bill. Exports have a big effect on the American economy. In 2009, we exported more than \$1.5 trillion of goods and services. America is the world's third-largest exporter.

These exports supported nearly 10 million American jobs. Exports accounted for 11 percent of our Gross Domestic Product. These numbers are impressive, but they are not nearly good enough. Ninety-five percent of the world's consumers live outside our borders. To ensure sustainable long-term economic growth here at home, we must do more to reach abroad.

In his State of the Union address, President Obama called for doubling our exports over the next 5 years. These additional exports will create nearly 2 million more American jobs, but these new exports will not happen without our help. Our export promotion programs provide American small businesses with the tools that they need to reach foreign markets. A number of agencies help small businesses to navigate the confusing and costly road to exporting.

First is the U.S. Trade Representative's enforcement of existing trade agreements and negotiation of new ones; there is the Commerce Department's assistance in identifying foreign customers; and there is the Small Business Administration's financing of small business exports.

We must ensure that these agencies have the resources that they need to boost American exports and create jobs. Our export promotion programs have a proven track record. The Commerce Department estimates that, for every \$1 million spent in export promotion, \$57 million in new U.S. exports are generated and 314 new

U.S. jobs are created. In my State of Montana, \$206,000 in export promotion programs resulted in \$26 million in exports last year. That means every \$1 invested in export promotion resulted in more than \$120 of Montana exports.

These programs work, and we must make sure they work for the maximum number of people. The tax code also includes policies that offer a good bang for the buck. Among these are provisions that put money in the hands of small businesses and increase their buying power. The examples are the expensing of certain investments or increased deductions for start-up expenditures. Helping a small business's cash flow, in turn, helps other businesses that will then be able to sell more of their products. As businesses rebound, they will need to retain and hire more employees.

Another tax provision to consider is a capital gain exclusion on the sale of small business stock, that is stock held for 5 or more years. This tax cut gives people an incentive to invest in small corporations who are struggling to find the capital they need to grow their businesses. Senators Kerry and Snowe have championed this idea.

New jobs are the cure for what ails the economy. Let us do what we can to help nature's physician. Let us help to create more new jobs in America's small businesses, and let us do more to restore the health and well-being of the American economy.

As I noted, Senator Grassley will return shortly to chair the hearing and will speak when he returns, so I will now introduce the panel.

The first witness is Mr. Jim Sanford. Mr. Sanford is Assistant U.S. Trade Representative for Small Business, Market Access, and Industrial Competitiveness, a position that was recently created based upon a request from Senator Snowe and myself. We created this position to help us do a lot better job and get more bang for our buck. Thank you, Mr. Sanford, for being here.

The second witness is Mr. Spencer Williams. Mr. Williams is the president and CEO for West Paw Design, a business in Bozeman, MT. Thank you, Spencer, for being here, and also for creating the kind of businesses that we need for the future. You might explain what you do when you testify, but basically it is eco-friendly products for dogs. Well, you can explain it better when you testify.

The third witness is Dr. Eric Toder. Dr. Toder is an institute fellow at the Urban Institute.

Then Chris Edwards, who is the director for tax policy studies at the Cato Institute. Thank you, Mr. Edwards, for being here.

Finally, we have Dr. Bill Rys, who is tax counsel for the National Federation of Independent Business.

Thank you all for coming. As is our regular practice, your prepared statements will be in the record. I would ask you each to speak for about 5 minutes.

So, Mr. Sanford, why don't you begin?

STATEMENT OF JIM SANFORD, ASSISTANT U.S. TRADE REPRESENTATIVE FOR SMALL BUSINESS, MARKET ACCESS, AND INDUSTRIAL COMPETITIVENESS, WASHINGTON, DC

Mr. SANFORD. Thank you, Mr. Chairman, members of the committee. Thank you for convening this hearing today. I appreciate

the opportunity to provide testimony on the effects and the efforts of the Office of the U.S. Trade Representative to expand exports of small businesses, create U.S. jobs, and promote sustainable economic growth.

As the President announced in his State of the Union address, agencies across the Federal Government are teaming up under the National Export Initiative to create jobs by expanding exports. USTR's role in the NEI is reflective of our role as an agency: to tear down barriers to trade and to open new market opportunities for American businesses to grow and create jobs.

In our efforts, USTR is partnering with the Small Business Administration, the Commerce Department, the Export-Import Bank, and others across the Federal Government to provide American businesses the resources and opportunities they need to succeed.

America's 30 million small businesses form the backbone of our economy. In the past 15 years, approximately 65 percent of net new private sector jobs were created at small businesses. Small businesses that export tend to grow even faster, create more jobs, and pay higher wages. But studies show that only 1 percent of U.S. Small and Medium Enterprises are currently exporting, and many of the SMEs that do export sell in only one country, and to only one customer in that country, so there is vast room for improvement.

Last fall, Ambassador Kirk launched an initiative reexamining our trade policy enforcement efforts to ensure that we are being responsive to the challenges and priorities of small business. As part of this initiative last month, Ambassador Kirk, in consultation with Chairman Baucus and Senator Snowe, designated me as the Assistant U.S. Trade Representative to help coordinate small business interests within the agency.

Working with Congress and other agencies across the government, our objective is to both increase the number of small businesses that export and to expand the number of markets and customers served by SMEs that do export.

To better understand the key challenges that are constraining U.S. SMEs from fulfilling their export potential, we have reached out widely to trade associations, companies, and our interagency colleagues. We are working with our trade partners to reduce costly trade obstacles often cited by SMEs, and of course we have consulted with the committee, and others, to ensure coordination of our efforts.

Here are some concrete steps we have undertaken at USTR. Starting in October of 2009, USTR launched an agency-wide review of our policymaking and enforcement efforts in relation to SMEs. Through our trade agreements and policy dialogues, we are examining ways to tackle obstacles to trade that loom particularly large for smaller businesses, issues like cumbersome or non-transparent regulatory procedures, complex customs processes, and requirements that force companies to open offices in foreign countries.

Last October, Ambassador Kirk requested that the U.S. International Trade Commission prepare a series of reports on SMEs and international trade in order to better understand SME performance and to help U.S. trade policy and trade promotion activities.

In January, Ambassador Kirk hosted a widely attended conference focused on trade opportunities and challenges confronting SMEs. In conjunction with this event, USTR conducted an agency-wide program of industry outreach activities on small business trade issues. Finally, we are increasing small business representation on our industry trade advisory committees; pursuing closer collaboration with SBA, Commerce, and the Export-Import Bank to improve the integration of our export promotion, finance, and policy activities; and broadening our business outreach beyond traditional trade circles.

Moving forward, USTR is working to identify specific trade tools and activities that offer particular potential benefits for American small businesses. As part of our negotiations to expand U.S. trade in the Asia-Pacific region through the Trans-Pacific Partnership, for the first time we will have a point person for SME issues and we will consistently emphasize the needs of smaller businesses across negotiation topics.

As an APEC agenda priority, we are seeking to make it cheaper and easier for companies, and particularly small businesses, to trade in the region. Under our existing FTAs we are seeking to establish working groups on small business to facilitate SME trade opportunities under these agreements.

FTAs offer valuable export opportunities for SMEs and all businesses. USTR continues to work to address outstanding concerns regarding the pending agreements with Panama, Colombia, and South Korea. Approval and implementation of the pending FTAs is a priority in the administration's export initiative.

In addition to these market access activities, we are focused on robust enforcement of our trade agreements and WTO rules. When unfair trade practices inhibit the ability of smaller exporters to get their goods and services into global markets, we are committed to knocking them down through negotiations if possible, and legal action if necessary.

In conclusion, the global economic downturn has adversely impacted all of our business sectors. Our effort to expand U.S. exports will have a critical role to play in advancing our economic recovery and the creation of quality jobs at home. USTR is committed to helping more small- and medium-sized businesses take advantage of opportunities to sell American goods and services overseas.

Thank you for this opportunity to outline USTR's efforts to expand exports of U.S. small business and support the creation of new jobs.

The CHAIRMAN. Thank you, Mr. Sanford, very much. I appreciate that.

[The prepared statement of Mr. Sanford appears in the appendix.]

The CHAIRMAN. Mr. Williams?

**STATEMENT OF SPENCER WILLIAMS, PRESIDENT,
WEST PAW DESIGN, BOZEMAN, MT**

Mr. WILLIAMS. Thank you, Chairman Baucus, Ranking Member Grassley, and the members of the committee for inviting me to testify before the Senate Committee on Finance. I am grateful for the opportunity to share my experience, observations, and opinions

with you regarding export trade and how small businesses can increase jobs in our country.

West Paw Design is based in Bozeman, MT, and it has built a reputation of manufacturing high-quality bedding, toys, and apparel for dogs and cats throughout our 13-year history. Our team of 36 employees are extremely proud that 100 percent of our products are made in the United States, and we sell them to 2,800 domestic retailers around the country and export them to 24 foreign countries.

The company is distinguished by a commitment to creating eco-friendly, safe, and quality products. West Paw Design has experienced continued sales growth, even during the economic downturn, with an increase so far this year of 33 percent. Part of this year's planned growth is based on a 140-percent projected increase in exports.

I would like to mention two Federal programs that West Paw Design has participated in: the SBA 504 Loan Program and the U.S. Commercial Service for Exporters. In 2009, we received SBA approval on a 504 loan for the expansion of our existing building. Because of the Recovery Act, two 504 Loan Program fees were eliminated. This resulted in over \$26,000 in savings, and these monies were directed to other critical business investments.

Regarding exports, West Paw Design has worked with the U.S. Commercial Service, which has provided us with technical assistance and market research. Additionally, we have used the Gold Key program. By selecting this service in 2002, we had hoped to improve upon a previous failure at an international trade fair. Unfortunately, due to my lack of experience with international pet product sales and the limited detail of research performed as part of Gold Key, this effort was not successful either.

These past learnings have helped me to be more successful in my subsequent years and have also helped me develop two suggestions to improve the U.S. Commercial Service. First, I believe that people are the biggest asset to helping exporters succeed. The U.S. Commercial Service should spend more money and time on finding great people and training them well.

Second, I believe that the fee to use Gold Key programs should be eliminated. Other countries, such as Canada, provide a great deal of free assistance to their exporters, and participants in this country are still contributing money toward all travel-related expenses to the foreign country, along with sample costs and staff time.

Looking forward, I do have several concerns about growing our exports that I wanted to share. I will mention four of them, and my opinion of each. First, it is difficult for us to identify compatible markets and partners. We must expand into other markets, and I believe that the U.S. Commercial Service can help us accomplish this, enabling us to grow faster and create new jobs.

Second, there is a great deal of intellectual property risk for our product designs and brand, and without strong and fair protection, IP infringement reduces the value of our innovation.

Third, protectionism removes competition and slows U.S. innovation. As a proponent of liberal trade, I believe that innovation is

borne out through a quality education, a free business environment, and strong competition.

Fourth, high-priced products slow our export sales. Thankfully, a weaker U.S. dollar has helped to keep prices low over the last few years. Yet, if the dollar increases dramatically, our prices will climb and our exports will drop.

There are two other areas that make our foreign competitors' prices artificially low and unfair, and that is low standards for basic human rights and poor environmental protection practices. When the companies that compete with us on the world stage take advantage of people and/or the environment, their products are cheaper because the true cost is not valued in the price. Consequently, our products have a high relative price to theirs. On the other hand, I want to say there are several advantages to growing our exports, and I will mention three of them, briefly.

First, many of our international buyers seek U.S.-made products because of their known high quality in comparison to other products from other markets.

Second, in general, I am a proponent of free trade agreements; however, I believe that, although small companies may know about FTAs, many of those companies will first export to the countries where the market and economic trends are the greatest.

Third, I believe that the reemergence of a positive Brand USA is a great benefit to U.S. exporters. The more open and cooperative position the U.S. is taking in its view toward the global, political, and economic community is reflecting positively on U.S. companies, products, and its citizens.

In summary, let me underscore that the livelihoods for approximately six employees at West Paw Design are dependent on exports. With nearly 17 percent of our sales being to foreign companies, West Paw Design exports more than twice the amount of an average Montana manufacturer.

By making the U.S. Commercial Service an even better organization through great hiring and training and by providing more manufacturers access to its programs by eliminating fees, the U.S. small manufacturers can grow their exports and increase employment.

Chairman Baucus, Ranking Member Grassley, and members of this committee, thank you for this opportunity. I appreciate your time and interest in helping small manufacturers succeed and create new jobs.

The CHAIRMAN. Thank you very much, Mr. Williams. It is very clear you are organized and you are focused, and you have a plan and you are executing. I congratulate you.

Mr. WILLIAMS. Thank you.

[The prepared statement of Mr. Williams appears in the appendix.]

The CHAIRMAN. Dr. Toder?

**STATEMENT OF DR. ERIC J. TODER, INSTITUTE FELLOW,
URBAN INSTITUTE, WASHINGTON, DC**

Dr. TODER. Thank you, Chairman Baucus, Ranking Member Grassley, and members of the committee. Thank you for inviting me to testify today on tax issues related to small business job cre-

ation. The views I express are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders.

For immediate job creation in periods of high unemployment, the size of any overall fiscal stimulus matters much more than its composition. Both small and large businesses will benefit from policies that increase demand for goods and services, but tax policies that provide cuts to those consumers and businesses most likely to spend them quickly will do the most to accelerate recovery.

My written testimony discusses three tax incentives the administration is proposing to help small businesses: the Temporary Incremental Jobs Tax Credit, the extension of increased limits on section 179 expensing, and the elimination of capital gains tax on qualified small business stock.

I make the following points: the Incremental Jobs Credit provides an incentive for employers to add to their workforce or payroll, but one cannot tell what employers would have done without the credit. Defining 2009 jobs as the baseline means the credit will reward growing firms for jobs they would have added anyway and fail to reward firms experiencing a decline in demand for retaining workers.

Past experience with a similar incentive in the 1970s was mixed. Many employers were unaware of the credit and most who were did not add workers, but there is some evidence the credit increased jobs. Those who knew about the credit hired more workers than those who did not. The credit's likely biggest impact will be to accelerate some hiring that would have occurred in 2011 into 2010.

Finally, the credit's effectiveness will depend a lot on design details, and in particular additional restrictions, including limits on categories of workers who are eligible, will reduce additional jobs created per dollar of budgetary cost.

Small business expensing. Raising limits on the amount of investment small businesses can expense will reduce the cost of capital for some firms and will lower compliance costs. There has been no research, however, on how much section 179 expensing affects the level of timing and investment; we think it is positive, but we do not know how much.

Temporarily extending the higher 2008 and 2009 limits into 2010 could cause businesses to shift some investment forward from 2011, but because these temporary higher limits have already been in the law for 2 years, some of the investment that might have been accelerated may have already happened.

Finally, capital gains. The administration is proposing to exempt capital gains on qualified small business stock. Exemption will substantially increase the size of this tax benefit, which is, under current law, quite small, or will be quite small after 2011.

Most small businesses do not qualify for the exemption, either because they are organized as flow-through enterprises or because they are in economic sectors that are excluded from the benefit. The short-run stimulus in this proposal is likely to be small because the tax cuts adding to demand will not be realized for many years. The proposal would spur some new ventures, but also divert

capital from investments which might be more productive that do not receive a tax break.

Finally, it is important to consider compliance. This exemption has been in the law for many years, but there are very few reporting requirements. Now that it is being made a lot more generous, there should be additional reporting requirements, if this should be enacted.

These points are developed more fully in my written testimony. Thank you.

[The prepared statement of Dr. Toder appears in the appendix.]

Senator STABENOW. Thank you. I will assume temporarily until our ranking member joins us. Chairman Baucus has had to step out.

Mr. Edwards, proceed.

**STATEMENT OF CHRIS EDWARDS, DIRECTOR, TAX POLICY
STUDIES, CATO INSTITUTE, WASHINGTON, DC**

Mr. EDWARDS. Thank you, Senator Stabenow. Thank you, Senators Snowe and Bunning, for inviting me today to talk about taxes and small business job creation.

The administration has offered some narrow tax breaks for small business job creation, but I think that is the wrong direction for tax policy. Instead, I believe Congress should focus on creating a simple and neutral tax structure with low marginal rates for all businesses, large and small.

I want to focus on the administration's proposal to raise the top two individual income tax rates. Higher marginal rates, I believe, will reduce incentives for productive behavior, such as working and expanding businesses, and they will increase incentives for unproductive behavior, such as tax avoidance.

How large are those behavioral responses to tax rate changes? The academic literature on this is pretty solid. If you raise the top income tax rate by 5 percentage points, reported income will drop by at least 3 percent. That is a lot. That 3-percent drop in reported income would result in at least a 40-percent revenue feedback or offset to any expected revenue gain.

Empirical studies find that taxpayers at the top end have larger behavioral responses to rate changes than other tax filers; they can more easily adjust their working and investment behavior. Today's highest earners are generally not passive investors/inheritors of wealth. They are self-made, talented, and entrepreneurial.

If you scan through the *Forbes* 400 Richest Americans edition every year, you find that the people at the top end are extremely entrepreneurial, extremely important to the economy. Many with high incomes are angel investors who help fuel small business growth. According to the Small Business Administration, there are at least 300,000 angel investors in the United States. If their taxes go up, they will have less money to invest and perhaps park more of their funds in tax-free muni bonds and other low-risk activities.

There is a lot of business income in the top two income tax brackets. A Joint Tax Committee analysis provided to this committee found that 44 percent of business income on individual returns is in the top 2 tax brackets. A similar Tax Foundation anal-

ysis found that, if the top two rates rise, 40 percent of the entire tax hit at the top end will be on business income.

My written testimony summarizes academic studies that look at the negative effects of these higher marginal rates on small businesses, but basically there are two negative effects: you raise the marginal rates on small business and they will have less incentive to earn additional profits; second, they will simply have less cash flow for further investment.

Finally, let me put these issues into international perspective. Ten years ago, before we dropped our top marginal income tax rates, the top U.S. rate, with average State taxes, was about 47 percent. Coincidentally, that was the same average top rate in the 30 nations of the OECD. So, that was 10 years ago.

Today, our top rate is 5 percentage points lower, but the OECD average rate has also fallen by 5 percentage points over the last 10 years. So today, both the United States and the OECD are at a top rate of 42 percent. If we raise our rate back up to 47 percent, we will be one of the major industrial countries with a high tax rate. In fact, we will have the ninth-highest tax rate in the OECD. So the world has changed over the last decade. We cannot simply go back to where we were in 2000.

In a world of capital mobility and mobility of entrepreneurs, I think this is very important. If you look, for example, at Silicon Valley, a number of studies have found that one-quarter of all businesses in Silicon Valley were founded by immigrant entrepreneurs, mainly from India and China. It seems to me, at the margin, if we are raising our income tax rates here and other countries are reducing their income tax rates, people who are internationally sort of mobile will tend to gravitate to the countries with lower marginal tax rates to start their businesses.

So, to conclude, it seems to me, rather than raising our income tax rates next year, we should be revisiting the approach of the Tax Reform Act of 1986, which reduced tax expenditures and used the revenue to lower statutory, personal, and corporate tax rates, which would benefit businesses across the board in every industry, big and small businesses.

Thank you very much.

[The prepared statement of Mr. Edwards appears in the appendix.]

Senator STABENOW. Mr. Rys?

**STATEMENT OF BILL RYS, TAX COUNSEL, NATIONAL
FEDERATION OF INDEPENDENT BUSINESS, WASHINGTON, DC**

Mr. RYS. Thank you, Senator. Thank you for the opportunity to appear on behalf of the National Federation for Independent Business. It is the Nation's leading small business advocacy organization, representing over 350,000 small business owners.

Small business accounts for about two-thirds of the net new jobs created, so, as the committee focuses on ways to incentivize job creation, small business is the proper place to focus.

Unfortunately, small business continues to struggle through the current economic recession. The NFIB conducts a monthly small business economic trend survey, and all the leading indicators in

that survey continue to be at or near all-time lows. For 7 straight quarters, in fact, we have been below 90, when the average is 100.

The biggest problem found in that survey, and in a study we released today, is lost sales. Small business owners simply do not have customers coming in the door. In fact, in June and July of 2009, lost sales hit an all-time low in the 35-year history of the small business economic trend survey.

This continues to be the number-one problem plaguing small business owners. This also means businesses have less capital, which means less investment in small businesses. Capital expenditures are at an all-time low, and plans to hire continue to be slow. We asked small business owners, "Why is this not a good time to invest in their business?" Economic conditions continue to be the first reason, and policy concerns that may raise their costs follow behind that.

The committee's focus on tax policy is an important way to help spur job creation with small business owners, so here are some ideas of what the NFIB's position is on a number of the proposals that are out there, and a few additional suggestions. First, NFIB's members believe that the current individual and capital gains rates should be extended.

Individual rates are very important to small business owners. About 75 percent of small businesses are organized as pass-through businesses, meaning they pay their tax at the individual level. This after-tax income is the money most small businesses use to invest back into their business. Some have proposed raising those taxes on those who make more than \$250,000.

Based on an NFIB survey, about 10 percent of small business owners could see their taxes go up under that proposal. If we dig a little deeper into those numbers, businesses with between 20 and 250 employees are the most likely to be hit by those tax increases. Those businesses account for more one-quarter of the American workforce. Regardless of how many and which, no small business should see their taxes go up in the current economic environment. In addition, the lower capital gains rate should also be kept in place.

Second, the Senate is soon to consider legislation to provide tax credits and payroll tax relief for hiring workers. While this will provide some small business owners with a tax break, and that is certainly a good thing to get through the current economic situation, we are skeptical that this is going to be a large incentive to hire. Demand is simply down. If there is no work for the employee to do, there is no reason for a small business owner to hire.

But that being said, there are ways to make a proposal like this more effective. As Dr. Toder said, we need to consider the amount of the credit, we need to consider how complex and how complicated the credit is, what kind of conditions are on that credit, and we need to make sure that awareness of the credit is out there.

Finally, timing. The proposal that Senators Schumer and Hatch put forth that would provide payroll tax relief gets the timing right. Payroll tax is an expense that a business pays on a regular basis. When businesses do not have cash and cash flow coming in to the business, providing payroll tax relief is a way to continue to help

remedy some of the cash flow problems that businesses have right now.

Increasing section 179. This, in general, is a very important provision to small business owners, and increasing the limit to \$250,000 is important for businesses that may be making investments this year, and maybe will move some businesses around the edge. Again, the challenge is going to be capital and demand, but there are ways to make that proposal better.

Senator Grassley's bill, S. 1387, would make those expensing provisions permanent. Senator Snowe has a very similar proposal. We think this is a good idea. This is going to be a long recovery. The current higher limits of 2007 expire at the end of this year. Let us give businesses the certainty that those tax benefits are going to be there as we continue to move through this recovery.

Second, section 179 currently only applies to equipment. Expanding the investments that can be deducted to include real property, such as new windows, new doors, new roofs, could increase the number of businesses and increase the business activity available for that deduction. In addition, this could help the struggling construction industry—which has seen a tremendous downturn over the last couple of years—that would be hired to put on the new roofs, windows, et cetera. Another proposal was to eliminate capital gains on certain investments. This is a good incentive. Unfortunately, it is somewhat narrowly focused, as Dr. Toder said.

Finally, uncertainty. Small business owners continue to struggle through this recession, and if they are going to get back into the game they need to know what the rules are. There are a lot of unresolved issues which we believe the Senate should move on as quickly as possible, things such as the estate tax, potential higher unemployment taxes, and expiring tax provisions such as restaurant depreciation and a shorter depreciation period for farm equipment.

Many of the proposals that will be considered by the Senate soon will help some small business owners. The biggest concern that we have is that these incentives require an investment of capital up front, and many businesses just do not have this capital right now. We believe that small business owners need broader tax relief and they need certainty. This is why extending the 2001 and 2003 tax rates is so important. Small business owners took a risk to start their business. They know how to make their business succeed, but they need the capital and certainty to do it.

I appreciate the opportunity to present the NFIB's views, and I look forward to any questions.

[The prepared statement of Mr. Rys appears in the appendix.]

Senator STABENOW. Well, thank you very much to each of you.

I will lead off at this point while we are waiting for our ranking member to join us today.

There is no question, as all of you have said, that small businesses have created 64 percent of the new jobs in the last 15 years and that, in the last year, almost 85 percent of the jobs that have been lost have come from small business.

So I am very pleased that the chairman is focusing on small business and that we will be moving forward to consider, and hopefully support, the President's initiatives on eliminating capital

gains taxes and other provisions that relate to capital availability for small businesses.

I guess the first thing I wanted to do, though, is, Dr. Toder, ask you if you might just respond to some of the other testimony on one area, because for those of us who want very much to focus on small business, and a majority of small businesses, I would just ask you to respond.

Secretary Geithner has stated that 97 percent of taxpayers, 97 percent with business income, would not be affected by the tax policy that is about to expire, and in fact it would be more wealthy folks, corporate executives, Wall Street traders, and so on. The CBO has issued, this month, an analysis, again, that extending that tax policy would be the least effective of all the spending and tax options in terms of creating jobs.

So, as somebody who has the highest unemployment rate in the country and wants to be laser-focused on how we are creating jobs and supporting small business, I am wondering, do you agree with those numbers, that in terms of 97 percent of the taxpayers with business income would not be affected by the tax provisions expiring?

Dr. TODER. We actually have our own numbers. They are fairly close to that, but that is in the ball park. I mean, the last time we looked was a year ago. If you define somebody who gets 50 percent or more of their income from schedule C, E, or F as a small business owner, about 1.9 percent of those tax returns are in the top two tax brackets. So, essentially that is correct, most small business owners will not be affected by this tax increase.

Now, that does not contradict what Chris was saying, which is that most high-income people—many high-income people—do have some small business income. But, if you were looking at sort of the majority of small business owners, they will not be affected.

With regard to the CBO statement, I think I agree with that, but I think you have to understand the context of it. They are really saying, in the short run, as I said in my statement, the most effective way to get more jobs quickly is to get demand up so businesses can sell the products they produce. You want to get tax cuts into the hands of people who will spend a lot.

Generally, the high-income people will not spend that much of their tax cut so, as an anti-recessionary policy, keeping the rates low is not necessarily an effective anti-recession policy. However, you do have to look at other issues in the long run as to what the incentives are in the economy from having higher rates, and that is a very different issue than talking about what is going to happen in the next year or two.

Senator STABENOW. Sure. Well, and certainly I am hearing—and I know in talking to colleagues—concerns when we are talking to small businesses right now that the ability to access capital is absolutely critical to be able to grow businesses. We have also been hearing concerns about collateral depreciation and cash flow shortfalls that relate to the ability to get loans as well, that I am hopeful we are going to take up.

But Dr. Toder, you mentioned demand, and Mr. Rys. But both mentioned, and others have mentioned, the lack of demand for products, and I could not agree more, which really means jobs and

people having money in their pockets. It means middle-class families having money in their pockets to be able to buy. I wonder if you have any other suggestions as it relates to the demand-side or increasing sales.

I have to say, as the author of Cash for Clunkers, that was a demand program. We got people into showrooms, they bought automobiles, and it also ended up putting people back to work making automobiles. That was a demand-side proposal. I am wondering if either of you have other suggestions for us. Certainly we have to address the tax side and issues related to loans, but any ideas on the demand side as well?

Dr. TODER. Well, I mean, if you read that CBO report that you cited, they do talk about other things, like extending Unemployment Insurance, there is the Making Work Pay credit, there are other ways of getting more money, in the short run, into the hands of those consumers, whether on the spending or tax side, who will be most likely to spend.

I think you do have to consider with some caution how markets will proceed if they think that we are not getting our fiscal house in order over the long run, so it is a very delicate balance. You want to have more demand now, but I think it is also important to take some credible steps so people can say that once we recover we are going to do something about these deficits. That is very important as well.

Senator STABENOW. And I know my time is up, but, Mr. Rys, if you had any quick comment on demand, any new ideas for us.

Mr. RYS. Well, that is really the big conundrum, how do you get demand out? We had proposed a payroll tax holiday for both the employers and the employees about 2 years ago so it would put money back into both the business and the employees' pockets right away. We think that would have been an effective way to at least get more money into the hands of consumers. But you are right, demand really is the challenge. Until that is addressed, a lot of these problems are going to continue to be there.

That gets to the capital issue that you are talking about. When demand is down, businesses do not have capital. It is their cash flow that they use to run their business, to make new investments. If that is not there, then the fuel for the engine just is not going to be there. So it is a challenge, but I think the payroll tax holiday, if we would have done that last year, I think would have put more money back into people's pockets.

Senator STABENOW. Thank you.

I see our distinguished ranking member. I will turn it back over to you, Mr. Chairman.

Senator GRASSLEY. All right. Senator Baucus is necessarily absent; he probably explained that. I was at another meeting.

What I will do here, for the benefit of my colleagues, is I will give my opening statement, and I will not ask questions, and then I will go to the four of you. Then I will ask my questions after you are done.

**OPENING STATEMENT OF HON. CHUCK GRASSLEY,
A U.S. SENATOR FROM IOWA**

Senator GRASSLEY. I appreciate the partial focus of this hearing on the value of international trade and promoting job growth, but I am skeptical of the forced distinctions among beneficiaries of trade, particularly when it comes to the job of U.S. Trade Representative.

The role of the USTR is to eliminate tariff and non-tariff barriers to U.S. exports and to enforce and defend U.S. rights and privileges under our international trade agreements. In doing so, the USTR benefits all American firms that export, not just firms of a particular size.

While small- and medium-sized enterprises—the purpose of this hearing—may have specific resource constraints to contend with in seeking export sales, no U.S. business will be internationally competitive in the face of tariff and non-tariff barriers to our exports. Reducing or eliminating such trade barriers should be our top priority. It is the single-biggest step we can take to increase exports.

The most effective and proven means of reducing tariff and non-tariff barriers is through the negotiation and implementation of trade liberalization agreements among nations, yet this administration and its leadership in Congress have demonstrated that they are unwilling to do so when it comes to implementing our pending trade agreements with Colombia, Panama, and South Korea.

So I am concerned with this administration's recent focus on export promotion because it comes as a distraction. We all want to see more exports, but that does not mean that we should throw more money and earmarks at export programs and call it somehow a day without taking into consideration Colombia, Panama, and South Korea.

I am particularly concerned when I learn that the President's new national export initiative has monies budgeted, and yet the participating executive department still has—can you believe it—180 days to submit detailed plans to the President on how such monies would be spent. Most bureaucracies will find a way to spend money if they are told to spend it, but that does not necessarily make good policy.

Unprecedented budget deficits are forecast for years to come. It is more important than ever that we scrutinize any proposals for increased spending. Those who seek to spend more must be able to explain why our current spending level is insufficient. What is the imperative for spending more taxpayers' money?

I want to discuss the tax portion of this small business hearing now. The first rule that Congress should follow is: when you are in a hole, stop digging. With unemployment at unacceptably high levels, Congress should not be raising taxes on small business, which creates 70 percent of the net new jobs in America. The worst thing that could happen to small businesses' abilities to create new jobs is to hit them with a job-killing tax hike.

Small business will be hit with this job-killing tax hike if Congress does not act to extend all of the lower tax rates that are set to increase at the end of this year. These lower tax rates are the result of the 2001 tax bill that passed with broad bipartisan support.

Congressional Democrats and the President have proposed increasing the top two rates from 33 percent and 35 percent to 36 percent and 39.6 percent, respectively. Now, let us look at what the Joint Committee on Taxation says. Everybody knows that this is the nonpartisan official scorekeeper on congressional tax issues. It provided data that shows that 44 percent of flow-through business income will be hit with a tax hike that will result from the increase of the top two tax rates if Congress does not act to stop it.

I will put that in the record so it is there for everybody to see. So it is not my statement, it is from the nonpartisan Joint Committee on Taxation.

[The memorandum appears in the appendix on p. 42.]

Senator GRASSLEY. Now, some on the other side will state that only a small percentage of the small businesses will be hit with tax hikes from the top two rate increases. We just heard that.

However, talking about the percentage of small businesses that are hit is misleading because it treats a small business with one employee the same as a small business with 400 employees. What we should be concerned with is the amount of income and the number of jobs in those small businesses that are affected and not what percentage of small businesses are affected.

This hearing will also cover small business tax issues that do not affect small business job creation as much as the tax hikes, but we should keep in mind this 800-pound gorilla in the room as we discuss the other tax issues that affect small business and job creation.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Senator GRASSLEY. Thank you.

Senator BUNNING. For Mr. Williams. Mr. Williams, in your testimony you listed a number of countries to which your company exports, including Taiwan. Why is China not on your list, and is China's practice of devaluing its currency a barrier to exporting your products there?

Mr. WILLIAMS. That is a very good question, Senator Bunning.

Senator BUNNING. I am having trouble hearing your answer.

Mr. WILLIAMS. I think the mic is on now, is it not?

Senator BUNNING. Now. Fine.

Mr. WILLIAMS. All right. I appreciate the question about Chinese currency and if that impacts us in our exports towards China. It is a consideration. Our primary concern in the Chinese market is intellectual property protection. We have already suffered once from a very significant copying of our product by the Chinese, by a Chinese firm, and that was very damaging to our company. So our first concern is intellectual property, a secondary concern would be currency.

Senator BUNNING. Thank you.

Mr. Rys and Mr. Edwards, the Treasury Department has repeatedly said that only 2 to 3 percent of small businesses will be impacted—and Senator Stabenow brought this out also—by raising the two top marginal rates, which the administration plans to do.

Why does this understate the true impact on small businesses, besides the facts that were brought out by my ranking member?

Mr. EDWARDS. Well, one additional interesting fact that I have in my written testimony is that Robert Carroll, a former Treasury Secretary—well, first of all, there are many individual tax returns that have very small bits of small business income on them, so Robert Carroll looked at just the individual tax returns where more than 50 percent of the income came from business, so these are essentially full-time businesses. Of this group of full-time businesses, fully one-quarter of the returns are in those top two brackets.

Senator BUNNING. Twenty-five percent?

Mr. EDWARDS. Twenty-five percent of essentially full-time businesses would be hit by the increase in the top two rates.

One additional point. I would like to sort of respond to a couple of the panelists earlier, on this whole issue of the demand-side stimulus. I mean, the last couple of years we have had the biggest demand-side stimulus in world history. If you look at our annual Federal deficits—

Senator BUNNING. I know about that.

Mr. EDWARDS. It is \$1.5 trillion a year. It seems to me—and Mr. Williams's business is in the global marketplace, big American corporations are in the global marketplace. The demand we are worried about is global demand. China and India continue to grow rapidly, so the question is the supply-side question: how do we get businesses to supply those foreign countries that are growing quickly; how do we get them to locate here in the United States? That is a supply-side question.

Businesses are forward-looking. If you are a small business like Mr. Williams's, or a big business like Intel Corporation, you know that demand is growing around the world, and at the margin Congress can change tax incentives so that either those businesses that supply those world markets are located here, or they are located abroad. So we have to look at the supply side.

Senator BUNNING. Mr. Rys?

Mr. RYS. Well, Senator, part of the challenge here is trying to find which small businesses we are talking about that are going to get hit. But what we can do, as an organization representing 350,000 small business owners, is we can talk directly to them and we can hear what they have to say about these tax rates and the concerns they have. This is not going to show up in any kind of economic model, but small business owners are concerned that their taxes are going to go up.

I can give you an example from Kentucky. We have a small business owner in Kentucky who owns a series of convenience stores. He would fall under this bracket where he would be hit with these tax increases. That money is what he has been using for the last 5 years to redo a number of his stores. This year, he has decided to sit that out.

The problem is, it is not just his stores and his employees that get hurt by that, it is the general contractor that he does not hire, and the subcontractors that that guy does not hire, and the equipment that they do not buy, and so on and so forth down the line. Just as Chairman Baucus said, there is sort of a snowball effect to all this. So it is that confidence that is out there.

What we have seen when these proposals have been offered from State to State is, they just do not work. I mean, the revenue is not

there. So, not only do you create uncertainty for the businesses that would be hit by those taxes, but how much further down do they have to creep to get the kind of revenue you need to deal with budget shortfalls, which sort of locks the small business owner up? They are uncertain as to what their tax rates are going to be. If they do not have customers coming in the door and they do not have cash flow, they are going to hold back, especially on the back end of such tough economic conditions.

Senator BUNNING. A last question. Mr. Sanford, is the administration's position that implementing the pending free trade agreements with Colombia, Panama, and South Korea will create jobs, including small business jobs? If that is the administration's position, why is the administration not taking concrete steps to implement them as soon as possible? If it is not the administration's position, why did the President mention the free trade agreements in his State of the Union?

Mr. SANFORD. Thank you, Senator. Look, FTAs are a value instrument for promoting exports of all our businesses, including small businesses. The President has instructed USTR to resolve the outstanding issues that are relating to the existing FTAs with Panama, Colombia, and South Korea. USTR is working on that now. It is a priority.

Senator BUNNING. We have experienced that. We have experienced it for 3 years prior to this administration taking office. Now we are experiencing it for 1 year since the administration took office. Would you like to clarify what they are doing?

Mr. SANFORD. Well, we continue to work with the three countries to resolve the outstanding issues. It is a priority in the administration's trade agenda. I know that Ambassador Kirk will be up here next week to testify on the trade agenda, and he can address this issue in more detail. But just to stress, yes, we do view the FTAs as a priority. They are a vehicle for promoting exports for all businesses, including small business, and we would like to see the approval and implementation proceed. Thank you.

Senator BUNNING. Thank you.

Senator GRASSLEY. Senator Snowe?

Senator SNOWE. Thank you.

Well, Mr. Sanford, I am delighted to see today here in this expanded capacity in your position because I have been championing it for the better part of a decade. So in any event, I think it is so crucial to enabling small businesses to be in a position to be able to export their goods. The fact is that small businesses, although they create two-thirds of all the new jobs in the country, export less than 1 percent. So, that truly is not acceptable. I think the key is, now, do you have the sufficient support to implement your mission, and exactly how will you be targeting and focusing on ensuring that small businesses do have an expanded export capacity?

Mr. SANFORD. Thank you, Senator. And thank you for your work in encouraging the position to be created, the designation. This is very much a priority within USTR in terms of, how can we provide more attention to SME issues? I think part of my new capacity at USTR is to ensure that, across the agency, we are coordinating all of our SME activities, all our negotiations, to ensure that, whatever the particular venue may be, that we are taking full advantage of

the opportunities that trade agreements or that dialogue may provide to knock down barriers that SMEs may be facing.

It means some new activities at USTR, frankly. We are expanding outreach that we are doing at all levels. Ambassador Kirk is traveling around the country and doing a lot of domestic outreach, and when he does that he is meeting with small businesses around the country. We need to make sure that we understand the barriers SMEs are facing.

The second level is, how do we more effectively reflect those barriers in our trade negotiations and our trade dialogues, and that is another element. If we look at what we are doing on TPP, for instance, we have dedicated a specific individual to work on SME issues across all the negotiating topics in TPP. It does mean that we have some new activities, and we will have to look at how we can allocate our resources to make sure that we are taking full advantage of that.

Senator SNOWE. Do you think you have the resources now?

Mr. SANFORD. I think, if we are taking this initiative seriously, we need additional resources to be devoted to these activities.

Senator SNOWE. Yes. Because I think it would be disappointing if it was just an adjunct in your position, in your capacity, adding small business as an adjunct but not having the means to implement it for small businesses. That is going to be key.

Mr. SANFORD. Yes.

Senator SNOWE. I just noticed in the administration's budget, they devoted, I think, two additional personnel within USTR. So, that is a concern, and I hope that we can work together on that to make sure it is being fully funded in the way that it should, because it is really key to job growth. We have to do everything we can, frankly, and move heaven and earth for job growth and job creation. Exports is a wholly under-utilized dimension and arena that we ought to explore and maximize.

Mr. SANFORD. We would welcome that. We look forward to working with you and other members of the committee to ensure that we are meeting expectations in terms of addressing SME issues, making sure that we have the resources that we need to devote to these issues.

Senator SNOWE. I appreciate that.

Mr. SANFORD. You are welcome.

Senator SNOWE. Mr. Rys, you mentioned a number of issues that are important to small business. I, frankly, have been really spending a lot of time having discussions with both the administration and here within the Senate regarding a truly targeted focus on small business initiatives now, not a month from now, not 2 months from now. We need to get it done now. There are a number of issues that clearly could be crucial to job creation, and at least to create the confidence among small businesses in terms of the direction of Federal policy, particularly with respect to taxes. Frankly, last night we passed an initiative. It is a good first step. It is a baby step, in many ways.

When you talk about expensing, which was my initiative in the stimulus and now has declined to \$134,000, but it is only a 10-month extension. I do not think a 10-month extension creates the kind of predictability that we need to assure small businesses that

that policy is going to stay in place. The same is true for the tax rates and the expiration of the tax rates. We have to provide some certainty, otherwise there is going to be a tremendous vacuum.

That is what I am hearing at home in a number of small business forums, and that is certainly what I have been trying to impart here, that we have to take actions now and have one major small business initiative so that there is an explicit direction in terms of the types of policies that are going to be in place here at the Federal level for an extensive period of time until we can turn this economy around.

Mr. RYS. Senator, I think you are exactly right. It does need to be fast, and it needs to be certain. Small business owners have gone through what in many cases is maybe the worst recession they have seen since they opened their doors, so they are coming out of a very rough economic time, a very rough economic patch, and they are not seeing any improvement. When they see policies on the horizon that are going to increase their costs or are going to increase the costs of maybe the businesses that they are working with, they are going to be less likely to get back into the game. So I think we do need a lot of certainty. We do need certainty so that we know what the tax rates are going to be. And as you said, with section 179, it is about \$130,000 this year; it was \$250,000 last year. Most businesses do not have the capital right now to make those expenditures. This is going to be a long-term recovery.

Senator SNOWE. Exactly.

Mr. RYS. We would go back down to \$25,000 if section 179 expires at the end of this year. I mean, that is a very small amount, especially if we are sort of beginning to move our way out of the recovery. You are going to have more and more businesses that have to replace equipment. They may be on the last legs of their truck or last legs of a piece of equipment in their factory, when they are holding out, to say, look, I do not have any money right now, but we can make do with this today. If they hit January of 2011 and the incentives are not there, they waited for nothing.

Senator SNOWE. Thank you.

Senator GRASSLEY. Senator Menendez?

Senator MENENDEZ. Thank you very much.

Mr. Edwards, unless we act soon, millions of Americans will find themselves no longer receiving Unemployment Insurance benefits to feed their families and pay their mortgages. Do you support the current level of Unemployment Insurance?

Mr. EDWARDS. No. Let me put it this way. I think that for every Federal aid program there are always negatives, and the negatives for Unemployment Insurance are that it ultimately increases burdens for taxpayers, our children, down the road, because it increases the Federal debt. Second, I think any economist would tell you that at the margin, higher Unemployment Insurance increases the unemployment rate slightly, because then people are willing to wait longer to accept a perhaps lower wage or do what they have to do to get a job.

Senator MENENDEZ. Well, let me ask you then, if debt is an issue that we should be concerned about, extending the tax breaks that exist under the Bush tax cuts would cost \$443 billion. How do you reconcile that? How do you reconcile the view that people will just

sit back and collect their unemployment benefits when there are 15 million Americans looking at 3 million jobs? So, if every one of them went out there, that is a 5:1 proposition, so obviously in the hunt for jobs, at least at this point in time, people would be left, despite their best efforts, still being unemployed.

Mr. EDWARDS. Well, I mean, on that issue we all agree that the way to get jobs back is economic growth. The American economy can create millions of jobs every year if it is growing, as we all agree. On the issue of the deficit, I would rank all the Bush tax cuts, sort of, from the highest and most efficient, the most likely to create growth, and then those tax cuts that are least likely to create growth.

For example, the \$500 additional child tax credit, in my view, is a lot less likely to create growth than the top marginal tax rate. So I would not necessarily be in favor of extending all the Bush tax cuts. I am in favor of extending the Bush tax cuts that are the most inefficient taxes in our whole array of taxes, and those are the top marginal rates.

Senator MENENDEZ. Well, I find it interesting, and the reason I want to pursue this with you is—I read your testimony—there are other economists, like Mark Zandi, who suggest that unemployment benefits produce a multiplier effect of \$1.64 in economic demand for every dollar spent. In contrast, extending the Bush tax cuts is, like, 27 cents.

I look at CBO, that all of us depend upon here, to give us analysis. Their analysis issued this month found that extending the tax cuts for high-income households would be the least effective of all spending and tax options the CBO examined for boosting a weak economy and creating jobs.

It talks about, in fact, how extending those tax cuts for the wealthiest people in the country would cost us \$443 billion, which is, of course, added to debt. In their analysis of job proposals—I would like to ask Dr. Toder this—they said the following: the three most cost-effective policy options—this is the CBO—to encourage economic growth and employment in 2010 are, according to the CBO, increasing aid to the unemployed since they spend a larger fraction of their income relative to the rich. It “boosts economic growth,” “drives employment growth.” These are their words, not mine. Two, implementing an employer tax credit, making it cheaper for employers to hire workers and increase employment. Three, reducing the payroll tax an employer pays. What do you think of those?

Mr. TODER. Well, again, I think the operative word here is 2010. If you are talking about the extraordinary circumstances we are in today, where there is 10-percent unemployment, there has been a major financial crash, we are not living in normal times. The most important thing for the economy is to get demand up. I would say, largely, I would agree with them. I have a little bit of skepticism about the Incremental Jobs Credit, whether it is quite as effective as they think, but it certainly is up there relative to other things.

However, if you are talking about what is going to cause economic growth in 5 to 10 years, for the longer haul, we do need to think about what incentives we have in the economy, and then I am sure CBO would give you a very different answer if you asked

them, what would be the most effective way to have long-term economic growth?

Senator MENENDEZ. Right.

Mr. TODER. But you do have to make that distinction.

Senator MENENDEZ. Undoubtedly there would be other opportunities for longer-term economic growth, but the focus of this hearing is, how do we create jobs in the short term? How do we use 2010 as beginning to create that job growth? It just seems to me, that some of the policies I have heard here certainly are not a 2010 focus.

Mr. TODER. That is correct.

Senator MENENDEZ. They are far beyond that. I will just close on this. Mr. Edwards, I found it interesting, in the last page of your testimony you cite a 1999 study noting that 24 percent of Silicon Valley firms were founded by Chinese and Indian immigrants, which is very interesting. You cite the study to underscore your point that you believe that raising individual tax rates could damage the Nation's historical role as a magnet for smart and productive people.

What I find interesting is that the study that you cite was released during a period in which all of America's income tax rates were higher than they are today, so it just seems to me, if tax policy then produced such positive results as you cite, one could argue that moving back to that policy only for the highest of earners would not be debilitating to the long-term prospects of the American economy. So we attracted all of those people even though all of America's tax rates were much higher. So, it is certainly food for thought.

Thank you, Mr. Chairman.

Senator GRASSLEY. Yes. Thank you.

I am going to ask my first question of Mr. Rys and Mr. Edwards. The Joint Committee on Taxation, which is the nonpartisan official scorekeeper, as you have heard me say now for the third time today, provided data that shows that 44 percent of flow-through business income will be hit with tax hikes that will result from the increase in the top two tax rates if Congress does not act to stop that by December 31. Most small businesses are flow-through businesses.

So to you two, Congress should be concerned with the impact that these tax increases have on jobs and not the percentage of small businesses affected. Would that be right? If you want to explain, go ahead.

Mr. EDWARDS. Well, I mean, obviously we have found out over the last few decades that more and more American businesses are being organized not as C corporations, but as S corporations, and LLCs and partnerships. Some of these businesses are very, very large businesses. Now, half of all business income in the United States is in these flow-through businesses and not C corporations, so some of these are very large. That is why your statistics of 44 percent works the way it does. There is a fairly small group, relatively, of very large businesses who file through the individual code, and obviously they are very, very important businesses.

I think the academic literature on the effect of marginal tax rates on these flow-through businesses is pretty clear. There is a whole

series of papers done in the 1990s by Robert Carroll and Doug Holtz-Eakin, co-authors who looked at the effect of marginal tax rates on small business hiring and investment. Their results were pretty unequivocal that, at the margin, if you increase the rates on small business, they hire less and they invest and expand less.

I want to make one more point in response to Senator Menendez's point about academic models. There was a very interesting 2005 study by the Joint Committee on Taxation, JCX-4-05, where they had two macroeconomic models and they looked at three different possible tax rate cuts: a corporate rate cut, individual rate cuts, and then an expansion in the personal exemption that would not affect marginal incentives.

They found that by far the biggest positive effect was with the corporate rate cut, the second-best tax policy would be lowered individual rate cuts, and then the least effective was a policy that does not affect marginal incentives. So, in counter to Senator Menendez, I think that marginal incentives are very important, especially because we live in a global economy, American businesses. We want businesses to invest here, to serve world markets, so we have to look at their cost of business.

Senator GRASSLEY. Do you want to add anything, Mr. Rys?

Mr. RYS. I think he summed it up pretty well. I think when you look at the way the business files its taxes, what they are reporting on that income is basically the profit of the business. It is after the expenses. That money eventually is going to go back in the business. This is not money that they are going to sit on. Right now, when capital is at such a premium, I do not think we should be siphoning a portion of that off from the top, we should let the business owner keep that. I mean, they are the ones who know what they need to keep their businesses operating.

When they see higher taxes down the line—and some of this is, you have demand low, you have sales low right now, but if they know in 2007, for example, they had a good year and they reported enough to put them in the top bracket, maybe they are down a little bit this year, but if things start to pick up they are going to see themselves into those tax brackets again, and they need the capital they have to make their business run. They are also then going to have to pay their tax liability, and that can be a real challenge in the next year or so.

Senator GRASSLEY. All right.

Small business tax relief made up less than one-half of 1 percent of the stimulus bill, \$787 billion big. Considering that small business creates 70 percent of the net new jobs in the economy, it seems kind of a puny amount of money for a bill that was sold by the President as creating millions of jobs in the private sector. The administration stated that 90 percent of the jobs that would be created from the stimulus bill would be private sector jobs, yet when it came to small business tax relief, that stimulus bill basically ignored small business. That is the engine of private sector job creation.

So, Mr. Rys and Mr. Edwards, should the stimulus bill have provided more than one-half of 1 percent for small business? Then let me follow up with some ideas that I propose in my Small Business Tax Relief Act, such as elimination of the capital gains taxes for

certain small businesses, as well as a 20-percent deduction for small business income.

Mr. RYS. Well, at the NFIB we did not support the stimulus bill, the first bill, just for the reasons that you mentioned. I think the tax relief was far too small for small business owners. As you said, it was around 1, 1.5 percent. But for a lot of that relief, it required you to invest some form of capital, capital that businesses just did not have at the time.

I think some broader tax relief that would have hit all small business owners—like I said, we proposed a payroll tax holiday for both the business and the employee. That would have put money immediately back into the business. It certainly would have helped to reduce the job loss in businesses because it would have reduced the cost of labor. We think that would have been the best solution at the front end of 2009.

But I think some of the proposals you are talking about as well, where we reduced the tax rates for a broader group of small business owners, is certainly going to be helpful because it is going to let them keep more of the capital, keep more of the money they have to reinvest back in the business and meet their expenses.

Senator GRASSLEY. Do you want to add, Mr. Edwards?

Mr. EDWARDS. I mean, the U.S. economy has returned to growth now. I think Congress should start shifting its focus more towards looking at long-term tax reform and long-term incentives for business. I think that there is a lot we can do for long-term growth and reform in the tax code that would also help in the short term because, of course, businesses are forward-looking. So, let us make that 179 expensing permanent, let us make the R&D tax credit permanent, let us lower the rate on multinationals, let us keep those top income tax rates, and let us put these permanently into law to give long-term stability so it will help in the short run and the long run.

Senator GRASSLEY. Mr. Sanford, you said this, and I want to ask you a question about your comment that, “USTR is prioritizing the particular barriers confronting our small- and medium-sized exporters when we deal with our trading partners.”

Now, from my point of view, a specific trade barrier may have a disproportionate impact on small- or medium-sized businesses, but I do not see how the barrier itself is particular to small- or medium-sized exporters. We all want to see more U.S. businesses engaged successfully in international trade, but why is it appropriate for the U.S. Trade Representative to be prioritizing its agendas this way, based on the relative impact of trade barriers?

Mr. SANFORD. Well, thank you, Senator. Perhaps the word “prioritize” is not the right word to use there. I agree with your statement that, in terms of the barriers that we are looking at, they are not unique SME barriers. They are typically barriers that disproportionately impact small- and medium-sized businesses. Some examples would be the cost of demonstrating that your product complies with foreign regulations; the testing costs, for instance; the process of exporting, in terms of understanding rules of origin and customs documentation issues. These are types of issues that present bigger challenges for our SMEs. There are issues that the big companies are having to deal with as well.

What I meant by that is that we want to make sure that there are no gaps, that there are no unique SME issues that we are not addressing that we should be. Second, when we are tackling some of these obstacles that impact all of our businesses, that we are conscious of the ones that are disproportionately impacting SMEs and that we are thinking creatively about how we can try to address some of these.

An example is, within APEC, for instance, we are looking at a lot of efforts to try to streamline customs documentation, for instance, make tariff information more accessible and transparent for small businesses. These are things that we are hearing from small businesses that are of concern to them, and they are things that we can address. It does not mean that they are a bigger priority, but it means that we need to be conscious of the fact that many of these issues do disproportionately hit SMEs.

Senator GRASSLEY. I want to look at what you said about the potential for increasing exports for small- and medium-sized businesses, Mr. Sanford. Just because there are a large number of small- and medium-sized businesses that are not currently exporting does not necessarily mean that each has the capacity to export competitively, at least in the short term.

So, this is my question. Two questions. Are you aware of any analysis of what makes a small- or medium-sized U.S. business a competitive exporter, and are there any lessons or best practices that apply regardless of the size of the exporting business?

Mr. SANFORD. I agree. I think this is an issue where it requires a lot of interagency cooperation in the sense that, at USTR, our bread and butter is to knock down barriers and open markets. It is a matter for our other colleagues, and particularly the Commerce Department, in terms of trade promotion activities, SBA and Ex-Im Bank in terms of the finance programs, to make sure that companies are able to take advantage of those opportunities.

I think many small businesses are not ready to be exporters. I think that Mr. Williams touched on some of these issues when he was first trying to export and the challenges that they were facing. I mean, there are programs out there that can help assess whether small companies are ready for export.

I think at USTR we are very conscious that not all small businesses are ready to do that, and that is not really our role in this, but we need to work with our interagency colleagues so that there is more education to SMEs, there is more outreach to SMEs, so they are aware of the opportunities, the market access opportunities that USTR has been able to obtain through its trade negotiations.

Senator GRASSLEY. Mr. Williams, according to your testimony, your company was only about 3 years old when you first pursued export opportunities. In retrospect, was that an appropriate time in your company's development to do that? If you had to do it over, would you have done anything differently?

Mr. WILLIAMS. Thank you, Senator. That is a really good question. The determination to export after really being in business about 3½, 4 years was driven by my personal interest in export. I have a degree in German. I am fluent in German and have lived overseas, and felt that I was comfortable enough to just do business

overseas. It was a grave mistake, and we spent a lot of money learning that that mistake was in fact the reality. What we tried to do was push into the market not knowing enough, not being export-ready. The challenge that we had was, we looked at the cursory data of market size and we felt that we knew enough about market size to then choose the biggest markets.

It was not based on our products and our company's ability to actually export, to know the regulations that would be required, to know the export codes, the harmonized codes for our products, to know the VAT rates in different countries, to know the distribution models. There was so much knowledge that we were lacking, that this is why I recommend that we really focus on the good services that are existing at the U.S. Commercial Services, because they can help a small business create demand for sales and increase their exports to foreign markets.

But first, small businesses have to know what the market has to offer, where the niche is, and how we can grow. Small businesses like mine do not have the resources to hire an export specialist or a sales professional who is well-versed in international trade relating to pet supplies. So we rely, now, very much on the U.S. Commercial Service for a lot of different services that really are impacting our business and driving demand.

Senator GRASSLEY. To what extent does a small company's success in exporting come down to its human capital?

Mr. WILLIAMS. I think that the human capital makes a big difference in a small company, because that is what drives innovation, that is what drives sales. When a small business has very tight constraints on the ability to hire in anticipation of sales, that is a very risky proposition for a business to enter into.

As a small company, it is very difficult to hire a professional who can drive that demand before a business owner is confident the demand exists. So internally, we suffer from having limited capital that we can put towards those kinds of experiences, and therefore we rely on these programs from the U.S. Commercial Service to sort of augment our internal staff's understanding of the markets.

By working with them and asking them to help us into new markets, we look first to the market potential: where are the sales going to be the greatest, where is our product most capable of fitting into the niche in that country, and that is why we push first there, and then, of course, we look at other barriers to export trade.

Senator GRASSLEY. I have asked my last question. I may have some that I will submit for answer in writing. Let me check with Senator Baucus on what he wants me to do. Senator Baucus, if he were here, would thank you very much for your participation on this very important issue. Small business is very, very important. We appreciate your testimony and participation and the hard work you took in preparation for it. Thank you very much.

The hearing is adjourned.

[Whereupon, at 11:25 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hearing Statement of Senator Max Baucus (D-Mont.) Regarding Small Business Job Creation

The Greek physician Galen once said:

“Employment is nature’s physician, and is essential to human happiness.”

Over the course of this Great Recession, more than eight million Americans have lost their employment. And along with their jobs, millions of Americans lost their wellbeing, their health, and their happiness.

Fortunately, the Recovery Act kept us from losing even more jobs. The nonpartisan Congressional Budget Office says that the Recovery Act lowered the unemployment rate by between 0.3 and 0.9 percentage points, from where it would have been.

But in the past two years, the unemployment rate more than doubled. It rose from 4.9 percent in December of 2007 to 10 percent in December of 2009.

Most economists don’t expect significant improvement in unemployment anytime soon. CBO projects that the unemployment rate will not reach its “natural state” of five percent until 2016.

Much work remains to be done. We cannot wait until 2016. We need to act now to help businesses and put people back to work.

So what can we do?

First, we must remember that the private sector is the backbone of American innovation and job creation.

And within the private sector, small businesses are the principle engine of job creation.

Over the past 15 years, small firms have generated two-thirds of new jobs.

Small businesses are the leading source of employment in Montana. In 2008, small businesses employed 325,000 Montanans. That's nearly three-quarters of the Montana workforce.

Small businesses have been hard hit by the Great Recession. The Small Business Administration reports that in 2008 alone, small business lost more than three million jobs.

And we know that small businesses and entrepreneurs will play an important role in the recovery.

Take, for instance, BioScience Laboratories, a small testing laboratory based in Bozeman, Montana. BioScience Labs was hit hard by the recession. But they adapted. And now they are growing rapidly.

In 1991, one person started the company. Today, BioScience Labs employs 51 Montanans.

They hired 10 of them in recent months. And they plan to hire seven more by the end of the year.

We need to find ways to further support the creation and growth of small businesses like BioScience Labs. Their flexibility and innovative solutions will be the key to economic recovery and job creation.

The policies that we consider must provide immediate relief. We must provide help when folks need it most.

We must be fiscally responsible. Creating jobs today should not come at the expense of fiscal stability tomorrow.

And we must create the most jobs at the least cost to the taxpayer. Policies must offer a big bang for the buck.

U.S. export promotion programs fit the bill. Exports have a big effect on the American economy. In 2009, we exported more than \$1.5 trillion of goods and services. America is the world's third-largest exporter.

These exports supported nearly 10 million American jobs. Exports accounted for 11 percent of our gross domestic product.

These numbers are impressive. But they are not nearly good enough.

Ninety-five percent of the world's consumers live outside our borders. To ensure sustainable long-term economic growth here at home, we must do much more to reach abroad.

In his State of the Union address, President Obama called for doubling our exports over the next five years. These additional exports would create nearly two million more American jobs. But these new exports will not happen without our help.

Our export promotion programs provide American small businesses with the tools that they need to reach foreign markets.

A number of agencies help small businesses to navigate the confusing and costly road to exporting. There's the U.S. Trade Representative's enforcement of existing trade agreements and negotiation of new ones. There's the Commerce Department's assistance in identifying foreign customers. And there's the Small Business Administration's financing of small business exports.

We must ensure that these agencies have the resources that they need to boost American exports and to create American jobs.

Our export promotion programs have a proven track record of creating American jobs.

The Commerce Department estimates that for every \$1 million spent on export promotion programs, \$57 million in new U.S. exports are generated and 314 new U.S. jobs are created.

In my home state of Montana, \$206,000 in export promotion programs resulted in \$26 million in exports last year. That means every \$1 invested in export promotion programs resulted in more than \$120 of Montana exports.

These programs work. And we must make sure they work for the maximum number of people.

The tax code also includes policies that offer a good bang for the buck.

Among these are provisions that put money in the hands of small businesses and increase their buying power. Examples are the expensing of certain investments or increased deductions for start-up expenditures.

Helping a small business's cash flow in turn helps other businesses, who will then be able to sell more of their products. And as businesses rebound, they will need to retain and hire more employees.

Another tax provision to consider is the capital gain exclusion on the sale of small business stock held for five or more years. This tax cut gives people an incentive to invest in small corporations who are struggling to find the capital that they need to grow their businesses. Senators Kerry and Snowe have championed this idea.

New jobs are the cure for what ails the economy. Let us do what we can to help “nature’s physician.” Let us help to create more new jobs in America’s small businesses. And let us do more to restore the health and wellbeing of the American economy.

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Taxes and Small Business Job Creation

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute,
before the Senate Committee on Finance

February 23, 2010

Mr. Chairman and members of the committee, thank you for inviting me to testify today on taxes and small business job creation.

Numerous provisions affect the tax climate for small businesses, including payroll taxes, capital gains taxes, and the treatment of capital investment. But I will focus on marginal income tax rates because that's where there seems to be the most disagreement and uncertainty about the future direction of tax policy. The Obama administration has proposed increasing the top two individual income tax rates, but that policy would likely have a negative impact on U.S. economic growth.

The administration has offered some narrow and temporary tax breaks for small business job creation, but that is not a promising approach for tax policy. Instead, Congress should focus on creating a simple, neutral, and pro-growth tax structure for all American businesses, large and small. After all, there is no strict separation of large and small businesses in the tax code. Many businesses that report their profits on individual returns are medium and larger businesses.

New jobs are created by fast-growing businesses, whether small or large. A new job at a multinational computer chip maker is certainly as valuable as a new job at the corner restaurant, and probably more durable. Thus, while my remarks focus on tax policies for smaller businesses, large C corporations are also crucial to U.S. economic growth. Policymakers should consider reforms to reduce statutory tax rates on both corporate and noncorporate businesses.¹

Responses to High Marginal Tax Rates

The Obama administration is proposed to raise the top two individual income tax rates from 33 and 35 percent to 36 and 39.6 percent, respectively, in 2011. That would likely harm investment, job creation, and growth. Higher marginal tax rates reduce incentives for productive activities, such as working and expanding businesses, and they increase incentives for unproductive activities, such as tax avoidance and evasion.

If income tax rates rise next year, we may not perceive large negative effects right away, but changes in marginal tax rates do affect behavior over the long term. Some high-income workers would decide to work fewer hours and retire a bit earlier. Some spouses in two-

earner families would decide to stay out of the workforce. Some angel investors would have less cash to invest in start-up ventures. And some small businesses would decide not to buy new equipment or hire new workers.

How large are the behavioral responses to marginal income tax rate changes? Many empirical studies have found that reported income is quite responsive to the top income tax rates. In a 2009 paper, for example, economists Emmanuel Saez, Joel Slemrod, and Seth Giertz noted that the share of income “received by the top 1 percent of income recipients started to increase precisely after 1981 when marginal tax rates started to decline. The timing of the jump in the share of top incomes from 1986 to 1988 corresponds exactly to the sharp drop in the weighted average marginal tax rates from 45 percent to 29 percent after the Tax Reform Act of 1986. [This] provides circumstantial but quite compelling evidence that high incomes are indeed responsive to marginal tax rates.”²

A typical finding is that a tax rate increase that reduces the after-tax share on additional income by 10 percent results in shrinking reported income by about 4 percent.³ For higher earners, empirical studies usually find substantially larger behavioral responses.⁴ That’s because higher-income taxpayers typically have more flexibility on their working decisions and they have greater shares of financial and business income, which are more responsive and mobile than labor income.

A side-effect of these behavioral responses is that governments raise less money than they expect from tax rate increases, particularly at the top end. If Congress raised the top income tax rate from 35 to 39.6 percent, the government would gain 4.6 percentage points on the money in the top bracket. But reported income would fall modestly, and that fall would offset a substantial portion of the revenue gain. In a recent paper, economist Robert Carroll summarized Treasury estimates that modeled changes in the top two income tax rates.⁵ The results suggest that raising the top two rates would cause reported income of affected taxpayers to fall three percent, which would be enough to offset about 40 percent of the expected static revenue gain.

When considering raising tax rates at the top end, Congress needs to think carefully about who would be hit. Today’s highest-earners are generally not passive inheritors of wealth, but are usually self-made and entrepreneurial.⁶ Business ownership and current earnings are the main sources of wealth for the richest individuals, while inheritances account for less than one-fifth of the assets of the richest people and that share has been declining.⁷ As economist Glenn Hubbard noted, “when you look at data, you see that people who are rich almost entirely are rich because of entrepreneurial risk taking,”⁸

Many with high incomes are angel investors, who help to fuel small business expansion. There are at least 300,000 angel investors in the United States, who are often wealthy individuals and have been entrepreneurs themselves.⁹ They provide an important source of financing for fast-growing small businesses. If their taxes go up, they will have less money and fewer incentives to invest, while perhaps parking more of their funds in tax-free municipal bonds.

In sum, trying to raise revenue by increasing the top income tax rates is a perverse budget strategy. It would hit some of the most talented people in the economy. Since high earners generally have the largest behavioral responses to taxes, the deadweight losses (or costs of inefficiency) of such tax changes would be quite large.¹⁰ And since deadweight losses rise more than proportionally as marginal tax rates rise, raising the top rates would be very counterproductive.¹¹

Top Tax Rates and Small Businesses

The income tax system has a wide-ranging impact on businesses. It affects decisions on building factories, purchasing capital equipment, and hiring workers. Rather than trying to micromanage these decisions through the tax code, we should design a system with low statutory rates and neutral treatment to allow businesses to allocate resources efficiently.

More than half of all business income in the United States is reported on individual returns, not corporate returns.¹² This income is reported by proprietorships, partnerships, LLCs, and S corporations. If the top two individual income tax rates are increased, it would hit a substantial amount of this business income.

It is true that only a small share of the total number of tax returns with business income would be hit by raising the top two tax rates. That's because many tax returns have small amounts of business income and many self-employed persons have modest incomes.

Breaking down the data, Robert Carroll looked at just those individual tax filers who derived more than 50 percent of their income from a business.¹³ Carroll found that one-quarter of these taxpayers—who number about 600,000—were in the top two tax rate brackets, and thus would be hit by the proposed tax increases.

A Joint Committee on Taxation analysis looked at the share of business income on individual returns that is in the top two tax rate brackets.¹⁴ The JCT found that about 25 million individual tax returns will report about \$1 trillion of net positive business income in 2011. Of that total, \$437 billion, or 44 percent, will be taxed in the top two income tax brackets and thus will face the proposed tax increase.

Finally, a microsimulation analysis by analysts at the Tax Foundation looked at the share of the proposed tax increase that would fall on business income versus other sorts of income.¹⁵ They found that the tax rate increase would raise about \$90 billion in 2011, measured on a static basis. Of that total, about \$36 billion, or 40 percent, would be from tax increases on business income.

In sum, various estimates show that while only a small share of tax returns will be hit by raising the top income tax rates, those that will be hit represent a large share of all business income on individual returns. Further, business income represents a large share of all the income that will be hit by the proposed tax rate increases.

How will higher tax rates affect entrepreneurship and small business growth? Economists Glenn Hubbard and William Gentry looked at how tax rates affect the initial risky decision to become an entrepreneur, and they found “large” effects.¹⁶ Higher marginal tax rates discourage entry into self-employment and business ownership. They found, for example, that the 1993 increase in the top tax rate to 39.6 percent “reduced the probability of entry into self-employment for upper middle income households by as much as 20 percent.” Hubbard concluded that today’s income tax code gives the message, “if you take a risk and you’re successful, we tax you at a high rate; if you take a risk and you fail, we don’t share that loss with you.”¹⁷

A study by Donald Bruce and Tami Gurley for the Small Business Administration similarly found that marginal tax rates affect levels of entrepreneurship.¹⁸ Using a detailed empirical model, the authors found that “A reduction in the marginal tax rate on entrepreneurial income of one percentage point would increase the probability of entry into entrepreneurial activity by 1.42 percentage points for single filers and 2.0 percentage points for married filers.”¹⁹

Once a small business is up and running, empirical tax research by economists Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen found that higher individual income tax rates negatively affect hiring, investment, and expansion. One of their studies found that changing the “tax price” (one minus the marginal tax rate) faced by small businesses by 10 percent changed the likelihood of hiring workers by about 12 percent.²⁰ Thus, raising the top income tax rate from 35 to 39.6 percent would reduce the likelihood of hiring by affected businesses by more than 8 percent.

Another one of their studies found that changing the tax price faced by small businesses by 10 percent caused business revenues to change by about 8 percent.²¹ That is, raising marginal income tax rates reduces business growth. Finally, one of their studies found that a 5 percentage point increase in marginal tax rates would cause a 10-percent reduction in small business capital expenditures.²²

The authors noted that tax rate changes affect businesses by altering the return to marginal investments and changing the cash flow available to fuel expansion.²³ In other words, higher tax rates reduce both the incentive and the funding for activities such as investment and hiring.

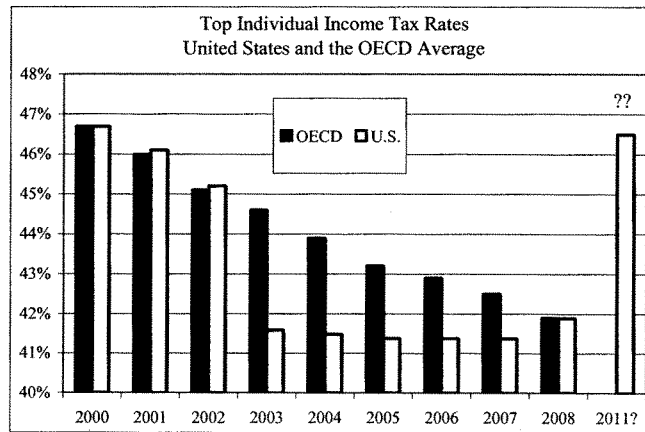
International Perspective

The bipartisan Tax Reform Act of 1986 reduced individual income tax rates to a simple structure of 15 and 28 percent. But then tax rates were increased during the 1990s, which the rate cuts of recent years have only partly reversed. President Obama’s proposed top individual rate of 39.6 percent is 41-percent higher than the 28-percent rate achieved in the late 1980s. (The top effective top rate next year will be even higher if Congress reinstates a phase-out of personal exemptions and a limitation on itemized deductions).

Some people think that raising the top income tax rate to 40 percent is no big deal because the top rate was even higher during the mid-20th century. But the world economy has dramatically changed since then. In recent decades, nations have floated their exchange rates and opened their borders to capital flows, with the result that cross-border investment has exploded. There is also rising international mobility of highly skilled workers in industries such as technology and finance. Thus, in addition to the domestic reasons to reduce marginal tax rates, the competitive pressures of globalization have convinced most nations to cut their top income tax rates.

The average top personal income tax rate in the 30 nations of the Organization for Economic Cooperation and Development fell from 68 percent in 1980 to 42 percent in 2008.²⁴ Federal tax rate cuts in 1981 and 1986 established the United States as a tax reform leader, but many other countries had caught up to us with their own rate cuts by 2000.

The chart shows that the top U.S. income tax rate was the same as the average top rate in the OECD in 2000 at just under 47 percent.²⁵ This data includes both federal and state-level taxes. Tax rate cuts reduced the U.S. rate to 42 percent by 2008, but other countries have been cutting as well, such that the OECD average rate also fell to about 42 percent.



Source: OECD Tax Database, Table 1.7. Includes subnational taxes.

If the top federal rate is increased by about 5 percentage points next year, the top U.S. rate with state taxes would be more than 46 percent. The United States would jump into the ranks of nations with high individual income tax rates, and we've already got the second-highest corporate tax rate in the OECD.²⁶ Our nation—which has been a bastion of market capitalism and individual achievement—has a tax code that is becoming more unfriendly to businesses and high-earners than the tax codes of many other nations.

Consider just one possible effect of increased individual tax rates—damaging the nation’s historical role as a magnet for smart and productive people. High-skill immigrants have flocked to places like Silicon Valley because they could start businesses in a more free-market environment than other locations around the world. One 1999 study found that 24 percent of Silicon Valley firms were founded by Chinese and Indian immigrants.²⁷ Similarly, a 2007 study found that one-quarter of U.S. technology companies launched in the past decade had an immigrant founder.²⁸

Taxes are only one factor that influences where highly skilled entrepreneurs decide to start businesses. But as other nations have improved their economic policies, America may lose one of its long-standing advantages in attracting the elite of the world’s knowledge workers.

Conclusions

The Obama administration has proposed a number of narrow tax breaks for business hiring and investment, including a capital gains provision for small-business stock and a \$5,000 tax credit for small business hiring. Those provisions would complicate the tax code and would be far inferior to broad-based tax rate reduction.

Rather than raising income tax rates next year, policymakers should consider ways to reduce them. The Tax Reform Act of 1986 eliminated deductions and credits while cutting statutory rates in a revenue-neutral fashion. Today, we have a number of large tax breaks—such as the mortgage interest deduction and the state and local tax deduction—that are tilted toward high-earners, and which we could repeal and use the revenues to cut the top tax rates. Such reforms would enhance economic growth because there is a large amount of business activity in those top rate brackets, as noted.

Even better, Congress should consider a simplified two-rate individual tax structure of 10 and 25 percent. Such a structure has been proposed by Rep. Paul Ryan (R-WI) and also discussed in the recent National Academy of Sciences study, *Choosing the Nation’s Fiscal Future*.²⁹ The NAS plan has individual tax rates of 10 and 25 percent combined with a 25-percent corporate tax in a revenue-neutral package. These lower rates would improve marginal incentives for American businesses of all sizes and in all industries.

Thank you for holding these important hearings. I look forward to working with the committee on these issues.

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¹ For more on tax reform, see Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).

² Emmanuel Saez, Joel Slemrod, and Seth Giertz, "The Elasticity of Taxable Income With Respect to Marginal Tax Rates: A Critical Review," May 20, 2009.

³ Jon Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research Working Paper 7512, January 2000. See also Robert Carroll, "The Economic Cost of High Tax Rates," Tax Foundation, July 2009.

⁴ Jon Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research Working Paper 7512, January 2000.

⁵ Robert Carroll, "The 2001 and 2003 Tax Relief: The Benefit of Lower Tax Rates," Tax Foundation, August 2008.

⁶ See, for example, the *Forbes* list of the wealthiest Americans. Matthew Miller and Duncan Greenberg, "The Richest People in America," *Forbes*, September 30, 2009.

⁷ Merrill Lynch and Cag Gemini, "World Wealth Report," June 2006, p. 19.

⁸ Interview with R. Glenn Hubbard, Columbia Business School, June 15, 2005. Available at www4.gsb.columbia.edu/ideasatwork.

⁹ Scott Shane, "The Importance of Angel Investing in Financing the Growth of Entrepreneurial Ventures," Small Business Administration, September 2008.

¹⁰ For a discussion of tax rates and deadweight losses, see Martin Feldstein, "The Effect of Taxes on Efficiency and Growth," *Tax Notes*, May 8, 2006.

¹¹ As a marginal tax rate rises, the deadweight loss rises by the square of the increased tax wedge between pre- and post-tax income.

¹² Peter Merrill, "The Corporate Tax Conundrum," *Tax Notes*, October 8, 2007.

¹³ Robert Carroll, "The Economic Cost of High Tax Rates," Tax Foundation, July 2009. I am referring to income from flow-through businesses, not income from C corporations.

¹⁴ Joint Committee on Taxation, Memorandum to Mark Prater from Edward Kleinbard, April 8, 2009.

¹⁵ Email from Gerald Prante, Tax Foundation, February 18, 2010.

¹⁶ William M. Gentry and R. Glenn Hubbard, "Success Taxes, Entrepreneurial Entry, and Innovation, National Bureau of Economic Research, Working Paper 10551, June 2004, p. 2.

¹⁷ Interview with R. Glenn Hubbard, Columbia Business School, June 15, 2005. Available at www4.gsb.columbia.edu/ideasatwork.

¹⁸ Donald Bruce and Tami Gurley, "Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data," Small Business Administration, March 2005.

¹⁹ Donald Bruce and Tami Gurley, "Taxes and Entrepreneurial Activity: An Empirical Investigation Using Longitudinal Tax Return Data," Small Business Administration, March 2005.

²⁰ Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," NBER Working Paper 6578, May 1998.

²¹ Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," NBER Working Paper 7980, October 2000.

²² Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," NBER Working Paper 6374, January 1998.

²³ Cash flow is important because external finance may not always be available to entrepreneurs, or may be more costly than internal funds.

²⁴ Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).

²⁵ See www.oecd.org/ctp/taxdatabase.

²⁶ KPMG, "Corporate and Indirect Tax Rate Survey," 2009.

²⁷ Anna Lee Saxenian, "Silicon Valley's Skilled Immigrants: Generating Jobs and Wealth for California," Research Brief, Public Policy Institute of California, June 1999.

²⁸ Vivek Wadhwa, et al., "America's New Immigrant Entrepreneurs," Master of Engineering Management Program, Duke University, January 4, 2007.

²⁹ National Academy of Sciences, *Choosing the Nation's Fiscal Future* (Washington: National Academies Press, 2010), www.ourfiscalfuture.org. See also Chris Edwards, "National Academy Fiscal Future Report," Cato Institute, January 2010.

**Senate Finance Committee Hearing
Tax and Trade Issues Relating to Small Business
February 23, 2010
Responses to Questions for Chris Edwards, Director, Tax Policy Studies, Cato Institute**

Questions from Senator Baucus

1. Yesterday the Senate passed the Hiring Incentives to Restore Employment (HIRE) Act. One provision included in that legislation would keep the Section 179 expensing limits at the same levels as 2008 and 2009. In addition to the higher thresholds, we have also heard a number of businesses asking that we expand the types of property that may be expensed to include buildings and structural components, air conditioning and heating units, and leased property.

- How would expanding the types of property that may be expensed under Section 179 help businesses create jobs?

Capital and labor are complementary inputs to production. Tax changes that increase the after-tax return on investment will cause some companies to increase investment. If they buy new machines, they will need to hire workers to run them. We should think about the "jobs" question like this: The incentive to invest and earn profits comes first and the hiring of workers comes second.

- How would you rank these additional types of property in order of effectiveness in helping to expand jobs?

I think the tax code should be neutral with respect to investment in different types of structures and equipment.

2. Senators Kerry and Snow have previously introduced a proposal to increase the capital gains exclusion for certain small business stock to 100%. The President included this proposal in his fiscal year 2010 budget as a part of the Jobs Package. What are your thoughts on this proposal? Will this proposal increase investment in small business?

As I understand it, the new incentive would only be for investment in C corporations. I'm not in favor of such narrow tax preferences. Why not just reduce the overall CG rate to 10%?

There are already too many different tax rules for businesses organized under different rules. We should try to equalize the tax treatment of C corps, S corps, LLCs, and proprietorships, rather than creating new business tax differences.

3. I also have a few questions about what incentivizes people to start new small businesses.

- What tax provisions might motivate people with good ideas to start businesses?

Lower marginal tax rates. If a husband or wife, for example, is considering starting a business, and their spouse has a full-time job, the added earnings of course would come at the couple's top

marginal rate plus any FICA taxes. See the work of Glenn Hubbard cited in my written testimony.

Also, I think non-tax factors are very important. New entrepreneurs in D.C., for example, always complain about the massive headache the city's regulatory and paperwork requirements are for business start-ups. Perhaps Congress or the SBA could shine a light on that problem. Inefficient and bureaucratic local governments don't help anyone, and they just kill new businesses.

- Would increasing business start-up deductions encourage people to start businesses?

As I understand the rules, Congress requires amortization over five years of costs associated with starting a new business. The theory is that start-up costs create value in future time periods and thus should not be immediately deducted. On the other hand, Congress has decided that research and development (R&D) expenses may be immediately deducted, even though R&D clearly generates benefits over future years.

Business start-up costs should be immediately expensed.

- Would creating tax-free savings accounts to allow people to save to start businesses encourage people to start businesses?

I don't think Congress should set up new special-purpose savings accounts. Instead, it should move toward the Lifetime Savings Account idea for all types of savings and withdrawals.

- How quickly do new businesses begin to hire employees once they begin?

It obviously varies. So-called "gazelle" businesses are a lot different than the new restaurant on the corner in terms of job-creation potential.

Questions from Senator Grassley

1. The House and Senate-passed health care reform bills would raise taxes by one-half trillion dollars. My friends on the other side of the aisle seem to applaud this fact when they say that their bills would reduce the deficit. Raising taxes for deficit reduction is not the answer, in good economic times or bad.
 - The House and Senate-passed health care reform bills include a long list of tax increases that would not only affect the middle class, but will fall heavily on small business. They range from the House "surtax" to the excise tax on an employer that does not offer government approved health insurance. Small business owners will also see a Self-Employment Contributions Act tax hike as a result of the additional Medicare payroll tax rate. Will these taxes kill jobs and stifle the growth of small business?

The craziest tax being considered in the health care bill is the special excise tax on medical device and equipment manufacturers. Advanced medical devices save lives. Higher taxes means fewer purchases of medical devices by hospitals and doctors. You do the math.

- My friends on the other side of the aisle claim that the small business tax credit included in the House- and Senate-passed bills is an effective way of helping small business pay for health insurance. Actually, some of my colleagues' support for the bills was based solely on this tax credit being included. Speaking specifically to the design of this tax credit in the House- and Senate-passed bills, will the tax credit be effective?


Creating a special tax credits for new jobs and other items is very bad tax policy. Everyone knows the tax code way too complex already. We should aim at overall reforms to reduce marginal tax rates.

SUBMITTED BY SENATOR GRASSLEY

Congress of the United States
 JOINT COMMITTEE ON TAXATION
 Washington, DC 20515-6453

APR 08 2009

MEMORANDUM

TO: Mark Prater 

FROM: Edward Kleinbard

SUBJECT: Revenue Estimate

This memorandum is in response to your request of April 7, 2009, for an estimate of the number of taxpayers with business income who would be taxed at a marginal income tax rate of 36 percent or 39.6 percent in calendar year 2011 under the proposals contained in the President's Fiscal Year 2010 Budget, as presented in the budget overview released on February 26, 2009.

We project that approximately 25.2 million taxpayers will report net positive business income on their 2011 individual income tax return. For purposes of this analysis, business income consists of income from sole proprietorships (Schedule C); farm income (Schedule F); and income from rental real estate, royalties, partnerships, subchapter S corporations, estates and trusts, and real estate mortgage investment conduits (Schedule E), as would be reported on lines 12, 17, and 18 of the 2008 Form 1040. We do not count as "business income" income from interest, dividends, or capital gains that may flow through certain pass-through entities but which is reported elsewhere on an individual's return.

If the proposals contained in the President's Fiscal Year 2010 Budget were enacted, we estimate that just over 750,000 taxpayers with net positive business income would be taxed at a marginal income tax rate of 36 percent or 39.6 percent in 2011. (Taxpayers whose marginal tax rate for the regular income tax is 36 percent or 39.6 percent, but who we project will pay the individual alternative minimum tax, are not included.) This represents approximately three percent of all taxpayers reporting net positive business income on their individual income tax returns in 2011.

We project net positive business income reported on individual income tax returns will be just over \$1 trillion in 2011. We further project that the total net positive business income for taxpayers who have some income taxed at a marginal income tax rate of 36 percent or 39.6 percent under the President's budget proposals would be \$470 billion. (Of course, not all of the \$470 billion in net positive business income for these taxpayers would be taxed at the 36 percent or 39.6 percent rate, by virtue of the tax system's marginal rate structure.) Finally, we estimate that approximately \$88 billion would be taxed at the 36 percent rate, and \$349 billion would be taxed at the 39.6 percent rate.



**Testimony by Mr. Bill Rys
Tax Counsel, National Federation of Independent Business**

**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.

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

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.

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

⁷ Testimony of James D. "Mike" McKeivitt, 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.

**Senate Finance Committee Hearing
Tax and Trade Issues Relating to Small Business
February 23, 2010
Responses to Questions for Bill Rys, Tax Counsel, National Federation of
Independent Business**

Questions from Senator Baucus

1. Mr. Rys, I understand that you are a tax lawyer and not a trade specialist. But from a business finance perspective, I'd like to get your views on the constraints facing small business as they seek to export. A recent ITC report looked at this issue and found that small businesses seeking to export can be limited by inadequate financing, market research, and risk management. Do your small business members face some of these constraints?

A number of challenges impede small businesses looking to export. The NFIB Research Foundation surveyed small business owners (focusing on small manufacturers) on the issue of trade. Thirteen (13) percent of small-business owners report that they have had foreign sales in the past three years. This figure jumps to 39 percent when the sample is comprised solely of manufacturers. The most frequent problem limiting small manufacturers from increasing foreign sales is difficulty locating sales prospects. Respondents also worry that they cannot find a reliable foreign representative to help.

If you are interested in more detailed information, you can view the entire survey at <http://www.411sbfacts.com/>.

2. I read on NFIB's website that it supports a higher Section 179 expensing limit. In fact, NFIB writes that it will continue to push for a permanent increase to "this important small business incentive." Yesterday the Senate passed the Hiring Incentives to Restore Employment (HIRE) Act. One provision included in that legislation would keep the Section 179 expensing limits at the same levels as 2008 and 2009. In addition to the higher thresholds, we have also heard a number of businesses asking that we expand the types of property that may be expensed to include buildings and structural components, air conditioning and heating units, and leased property.
 - How would expanding the types of property that may be expensed under Section 179 help businesses create jobs?

Expanding the types of property that are eligible for expensing expands the number of businesses that may be incentivized to make new investments in their business as a result of the deduction. Increasing the number of businesses that may take advantage of expensing, increases the overall amount

of economic activity generated by expensing. In addition, since the higher expensing limits have been in place for the past few years, many businesses may have already made new investments in equipment. At this time, they may not need to replace that equipment and this is especially true when small businesses are struggling to keep their business open. If they don't have to replace equipment right now, they won't take on that expense, which is evident in the NFIB's Small Business Economic Trends Survey (SBET) as capital expenditures are near a 35-year low in the survey.

It is difficult to quantify what an expansion might mean, but looking at the IRS Statistics of Income (SOI) data of sole proprietors following the increase in section 179 showed the largest single-year increase in depreciation deductions claimed since the passage of the Tax Reform Act of 1986. Amending the law to increase the eligible uses for section 179 could have a similar effect.

Ensuring that expensing is in place for future years is especially important, as the economic recovery will take some time. And with the expensing limit set to fall back to \$25,000 at the end of this year, acting now will ensure that this tax relief is in place for small businesses as they begin to see a pick-up in economic activity.

- How would you rank these additional types of property in order of effectiveness in helping to expand jobs?

Section 179 currently applies mostly to equipment. Including any structural changes to section 179 would be most beneficial for a number of reasons. Structural changes tend to have a longer depreciation period, so shortening the period provides an incentive to make changes now and many businesses may have held off making such changes knowing that they still technically had useful life in their current property.

Further, the down-stream impact of structural changes would support the struggling construction industry. Since a business owner will have to hire a local contractor to do the work associated with the structural change, many small construction businesses would benefit from this additional work.

3. Senators Kerry and Snow have previously introduced a proposal to increase the capital gains exclusion for certain small business stock to 100%. The President included this proposal in his fiscal year 2010 budget as a part of the Jobs Package. What are your thoughts on this proposal? Will this proposal increase investment in small business?

Senator Kerry and Snow's proposal to eliminate 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.¹ A “qualified small business” is defined as a business organized as a C Corp and having less than \$50 million in gross assets.² Only 25 percent of small businesses are organized as C corps, so the proposal immediately excludes 75 percent of small businesses.

4. I also have a few questions about what incentivizes people to start new small businesses.
 - What tax provisions might motivate people with good ideas to start businesses?

One challenge of incentivizing a business creation through the tax code is that having the money “up front” is most important. Whether starting or expanding a business, the sooner the business owner has access to the capital needed to make business investments, the better. Timing of tax relief is very important.

Realizing that not all tax relief is perfect, there are things Congress can consider to incentivize business creation. One key change would be to simplify the current home office deduction. The number of businesses operating from the home continues to increase. With more individuals looking to replace lost income in the current recession, they may be looking to start a business and much of this activity is likely to be done from the home.

Simplifying the current deduction would help a growing number of small business owners and especially those looking to start a business now. The current deduction is unnecessarily complex. In fact, the one-page form to claim the deduction directs the taxpayer to the instructions 14 times. In addition, the deduction is often considered a “red flag” for an audit. In fact, according to an NFIB Small Business Survey, only 27% of businesses located in the home and 36% of businesses with a primary office in the home claimed the deduction.

Legislation, such as Senator Snowe’s bill S. 1349, would provide many new businesses with a simpler tax return and an important deduction at the end of the year.

- Would increasing business start-up deductions encourage people to start businesses?

Increasing the start-up deduction could help to encourage business creation. Writing-off the costs associated with starting a business earlier in the life on the business will put money back into the firm when the business needs the money most.

¹ 26 U.S.C. 1202(a).

² 26 U.S.C. 1202(d).

- Would creating tax-free savings accounts to allow people to save to start businesses encourage people to start businesses?

Allowing individuals to save tax-free to start-up a business is a well-intentioned proposal, but it is unclear how effective this would be especially as a short-term incentive to start a business. The complexity involved with starting the account and how such an account might be offered by financial institutions could limit its effectiveness. In terms of a short-term incentive, clearly saving money is contrary to a short-term program.

A more effective way to support start-up businesses could be to look at the rules associated with current savings vehicles and allow some flexibility to withdraw money penalty-free for business expenses. This could be a way to support existing firms as well. For example, a proposal such as H.R. 3079, allows qualified small business loans from a Simple Employee Pension plan.

- How quickly do new businesses begin to hire employees once they begin?

This is a straight-forward question that is much more complex than it would seem. Imprecisely, we can say that most businesses achieve most of their growth in the first five years of existence. But there are obvious and important exceptions. The problem in being more precise revolves around the question, when does a business begin? People spend greatly varying amounts of time developing their firms and the steps to entry are not sequential. The result is pinpointing "start". For example, the first positive cash flow may be years apart from when the individual thinks he/she has entered. Both may differ from a first tax return which may differ from entry into the Dun & Bradstreet files. In addition, there is the part-time business that morphs into a full-time business and a solo operation that transitions into one that employs other than the owners. More on these questions appear in the Panel Study of Entrepreneurial Dynamics, which can be found at www.psed.isr.umich.edu/psed/home.

Questions from Senator Grassley

1. The House and Senate-passed health care reform bills would raise taxes by one-half trillion dollars. My friends on the other side of the aisle seem to applaud this fact when they say that their bills would reduce the deficit. Raising taxes for deficit reduction is not the answer, in good economic times or bad.
 - The House and Senate-passed health care reform bills include a long list of tax increases that would not only affect the middle class, but will fall heavily on small business. They range from the House "surtax" to the excise tax on an employer that does not offer government approved health insurance. Small business owners will also see a Self-Employment Contributions Act tax hike

as a result of the additional Medicare payroll tax rate. Will these taxes kill jobs and stifle the growth of small business?

Any tax increases on small business – and both the House and Senate passed bills include many – in the current economic climate would create a disincentive to hire. Simply put, if the government takes capital out of a small business with higher taxes, this is less capital the business has to spend on day-to-day expenses, new investments, and new employees. At a time when capital is at a premium, this is an especially bad idea.

In addition, the uncertainty of what taxes might be raised, when the might be raised, and by how much are creating additional uncertainty for small businesses. When small businesses lack confidence in the future economic climate, uncertainty about the policies that will directly impact their business means they are more likely to curtail business investments.

- My friends on the other side of the aisle claim that the small business tax credit included in the House- and Senate-passed bills is an effective way of helping small business pay for health insurance. Actually, some of my colleagues' support for the bills was based solely on this tax credit being included. Speaking specifically to the design of this tax credit in the House- and Senate-passed bills, will the tax credit be effective?

While we have supported a small business health care tax credit, we recognize that it is not the answer to all of the small business concerns with providing health insurance. Reducing the cost of health insurance is the number one small business priority and, while a tax credit replaces cost by covering the costs small business pays to purchase insurance, it does not reduce the actual cost of health insurance.

How the tax credit is structured plays a major role in whether it will be effective. Both the House and Senate tax credits phased out based on number of employees and the average wages paid to the employees. The credit included in the final Senate passed bill was improved from the original draft by increasing the average wage still eligible for the full value of the credit. But many small businesses still will not receive the credit. Ironically, the businesses likely to lose the credit are the businesses that increase wages or add workers – something else that the Congress is encouraging small business owners to do.

The credit will help some small businesses by covering some of the cost of health insurance. But the credit is unlikely to be a major incentive for a firm to begin to offer insurance and is only a temporary patch to the problem of rising costs. A tax credit for small business is not the answer to all of the concerns of small business owners and does not directly effect their number one concern – reducing costs.

**Testimony of James Sanford
Assistant U.S. Trade Representative
for Small Business, Market Access and Industrial Competitiveness**

**Before the Senate Finance Committee
Hearing on “Trade and Tax Issues Relating to Small Business Job Creation”
Room 215, Dirksen Senate Office Building
10am Tuesday, February 23, 2010**

Chairman Baucus, Ranking Member Grassley, members of the committee, thank you for convening this hearing today. I appreciate the opportunity to provide testimony on the efforts of the Office of the U.S. Trade Representative to expand exports of U.S. small and medium-sized businesses, create well paying U.S. jobs, and promote sustainable economic growth.

As the President announced in his State of the Union address, agencies across the federal government are teaming up under the National Export Initiative to create jobs by expanding exports. USTR’s role in the National Export Initiative is reflective of our role as an agency – to tear down barriers to trade and open up new opportunities for American businesses to grow and create jobs through exports. In our efforts, USTR is partnering with the Small Business Administration (SBA), the Commerce Department, the Export-Import Bank, and others across the federal government to provide American businesses the resources and the opportunities they need to succeed.

America’s 30 million small businesses form the backbone of our economy. Over the last 15 years, approximately 65 percent of net new private sector jobs were created at small businesses. And small businesses that export tend to grow even faster, create more jobs, and pay higher wages than small businesses that do not.

But studies show that only one percent of U.S. small and medium-sized enterprises (SMEs) are currently exporting. And even though small and medium-sized businesses account for 97

percent of American exporting companies, their exports account for only 30 percent of the total U.S. goods exported. Most small and medium-sized exporters sell their goods to only one foreign country and to only one customer in that country. So there is vast room for growth that we need to tap.

USTR is doing its part to tap that growth. For the past year, Ambassador Kirk has been reaching out to workers and small business owners across the country. From Kalispell to Atlanta to Des Moines, workers and small business owners have repeated the same message. Small businesses must export and compete globally to ensure long-term growth and success. Ambassador Kirk heard that message loud and clear, which is why he is committed to the goal of creating more jobs at home by helping more small businesses to sell American goods and services around the world. And USTR is taking concrete steps to make that happen.

Last fall, USTR launched an initiative re-examining our trade policy and enforcement efforts to ensure that we are being responsive to the challenges and priorities of small and medium-sized businesses and their workers. And as part of this initiative, last month Ambassador Kirk designated me as the Assistant U.S. Trade Representative to help coordinate small business interests within the agency. The success of small and medium-sized businesses is a priority for everyone at USTR – but the designation of an office to coordinate initiatives among all our offices and serve as a focal point for small business will aid our efforts. Working with Congress and other agencies across the government, our objective is to both increase the number of small and medium-sized businesses that export and to expand the number of markets and customers served by the SMEs that do export.

Snapshot of the Role of SMEs in U.S. Exports

The U.S. economy is increasingly integrated with the global economy. In 2008, U.S. exports accounted for 13 percent of the U.S. GDP – up from 9.3 percent in 2003.

SMEs accounted for 30 percent of U.S. merchandise exports between 1997 and 2007 – and SME merchandise exports doubled in value from \$153 billion to \$307 billion during this period. Much of the growth in SME manufactured goods exports was attributable to SMEs that were new to exporting. The leading merchandise export markets for SMEs are Canada and Mexico – and the principal products exported are computers and electronics products, machinery, and chemicals.

The potential for SMEs to increase services exports is also significant. Overall U.S. services exports nearly doubled in the ten years between 1999 and 2008 and now constitute 30 percent of total U.S. exports. However, the SME share of these exports is unknown because of a current lack of available SME services-sector trade data. We face a similar information gap with respect to the role of indirect exports in sustaining and strengthening our SMEs.

We know small businesses can be successful exporters. Businesses all across the country – from a small manufacturing company that sells Montana-made mining equipment on every continent except Antarctica to an Iowa-based nutritional products company with customers in more than 40 countries – are succeeding in the international marketplace. But to ensure more small business export successes, we need to know more. At Ambassador Kirk's request this past October, the International Trade Commission is now identifying how such data gaps might be overcome to further enhance our understanding of SME exports.

Identifying the Challenges Facing SME Exporters

In order to better understand the key challenges that are constraining U.S. SMEs from fulfilling their export potential, we have reached out widely to trade associations and individual companies, from the National Association of Manufacturers, to the National Small Business Association, to individual SMEs such as Traffax, a Maryland-based transportation monitoring equipment exporter. And we are consulting economists inside and outside the government, and our interagency partners, in an effort to identify the key barriers.

When compared to larger companies, SME exporters generally face particular challenges that may limit their ability to take full advantage of export opportunities. SMEs often have limited in-house resources available for understanding foreign markets and how to comply with specific foreign regulatory or documentation requirements. Access to financing to support exports can be another important constraint for SMEs. For such firms, exporting is often viewed as a venture associated with greater risks and higher transaction costs than domestic sales.

For example, firms frequently must subject their products to testing to demonstrate compliance with foreign regulatory requirements. For large firms, this fixed expense is absorbed across a large number of sales. But SMEs often face higher relative costs to comply with foreign product regulations because of smaller or infrequent sales. Situations such as these can deter SMEs from taking full advantage of overseas opportunities.

Through our recently expanded small business initiative, USTR is fighting many of these barriers to SME exports. We are reaching out actively to a broad range of business representatives and soliciting input on SME trade challenges and opportunities. We continue to gather insights and suggestions from U.S. business. And we are working with our trading partners to reduce costly trade obstacles such as unnecessarily complex and/or costly foreign standards and regulations, a lack of transparency in some markets, and burdensome customs procedures. These issues all raise the costs of exporting for SMEs, in particular.

I would like to outline more fully some of the concrete steps we are undertaking at USTR to better understand the challenges facing SMEs and how we can better address them in our trade policy activities:

- USTR agency-wide review of SME-related activities: Starting in October 2009, USTR launched an agency-wide review of our policymaking and enforcement efforts in relation to SMEs. USTR is prioritizing the particular barriers confronting our small and medium-sized exporters when we deal with our trading partners. Through our trade agreements and policy dialogues, we are examining ways to tackle obstacles to trade that loom

particularly large for small and medium-sized businesses – issues like cumbersome regulatory processes, complex rules of origin for goods, and requirements that force companies to open offices in foreign countries.

- Request for ITC Studies on SMEs: Last October, Ambassador Kirk requested the U.S. International Trade Commission to prepare a series of three reports on U.S. SMEs in international trade in order to better understand SME performance and to help guide U.S. trade policy and trade promotion activities. In January, we received the first ITC report on the role of small and medium-sized businesses in U.S. trade. Our agency-wide small business working group is combing through those results for insights into how trade policy can help small and medium-sized exporters reach their export potential. The second report, to be issued in June, will provide a comparison of U.S. SME performance with SMEs in the European Union. And the final report, to be delivered in October 2010, will examine SME services trade, key tariff and non-tariff barriers that may disproportionately affect SMEs, and the role of indirect exports (*i.e.*, SMEs that provide inputs to larger firms that export the final product).
- USTR-hosted SME Conference: On January 21st, Ambassador Kirk hosted a conference titled “Jobs on Main Street, Customers Around the World: A Positive Trade Agenda for U.S. Small- and Medium-Sized Enterprises” at the Peterson Institute for International Economics in Washington D.C. Attended by over 200 participants, speakers also included SBA Administrator Karen Mills, Deputy Secretary of Commerce Dennis Hightower, and Deputy U.S. Trade Representative Miriam Sapiro. The event featured three panel discussions with leaders of small businesses from Florida, Indiana, Maryland, Montana, New York and around the country focused on trade opportunities and challenges confronting SMEs, including key constraints as well as possible Administration policy and trade-promotion activities that could support increased export activity by SMEs.

- USTR SME week: In addition to the conference, USTR conducted an agency wide program of activities in January focused on SME outreach and meetings with industry groups and organizations designed to yield insights into the specific trade policy challenges and priorities of small businesses.
- Increased SME Representation on Industry Trade Advisory Committees: USTR and the Department of Commerce are bringing more small and medium-sized businesses to the table through our advisory committee system. More than 100 have joined us and are actively sharing their ideas for a trade policy that benefits all small and medium-sized enterprises.
- Collaboration with SBA, Commerce, Export-Import Bank: USTR is pursuing closer collaboration with our trade promotion and trade financing agencies to improve the integration of these activities with our trade policy efforts to support SME interests.
- Expanded SME Stakeholder Outreach: Under Ambassador Kirk's leadership, we are broadening our business outreach beyond the traditional trade circles to better understand SME trade policy concerns and challenges. Expanding our business outreach to better tap into SME sources supports our efforts to more effectively address SME interests in our trade policy development and implementation.

Moving Forward

USTR is actively working to identify specific trade policy tools and activities that offer particular potential benefits for American small and medium-sized firms.

As part of our negotiations to expand U.S. trade in the Asia-Pacific region through the Trans-Pacific Partnership, we will have a point person for SME issues, and we will consistently emphasize the needs of smaller businesses – as well as small business issues like competitiveness and transparency – alongside traditional negotiation topics.

As an agenda priority in the Asia Pacific Economic Cooperation forum priority, we are seeking to make it cheaper and easier for companies, and particularly small and medium-sized businesses, to trade in the region. APEC is also working on making trade documentation and procedures more consistent across all APEC economies, and has launched an initiative to improve the transparency and accessibility of tariff and other customs-related information. APEC has also recently launched a multi-year initiative to improve the regulatory environment for doing business in APEC economies. We will be looking to increase activities in APEC that will help SMEs by seeking to rationalize complex and divergent trade rules, and reduce transaction costs.

We are also seeking to establish, as appropriate, free trade agreement (FTA) working groups on small and medium-sized enterprises to facilitate expanded SME trade opportunities with our FTA partners. We will look to use the fact-finding and consultation mechanisms built into our bilateral and regional free trade agreements to help SMEs increase trade opportunities and confront trade barriers. As part of these activities, we plan to invite SMEs from U.S. and FTA partner countries to provide input on the benefits and challenges to SME trade under our FTAs.

Our FTAs offer valuable export opportunities for U.S. SMEs, and are part of USTR's overall export promotion initiative. In addition to engaging in negotiations to conclude the TPP, USTR will continue to work to address outstanding concerns regarding the pending FTAs with Panama, Colombia and South Korea. FTAs with each of these countries offer valuable export promotion opportunities for SMEs, and approval and implementation of the pending FTAs is an important priority in the Administration's export promotion agenda.

In large developed markets, such as Europe and Japan, regulatory barriers reduce prospects for even larger sales by U.S. SMEs. The Transatlantic Economic Council and the US-Japan Regulatory Reform Initiative both provide high-level venues for follow-up. And our broad array of Trade and Investment Framework Agreements (TIFAs) offers policy vehicles for addressing trade barriers identified by SMEs in many markets.

In April and May, USTR will issue a series of annual reports detailing specific trade issues of concern, including our National Trade Estimates Report, Special 301 Report (IPR), Section 1377 Report (Telecom), and our new reports detailing technical and sanitary and phytosanitary barriers to U.S. exports. The results of these reports will help identify key barriers to be addressed in our policy initiatives.

And in addition to these market access activities, we are focused on robust enforcement of the commitments other governments make to us under our trade agreements, including both our FTAs and the various WTO agreements. When unfair trade practices inhibit the ability of small and medium-sized exporters to get their goods and services into global markets, we are committed to knocking them down – through negotiations if possible and legal action if necessary.

Conclusion

The global economic downturn has adversely impacted all of our business sectors. Our efforts to expand U.S. exports have a critical role to play in advancing our economic recovery and the creation of quality jobs at home. USTR is committed to helping more small and medium-sized businesses take advantage of opportunities to sell American goods and services around the world. Working with other agencies across our government under the National Export Initiative, we will strive to remove foreign barriers and open up new markets for companies of all sizes, with special attention to the obstacles that SMEs confront.

Our objective is that the next time Ambassador Kirk travels to your states he'll meet more of your businesses leaders who are exporting.

Thank you for this opportunity to outline USTR's efforts to expand exports of U.S. small- and medium-sized businesses and support the creation of quality jobs.

**Senate Finance Committee Hearing
Tax and Trade Issues Relating to Small Business
February 23, 2010**

**Responses to Questions for Jim Sanford, Assistant United States Trade Representative for
Small Business, Market Access and Industrial Competitiveness**

Questions from Senator Baucus

Baucus Question 1: The President set a goal of doubling U.S. exports over the next five years to support two million new jobs. Small businesses will play a key role in achieving that goal. In Montana, almost 98 percent of businesses are small firms. These folks need resources and know-how to export. What is USTR doing to address the needs of small businesses? What steps can this Committee take to help you facilitate small business exports?

A: The Office of the United States Trade Representative is making a special effort to help small and medium-sized businesses succeed through exports. First, we are bringing small- and medium-sized businesses to the table through our advisory committee system. More than 100 have joined us and are actively sharing their ideas for a trade policy that benefits all small- and medium-sized enterprises.

Second, USTR has held special SME focused events in October and January and announced the creation of a Small Business AUSTR. At the same time, USTR is also working to ensure greater interagency coordination. We are partnering with the Small Business Administration (SBA), the Commerce Department, the Export-Import Bank, and others across the federal government to give small businesses the resources and the opportunities they need to succeed.

We will also bring a focus to working with our trading partners to lower trade barriers for SME exports. For example, as part of our TPP negotiations we will have a point person for SME issues, and we will consistently emphasize the needs of smaller businesses. Additionally, we will establish, as appropriate, FTA working groups on small and medium-sized enterprises to facilitate expanded SME trade opportunities with our FTA partners.

USTR wants to work closely with this committee to ensure that we do everything we can to create more opportunities for growth and economic activity among our SMEs. In particular, we plan to work with this committee on identifying and removing trade barriers, and looking for new export opportunities for SMEs.

Baucus Question 2: I understand that the President's budget request for FY11 essentially freezes funding for USTR. In contrast to USTR, the President's budget requests an additional \$87 million for export promotion programs at the Commerce Department and an additional \$54 million at USDA. Given the important role that USTR plays in promoting small business exports, I want to be sure your agency has adequate funding to do the job. Could you please describe how resource constraints affect your work at USTR?

A: Like other agencies, USTR is operating under severe budgetary constraints and will want to work with you and Members of this Committee to be sure that we have what we need to accomplish our mutual expectations and goals. Like all Americans, we are tightening our belts. However, our growing objectives to better serve Americans with our

SME focus, TPP negotiations, and other initiatives, which I will briefly outline below, will require USTR to make choices about how to most effectively use its resources.

- USTR's first step is to identify the barriers that raise costs for exporting SMEs. That requires reaching out to trade associations and individual companies. Ambassador Kirk recently hosted a conference that focused on trade opportunities and challenges confronting SMEs. We envision hosting many more conferences like this across the country. USTR will also be consulting economists inside and outside the government, and our interagency partners, in an effort to identify the key barriers.
- Our next step will be to work with our trading partners to lower these trade barriers. This, in particular, will take a special focus and require staff resources. For example, as part of our TPP negotiations we will have a point person for SME issues, and we will consistently emphasize the needs of smaller businesses. Or consider our issues with China. China is one of the most difficult foreign markets to navigate, but also one of the world's more promising export destinations. Resolving existing and potential problems in the JCCT is the best way to assure SMEs can succeed in the Chinese market. Additionally, we will establish, as appropriate, FTA working groups on small and medium-sized enterprises to facilitate expanded SME trade opportunities with our FTA partners.
- Additionally, as an agenda priority in the Asia-Pacific Economic Cooperation (APEC) forum, we are making it cheaper, easier and faster for companies, and particularly small and medium-sized businesses, to trade in the region through concrete initiatives to break down barriers to trade and investment. For example, the United States is working on simplifying rules of origin documentation and procedures to make it easier to take advantage of preferential trade deals in the region and improving the transparency and accessibility of APEC economies' customs information and regulations, among other actions to help U.S. companies doing business in the region.
- We are also seeking to level the playing field for SMEs by addressing environment and labor concerns. Harmful labor practices can give unfair trade advantages to foreign companies and hurt U.S. company competitiveness. When this occurs, SMEs are often the first to suffer. USTR's green goods initiative aims at liberalizing trade in goods many U.S. SMEs produce. Also, combating illegal logging and increasing transparency can also help identify legitimate avenues for trade.

As I stated previously, under the current budget constraints, USTR will have to make choices about the best way to pursue our goals of doubling exports to create good paying jobs in America. We will continue working with this committee and other members of Congress to make sure we get those priorities right.

Questions from Senator Stabenow

Stabenow Question 1: Last week I was in Michigan where I saw the commitment of our manufacturers to keeping jobs in Michigan by making things here. As I've said before, our

middle class will all but disappear if we don't continue to strengthen our manufacturing. I know we can make the best things here, but we are hurting our manufacturers if we don't establish a sound manufacturing strategy, including one involving trade. The President wants to double our exports in five years, but we can't do it if we haven't gotten rid of the tariff and non-tariff barriers blocking our manufactured goods. If we get rid of those, we can create more jobs. I know your office is responsible for getting market access for our goods, so can you share with us which tariff and non-tariff barriers on industrial goods have been eliminated over the last year?

A: Expanding export opportunities is an important element in revitalizing American manufacturing. USTR is working hard to open up foreign markets and reduce barriers to trade for all U.S. goods and services. For example, in the past year, through the entry into force of our FTA with Peru in February 2009, tariffs on 80 percent of U.S. manufactured exports to Peru were eliminated immediately. Tariffs on remaining manufactured goods including leading Michigan exports such as transportation equipment, chemicals, and machinery will continue to be reduced over the next nine years. Under CAFTA, Costa Rica eliminated its duties on many U.S. manufactured goods in January 2009, and many remaining tariffs in other CAFTA members were further reduced over the last year. Non-tariff barriers including restrictions on U.S. remanufactured exports were eliminated in Peru and Costa Rica. We are also working to enforce our trade agreements, including recently initiating a WTO case challenging Chinese export restrictions on raw materials that are of particular concern to a range of US manufacturers.

In the past year, the United States has been successful in persuading China to remove a series of trade restrictive testing and border requirements for imported medical devices that would have created a significant compliance burden for our medical device manufacturers. In response to U.S. requests, Israeli officials recently indicated that their customs authority would no longer enforce additional marking requirements for U.S. automotive and other spare parts that did not apply to such parts from other countries. In April 2009, in response to concerns raised by the United States and other trading partners, Ecuador rescinded burdensome certification requirements on imports of apparel and footwear, rubber and tires, safety glass, transformers, ceramic and porcelain houseware and tableware, white goods and appliances, auto parts, cement, plastic, steel and aluminum products, matches, batteries, and lubricants. And in September 2009, Korea published final measures that will allow non-Korean laboratories to test lithium-ion batteries for conformity with Korean safety requirements, which will help U.S. producers and conformity assessment bodies have better access to the Korean market.

Stabenow Question 2: I know that while in Detroit last week, Ambassador Kirk met directly with many small businesses in Michigan who export. I'm glad that he was able to hear about what I have known for a long time – that small businesses struggle protecting their intellectual property abroad, particularly in China. I'm sure you have heard the troubling stories of how our small businesses go over to China to try and establish a business relationship only to leave with their intellectual property stolen. Because industrial competitiveness is so closely tied with strong intellectual property protections, my question to you is what has your office, either apart from or with the Office of Intellectual Property and Innovation, specifically done to combat these problems?

A: Ensuring strong IP protection in China and around the world is one of USTR's top priorities. We know that our competitive advantage in the world depends on people who are using their minds to create new products and new services. But, as the President has

observed, that only helps us if somebody can't just steal the intellectual property and suddenly start making the product or providing the service somewhere else with very cheap workers.

Because fostering innovation is essential to our prosperity and to the support of countless jobs in the United States, we are working hard to protect American inventiveness and creativity with all the tools of trade policy. USTR's approach to IPR issues in China is a good illustration. We have used all of our bilateral trade dialogues with China, at every level from President Obama on down, to highlight the need for better IPR protection. At the JCCT meetings last fall we pressed on key issues and won several commitments. WTO dispute settlement is another key tool. USTR recently won two WTO cases related to IPR protection and market access for products of certain IPR-intensive industries.

Beyond China, we are working to raise the bar for enforcement of intellectual property rights around the world. For example, USTR has made active use of the Special 301 process, including holding recent public hearings. We are also working with a group of trading partners representing about fifty percent of global merchandise trade to move forward with negotiations of an Anti-Counterfeiting Trade Agreement (ACTA), which we hope to conclude this year. More information about the ACTA is available on the USTR website at www.ustr.gov/acta.

Questions from Senator Hatch

Hatch Question 1: How do you expect American businesses to export globally especially, small businesses, when China maintains at least a 25 percent price advantage over American goods by artificially manipulating the value of their currency? And since we have been reluctant to address this issue have not other Asian countries also manipulated their currencies to the detriment of our nation's products? I agree we should be doing everything possible to assist small businesses in discovering and accessing new markets for their products and services. Yet, how can the Administration's policy reach its full potential without addressing the issue of currency manipulation?

A: The Treasury Department is responsible for exchange rate matters. I would note that in its most recent foreign exchange report, the Treasury Department observed that although China's overall policies played an important role in anchoring the global economy in 2009 and promoting a reduction in its current account surplus, the recent lack of flexibility of the Renminbi exchange rate and China's renewed accumulation of foreign exchange reserves risk unwinding some of the progress made in reducing imbalances as stimulus policies are eventually withdrawn and demand by China's trading partners recovers. Treasury remains of the view that the Renminbi is undervalued.

The Administration will continue to work with China both in the G-20 and the bilateral Strategic and Economic Dialogue to pursue policies that permit greater flexibility of the exchange rate. Through these efforts, combined with the work we are doing in the JCCT, USTR is working with the Treasury Department and other agencies to implement a comprehensive China policy that will address the full range of China's trade and economic policies that impact the United States, and that will lead to a more fair, sustainable and balanced trade and economic relationship.

Hatch Question 2: The United States has already concluded three Free Trade Agreements: Korea, Panama and Columbia, yet the Administration has yet to push for their consideration. C. Fred Bergsten of the Peterson Institute for International Economics recently noted goods from Colombia and Panama enter the United States virtually free of duties but our small business must pay duties on our exports to these countries. Dr. Bergsten also wrote if the pending deal with Korea is enacted our nation would save 300,000 jobs. Therefore, how many jobs and how much economic activity will be created for small businesses if the Korea, Panama and Columbia Free Trade Agreements are enacted?

A. As required under the Trade Act of 2002, the U.S. International Trade Commission (ITC) analyzed the likely economic impact of the agreements with Korea, Colombia and Panama. According to the 2007 ITC report on the effects of the U.S.-Korea FTA, the reduction of Korean tariffs and tariff rate quotas on goods alone would add \$10 billion to \$11 billion annually to U.S. exports to Korea, and \$10 billion to \$12 billion annually to U.S. GDP. According to the 2006 ITC report on the effects of the U.S.-Colombia FTA, the reduction of Colombian tariffs and tariff rate quotas on goods alone would add \$1.1 billion annually to U.S. exports to Colombia, and \$2.5 billion annually to U.S. GDP. The ITC was not able to quantify the economy-wide effects of the Panama agreement on the U.S. economy because necessary data was not available, but the ITC qualitatively concluded that the agreement was likely to have a small, positive impact on the U.S. economy.

It should also be noted that formal economic models, such as the ITC model, do not quantitatively estimate all of the effects from free trade because their scope is limited (e.g. they cannot quantitatively assess the impact of rules changes such as improved IPR protection) and because not all the expected effects of the Agreement are necessarily measured (e.g., they do not estimate or fully estimate dynamic or intermediate growth gains from trade liberalization). The ITC also specifically did not estimate the effects of removing barriers to trade in services in the quantitative assessment. These are other areas of potential gain to U.S. exporters and the U.S. economy.

As exports to these three countries grow as a result of these agreements, it can be expected that those industries' demand for labor would also increase. This could also include increases in business for services industries that are connected with exports, such as delivery, transportation, and financial services. As indication of the potential of expanded exports to support job-growth, the President has set a goal of doubling U.S. exports in the next five years—an increase that will support millions of additional jobs in America. Approval of these three agreements would support export expansion. SMEs are also expected to benefit since 30 percent of the value of all U.S. goods exports to the world are by SMEs.

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Statement of

Eric J. Toder
Institute Fellow, The Urban Institute and
Urban-Brookings Tax Policy Center

Before the
Senate Committee on Finance

Tax Issues Related to Small Business Job Creation

February 22, 2010

The views expressed are those of the author and should not be attributed to the Urban Institute, its trustees, or its funders.

Chairman Baucus, Ranking Member Grassley, and members of the Committee:

Thank you for inviting me to testify today on tax issues related to small business job creation. I will limit my comments today to how recently proposed incentives for small business may help economic recovery. These incentives are only a small component of broader policies to accelerate recovery from the deep recession we have experienced in the past two years and reduce unemployment.

The criteria for assessing tax policies to promote economic recovery differ from those used to assess how policies might affect sustained economic performance and growth. With unemployment still around 10 percent of the labor force, the most important immediate need is to increase demand for goods and services in the U.S. economy. Over time, we need to reform the tax system so that it is fairer, simpler, and more conducive to economic growth. If more revenues are needed to close a long-term budget gap, we should look to tax policies that do not retard the saving and investment, including investment in human capital, needed to add to the nation's wealth and productive potential. But over the next year or two, we need instead to encourage personal and business spending so that we can bring unemployment down more rapidly. The challenge is how to provide more fiscal stimulus in the short run, while taking credible steps to persuade financial markets worldwide that we have the discipline to reduce our deficits once the economy has recovered.

For immediate job creation, the size of the overall fiscal stimulus matters more than its composition. And both small and large businesses will benefit from policies that increase demand for goods and services. But not all tax cuts have the same effects on the pace of recovery. Policies that provide tax cuts to those consumers and businesses most likely to spend them quickly will do the most to accelerate recovery.

I comment on three tax incentives in the president's fiscal year 2011 budget that are designed to help small businesses—the targeted jobs tax credit, the extension of increased limits on Section 179 expensing, and the eliminating of capital gains taxation on small business stock. The Tax Policy Center has recently posted a summary and assessment of these and other tax proposals in the president's budget.¹

Targeted jobs tax credit

The president is proposing a new temporary jobs tax credit for companies that hire additional employees, expand hours, or increase wages in 2010. The credit proposal is described in a White House fact sheet, which estimates its cost at \$33 billion. The proposal is not discussed in the budget documents, except for a reference to a line item called “allowances for jobs initiatives” that calls for incentives that will cost \$12 billion in fiscal year 2010, another \$33 billion in fiscal years 2011 and 2012, and \$5 billion more in fiscal years 2013 and 2014.

¹ Tax Policy Center, “Tax Proposals in the 2011 Budget” at http://www.taxpolicycenter.org/taxtopics/2011_budget.cfm.

The jobs credit is modeled in part on a temporary credit for increasing employment that was enacted during the first year of the Carter administration in 1977, with some modifications. The 1977 credit was in effect for two years as the economy was recovering from the 1974–75 recession and was then replaced by the Targeted Jobs Tax Credit, which was more narrowly focused on disadvantaged workers.

The new proposal would give employers a \$5,000 tax credit against payroll taxes for net increases in employment in 2010 compared with 2009. Employers could also receive a credit of 6.2 percent of any increase in total real wages they pay in 2010 below the Social Security taxable maximum of \$106,800 per worker. This second credit would effectively exempt employers from paying their share of Social Security payroll taxes on these higher wages. The total amount of credits for any single employer could not exceed \$500,000, enough to provide an incentive to hire an additional 100 workers. This total limitation would make most of the credit go to small businesses. New firms with no employees in 2009 would be eligible for half the subsidy existing firms would receive for any increase in employment or wages. Nonprofit organizations would be eligible for the credit, but government agencies at all levels would not be eligible.

Various provisions would prevent employers from receiving a subsidy for hiring more workers while reducing total hours or wages, or for increasing total payroll while reducing the number of workers. These provisions aim to prevent, for example, employers from claiming an employment credit for replacing high-wage workers with many low-wage workers or for substituting more part-time for fewer full-time workers. To prevent this abuse, the proposal would make any business that reduces either its total employment or its payroll in 2010 ineligible for the credit and would limit the maximum jobs credit to 25 percent of the increase in the Social Security payroll wage base.

The credit would be based on the difference between average employment and payroll over the entire year 2010 compared with employment and payroll in 2009. But firms would not have to wait until filing their full-year tax return to claim the credit; they could instead claim credits in every quarter of 2010 based on their estimated tax benefit for the entire year. They would, however, have to settle up when they file their 2010 tax return.

The credit aims to accelerate recovery by reducing the cost to employers of hiring new workers or increasing wages in 2010. A similar incentive to raise employment levels or payroll could be achieved by offering a temporary \$5,000 per-worker credit or credit against employer contributions to Social Security for all employees. The purpose of making the credit apply only for increases in employment or payroll above a base amount is to increase the share of the subsidy that supports additional employment instead of baseline employment or wages that would have been paid without any subsidy. In theory, by reducing subsidies to these baseline wages or employment, an incremental credit yields more “bang for the buck”—that is, more additional payroll or jobs per dollar of government budgetary cost. Put another way, making the credit incremental enables the government to provide a larger incentive for adding new employment at the same

budgetary cost than it could with a credit that applies to all jobs, up to the \$500,000 per firm maximum.

Because of anti-abuse provisions and inclusion of a subsidy to both additional employment and additional payroll, the administration's proposal may be a more cost-effective wage subsidy than the subsidy Congress enacted in 1977. But any incremental credit is an imperfect incentive because government cannot know what firms would have done without the credit. The proposed credit supports only new employment if 2009 employment and payroll represent what firms would have done in 2010 without any wage subsidy. But many firms would have either increased or reduced employment without the credit. In those circumstances, an incremental credit rewards growing firms with rising demand that would have hired more workers without a subsidy, but fails to provide an incentive for firms with falling demand to lay off fewer workers. It has arbitrary and capricious distributional effects, rewarding firms and workers in expanding industries and regions of the country, while failing to help industries and firms still experiencing economic stagnation.

How well the credit would work in creating new jobs is a matter of dispute. Injecting an additional \$33 billion of employment tax cuts into the economy provides some stimulus to consumer demand, but how much stimulus depends on how quickly beneficiaries spend the tax cut. The credit would raise wages to the extent it encourages firms to hire more workers or pay them more, but to the extent it simply pays firms for what they otherwise have done, it will instead raise the profits of business owners, who have higher incomes and are likely to spend less from an additional tax cut than their employees.

So how much will the reduction in net wage costs encourage businesses to hire more workers or increase payroll? On the surface, the subsidy appears fairly large—a \$5,000 tax cut is 12.5 percent of the wage of a worker making \$40,000 per year and if permanent could make a difference between an additional hire being profitable or unprofitable. But the subsidy is only for one year, while for many firms, recruiting and training costs for new workers are fairly high relative to their productivity in the first year on the job. Taking account of these costs and the reluctance of many firms to hire workers they will not be able to retain, the effective subsidy could be quite small for many firms.

Rules to prevent abuse may make it difficult for small firms or their personnel departments to assess whether hiring an additional worker would qualify them for a subsidy or not. This may deter many firms from responding to the incentive or may lead them only to calculate their eligible benefit after the fact and not while making hiring decisions. For example, a subsequent Labor Department study of the 1977 new jobs tax credit found that most firms were either unaware of the credit or did not respond to it. Research based on data in that survey found that only 6 percent of firms that knew about the credit said it prompted them to hire more workers.²

² Jeffrey M. Perloff and Michael L. Wachter, "The New Jobs Tax Credit: An Evaluation of the 1977–78 Wage Subsidy Program," *American Economic Review* 69-2: 173–179. May 1979.

Limiting the credit to \$500,000 per firm effectively directs most of its benefits and all of its incentive to small firms, which represent the vast majority of employers. Larger firms and their employees would benefit indirectly, however, to the extent the credit raises demand through increased spending by those newly employed and business owners with increased profits. But limiting the credit to \$500,000 per firm also raises its cost per additional job because larger firms otherwise increasing jobs by more than 100 workers receive some of the credit, but no direct incentive to hire more workers.

There are some reasons, however, to think the credit may have some beneficial effect on employment. Because it is only available for hires in 2010, it could encourage some firms to hire workers late in 2010 who they otherwise would have hired in 2011. This acceleration of jobs would not directly increase employment in 2011 and beyond, but could indirectly raise jobs in 2011 if the new hires help accelerate the economic recovery by spending some of their increased wages.

Some economists point to the 1977 experience as a successful model, citing a research finding that firms that were aware of the credit increased employment about 3 percent more than other firms.³ This may reflect a positive incentive effect; alternatively, firms that were planning to hire additional workers may have been more likely to find out about the credit. Overall employment grew substantially in the years the credit was in effect, notably in industries with many small firms, such as construction and retailing.⁴ Employment growth slowed considerably after the credit expired at the end of 1978, but this may have been caused by factors other than the credit's expiration, such as the spike in oil prices in 1979.

I conclude by expressing significant uncertainty about how much this proposal will raise jobs. In theory, a temporary incremental jobs credit could be a cost-effective way of accelerating increases in employment, and there is some evidence, though inconclusive, that the 1977 credit increased jobs. The effectiveness of the subsidy will depend greatly on the details of the proposal and how eligible employers perceive its potential benefits when making hiring decisions. Additional restrictions on the use of the credit, such as limits on the categories of workers who are eligible or limits on the number who qualify for the subsidy, are likely to reduce the cost-effectiveness of the credit, even as they limit its budgetary costs.

³ Timothy J. Bartik and John H. Bishop, "The Job Creation Tax Credit," Economic Policy Institute Briefing Paper #248, October 2009, at <http://www.epi.org/publications/entry/bp248/>.

⁴ John H. Bishop, "Can a Tax Credit for Employment Growth in 2009 and 2010 Restore Animal Spirits and Help Jump Start the Economy?" at <http://digitalcommons.ilr.cornell.edu/articles/184>.

Increased Expensing for Small Businesses

Section 179 of the Internal Revenue Code allows small businesses to deduct immediately instead of capitalizing and recovering through depreciation the first \$25,000 of qualifying investments (machinery and equipment). The amount of spending available for the deduction decreases dollar for dollar for investments in excess of \$200,000.

In 2003, Congress increased the amount that could be expensed to \$100,000 and the start of the phase-out to \$400,000 through tax year 2009. These limits were raised to \$125,000 and \$500,000 for tax years 2007 through 2010 and then subsequently to \$250,000 and \$800,000 for 2008 and 2009. In 2010, the limits are scheduled to revert to \$125,000 and \$500,000, and in 2011, they will be further reduced to their pre-2003 levels of \$25,000 and \$200,000.

The administration is proposing to extend the 2008 and 2009 limits of \$250,000 of expensing with a phase-out beginning at \$800,000 in 2010. The administration's baseline also assumes that the post-2006 limits of \$125,000 and \$500,000 will be extended after 2010.

Section 179 reduces the cost of capital for firms that use qualifying machinery and equipment and reduces compliance costs by eliminating the need to apply tax depreciation rules and keep track of the basis of assets. IRS-sponsored research on compliance finds that depreciation rules contribute significantly to compliance costs for small businesses.⁵ Section 179 produces little benefit for firms whose capital consists mainly of structures or inventory and no benefit for firms whose investment exceeds the sum of the maximum expensing amount and the beginning of the phase-out limit (\$1,050,000 in 2008 and 2009, \$625,000 in 2009 and 2010, and \$225,000 after 2011). The benefit of expensing is larger for longer-lived equipment than for shorter-lived equipment, such as computers, that could otherwise be amortized over three years.

It is hard to know how much this proposal would boost the economy in the short run. There have been no studies on the effect of Section 179 expensing on the long-term level or timing of investment. A temporary tax incentive could accelerate some investments, but since generous expensing rules have been in place for several years, some capital purchases that may otherwise have been accelerated already have occurred. And if taxpayers believe the higher limits in 2010 will be permanent, their short-term stimulus effect would be smaller because taxpayers would have no incentive to accelerate the timing of investments.

Elimination of Capital Gains Tax on Qualified Small Business Stock

Individual taxpayers may exclude 50 percent of the gain from the sale of certain small business stock acquired at original issue and held for at least five years. The exclusion

⁵ Donald DeLuca, John Guyton, Wu-Lang Lee, John O'Hare, and Scott Stilmar, "Estimates of U.S. Federal Income Tax Compliance of Small Businesses," presented at 2007 National Tax Association meetings, Columbus, Ohio, November 2007.

was increased to 75 percent for stock acquired between February 17, 2009, and December 31, 2010. The administration is proposing to raise the exclusion to 100 percent for stock acquired after February 17, 2009, eliminate the current AMT preference for gains benefiting from the exclusion, and require additional documentation to prevent noncompliance.

Under current law, long-term capital gains are taxed at a maximum rate of 15 percent. But gains on small business stock before 2009 faced a 28 percent rate before application of the 50 percent exclusion, for an effective rate of 14 percent. The result is that, with capital gains rates in effect after 2003, small business stock received little additional preference and will receive little preference when the current 75 percent exclusion expires. If the maximum rate on capital gains rises to 20 percent, as the administration is also proposing, some of the targeted subsidy to small business stock will be restored.

Since its original enactment in the 1993, use of the partial capital gains exclusion on small business stock has been quite limited. To be eligible for the exclusion, the stock must be held for at least five years. The maximum amount of eligible gain is ten times the taxpayer's basis in the stock issued by the corporation and disposed of during the year or \$10 million, reduced by the gain excluded in prior-year sales of the corporation's stock. To qualify as a small business, the corporation may not have gross assets exceeding \$50 million, including proceeds of the newly issued stock.

Numerous other requirements constrain eligibility for the benefit. The stock must be issued by a subchapter C corporation, even though most small businesses today accounting for the majority of gross revenues from small businesses are organized as flow-through enterprises—partnerships, limited liability companies, and subchapter S corporations. Corporations in a wide variety of specified activities are ineligible, as are any corporations in a trade or business where the principal asset is the reputation or skill of one or more employees. There are limits on the amount of real property a qualified small business can hold and ownership of, dealing in, or renting real property is not treated as an active trade or business. Most firms that do qualify are in manufacturing, food processing (but not farming, which is ineligible), construction, transportation, and wholesale and retail trade.

Eliminating all capital gains on qualified small business stock will greatly increase use of the benefit. For example, OMB estimates that capital gains exclusion for small business stock cost only \$50 million in 2010. But Treasury estimates the annual revenue loss from expansion of the incentive will reach \$2.2 billion by 2020.

The benefit will reduce taxes on investors in some start-ups and could encourage some new entrepreneurial activity in small businesses that qualify. The short-term stimulus effects are likely very small, however, as the incentive is more likely to redirect savings to favored sectors than to encourage new investment. The proposal will direct capital to qualifying investments at the expense of potentially more productive investments that do not receive a special tax benefit.

Noncompliance with the provision is also a potentially serious issue. Individuals report their entire gain and their exclusion for qualified small business stock on two adjoining rows of line 8 of Schedule D of Form 1040. But the IRS receives no reporting from brokers or issuers of stock of the qualified exclusion amount and therefore has no way, short of a detailed audit, to verify that the exclusion is appropriate and satisfies all the relevant criteria. In contrast, the IRS receives third-party information on interest, dividends, and sales of capital assets and will receive reports from brokers on the basis of capital assets purchased after January 1, 2011. With the expansion of the benefits from the exclusion, additional reporting requirements may become necessary to prevent abuse.

Conclusion

The best way to promote job creation in small and large businesses and accelerate recovery is through policies that produce more fiscal stimulus in the short run that will increase demand for goods and services, while at the same time initiating steps that persuade markets that the United States will have the ability to address its fiscal deficits as the economy recovers. In addition to general fiscal stimulus, however, the administration has also proposed new targeted incentives for small business. The proposed targeted incremental jobs credit may encourage some acceleration of hiring from 2011 into 2010, but its overall effects are uncertain. Extension of higher limits for small business expensing will reduce compliance costs of businesses and could lead to some acceleration of investment. But businesses that built up their assets to take advantage of the temporary benefit for the past two years are less likely to respond to an additional extension. The proposed exemption of capital gains tax on selected small business investments is unlikely to provide much short-run stimulus to demand, may divert capital from more productive investments in less tax-favored assets, and will require additional reporting requirements to prevent abuse.

**Senate Finance Committee Hearing
Tax and Trade Issues Relating to Small Business
February 23, 2010
Responses to Questions for Dr. Eric J. Toder, Institute Fellow, Urban Institute**

Questions from Senator Baucus

1. We tax net income, not gross income. The expiration of the higher tax rates applies to individuals with net incomes over \$200,000 (and joint filers with net incomes over \$250,000). This means an owner of a pass-through business is taxed only on the profit of the business, not all income of that business.
 - Mr. Toder, what percentage of small business owners will be affected if the top two tax rates revert back to pre-2001 levels?

If we define a small business owners as a taxpayer who receives 50 percent or more of their income from sole proprietorships and self-employment (schedule C), partnerships (schedule E), or farms (schedule E), then from our most recent estimates at the Tax Policy (March 2009), only 1.9 percent of tax units (226,000 tax units) were in either the 33 percent and 35 percent tax brackets.

- What incentives does the tax code already provide that favor smaller over larger businesses?

There are three main benefits that are targeted to small businesses:

- 1) *Section 179 Expensing. In 2010, under current law, small businesses will be able to expense instead of capitalizing the first \$125,000 of qualifying investment in machinery and equipment. The amount of spending available for the deduction decreases dollar for dollar for qualifying investments in excess of \$500,000, so the incentive is not available to big business. For tax years 2008 and 2009, these limits were increased to \$250,000 and \$800,000, respectively. The Administration is proposing to extend the 2008 and 2009 limits to 2010 and the current law 2010 limits permanently. If Congress takes no actions, the limits will drop in 2011 to their pre-2003 levels of \$25,000 and \$200,000.*
- 2) *Graduated Corporate Rates. For small corporations, the rates are 15 percent on the first \$50,000 of taxable income and 25 percent on the next \$25,000 of income – this compares with rates up to 35 percent (39.6 percent after 2011 under current law) if the profits were taxed to owners as ordinary income. The benefits of lower rates are mostly phased out by a 5 percent tax on corporate income between \$100,000 and \$335,000, so that income between \$335,000 and \$10 million is taxed at a flat rate of 34 percent. There is an additional clawback of the 34 percent rate, which raises average and marginal tax rates for corporations with income over \$18.33 million to 35 percent. The graduated corporate rates benefit small, closely held businesses whose owners do not need to pay dividends*

to attract capital. (Otherwise, they might be subject to double taxation of dividends and choose to organize themselves as a flow-through enterprise – see answer to the next question)

- 3) 50 percent exclusion of capital gains on small business stock. This exclusion was not worth very much between 2003 and 2008 because it reduced the top capital gains rate only from 15 percent to 14 percent (half of the 28 percent rate applied to small business stock and collectibles). But a 75 percent exclusion applies for stock issued between February 2009 and the end of 2010 and the Administration is proposing a 100 percent exclusion in the budget, while also proposing to raise the capital gains rate generally to 20 percent. The exclusion is limited to stock held at least five years issued by a subchapter C corporation with less than \$50 million in gross assets. Corporations in a wide range of specified activities are ineligible, as is any corporation in a trade or business where the principal asset is the reputation or skill of one or more employees. Most companies that qualify for the incentive are in manufacturing, food processing, construction, transportation, and wholesale and retail trade.

- Could you go into a bit more detail on the choice of entity classification as a tax benefit to small businesses?

Small businesses can choose to organize themselves as flow-through enterprises – subchapter S corporations or limited liability companies – and gain the benefits of limited liability without paying the double tax on dividends that large corporations and their shareholders pay.

For, example, if a large corporation earns \$100 of profits and uses the proceeds to pay dividends to a shareholder in the top (35 percent) bracket, the corporation first pays \$35 of tax on the profits and then the shareholder pays an additional \$9.80 (15 percent) of tax on the \$65 of dividends the corporation pays after paying corporate income tax. The total tax rate on the profits is 44.8 percent. In contrast, the top tax rate paid by the owner of an S-corporation on the same income would be his personal rate of 35 percent. If the Bush tax cuts expire in 2011 as scheduled, the tax rate on corporate dividends will increase to 60.74 percent (\$35 at the corporate level plus 39.6 percent of the \$65 after-tax dividend at the shareholder level), compared to 39.6 percent for the owner of the S-corporation.

In 2003, according to data reported by the IRS Statistics of Income division, flow through enterprises accounted for 81 percent of gross business receipts for companies with total receipts less than \$1 million, 61 percent of receipts for companies with receipts between \$1 million and \$50 million, and only 19 percent of receipts for companies with receipts greater than \$50 million. The share of small businesses that are small corporations and the share of small business receipts from C corporations have been steadily declining in recent years.

2. Yesterday the Senate passed the Hiring Incentives to Restore Employment (HIRE) Act. One provision included in that legislation would keep the Section 179 expensing limits at the same levels as 2008 and 2009. In addition to the higher thresholds, we have also heard a number of businesses asking that we expand the types of property that may be expensed to include buildings and structural components, air conditioning and heating units, and leased property.

- How would expanding the types of property that may be expensed under Section 179 help businesses create jobs?

There is no economic justification for limiting section 179 expensing to some types of capital (machinery) as opposed to others (structures). But, as I suggested in my testimony, there are no studies available on the extent to which section 179 has raised investment. And because section 179 limits have been temporarily raised in previous years, some of the acceleration of investment that a further temporary extension may have otherwise induced may have already occurred.

- How would you rank these additional types of property in order of effectiveness in helping to expand jobs?

Policies that increase consumer demand by putting more money into the pockets of low and middle-income households who are likely to spend are probably more effective in the short-run at stimulating employment than further extension of the higher section 179 limits or allowing those limits to be used for more types of capital.

3. Senators Kerry and Snowe have previously introduced a proposal to increase the capital gains exclusion for certain small business stock to 100%. The President included this proposal in his fiscal year 2010 budget as a part of the Jobs Package. What are your thoughts on this proposal? Will this proposal increase investment in small business?

As I stated in my testimony, eliminating all capital gains taxation on qualified small business stock will greatly increase use of the benefit and its revenue cost. But increased claiming of tax benefits does not necessarily mean there will be additional investment.

The benefit will reduce taxes on investors in some start-ups and could encourage some new entrepreneurial activity in small businesses that qualify for the tax break. The short-term stimulus is likely to be small, however, as the incentive is more likely to redirect saving to those activities that qualify for the tax break than to encourage new investment in the economy as a whole. The proposal will direct capital to those investments that qualify at the expense of potentially more productive investments that do not receive a special tax break.

Instead of trying to micro-manage the economy with targeted tax breaks, Congress would do better to find ways to eliminate unnecessary special tax benefits so that tax rates can be kept low for all businesses.

4. I also have a few questions about what incentivizes people to start new small businesses.

- What tax provisions might motivate people with good ideas to start businesses?

People with good ideas are motivated to start businesses by a combination of the prospect of contributing to society and reaping financial rewards. Taxes are not motivators for private innovation, but the tax system should get in the way as little as possible, given that we need to fund society's public needs in a way that distributes tax burdens based on ability to pay tax. The best tax policy would be raise revenues with as low a set of rates and as broad a tax base as possible so that individuals choose activities based on their social productivity, not tax consequences.

- Would increasing business start-up deductions encourage people to start businesses?

If individuals can organize start-ups as flow through enterprises, they and those who finance them can deduct losses in early years against other sources of income. The current tax law allows this. Businesses should be allowed to deduct costs, but additional deductions in excess of costs for selected uses of capital only means that government would be subsidizing activities that fail to meet a market test.

- Would creating tax-free savings accounts to allow people to save to start businesses encourage people to start businesses?

People can already use their tax-free saving accounts to purchase shares of new corporations. However, given the current favorable tax treatment of new businesses (most start-up of costs which are really capital such as hiring workers to develop new products are already deductible), it would not be tax-efficient to use a tax-favored vehicle to invest in a new business (investors would gain more by using their IRAs to invest in an activity that would otherwise generate tax on the return to capital).

- How quickly do new businesses begin to hire employees once they begin?

I have no specialized knowledge of this. I'm sure it varies among types of businesses, but would guess in most cases, they would begin to hire fairly quickly after start-up.



United States Senate
Committee on Finance
The Honorable Max Baucus (Montana), Chairman
Testimony of Spencer Williams, President/CEO
West Paw Design
February 23, 2010, 10:00 a.m.

Thank you Chairman Baucus, Ranking Member Grassley, and members of the Committee for inviting me to the Senate Committee on Finance. I am grateful for the opportunity to share my experience, observations and opinions with you regarding export trade and how small businesses can increase jobs in our country.

West Paw Design Company Background

Based in Bozeman, Montana, West Paw Design has built a reputation for manufacturing high-quality bedding, toys and apparel for dogs and cats throughout the company's 13-year-history. West Paw Design's team of 36 employees are extremely proud that 100 percent of the company's products are manufactured in the United States – a characteristic that sets West Paw Design apart from a competitive field that largely manufactures overseas. More than 2,800 pet retailers carry West Paw Design products domestically and products are also sold in 24 countries internationally. Distinguished by a commitment to creating eco-friendly, safe and quality products, West Paw Design has experienced continued growth even during the economic downturn. In the summer of 2009, construction crews broke ground on a facility expansion that will more than double the size of West Paw Design's production floor when it opens later this month.

Our Products

As much as West Paw Design values pets, the company also values sustainability for the global environment. In all its manufacturing West Paw Design uses recycled raw material wherever possible. A commitment to recycling is inherent in the designs of its bedding, toys and apparel. Beds are stuffed with recycled post-consumer plastic from plastic soda-pop bottles that creates a soft and durable material that is a better quality fiber than conventional bedding. All materials used in manufacturing West Paw Design's innovative Zogoflex® toys are engineered to be recyclable and environmentally friendly. Unusual in the plastics world, West Paw Design creates virtually no waste from the manufacturing process of these toys.

**Current Economic Climate**

Domestically West Paw Design has experienced strong sales growth but 2009 was a difficult year to grow. However, we were successful at increasing our sales in 2009 by 1.3 percent over 2008. Export sales have grown faster than domestic sales over the last three years and export revenue was critical to our growth in 2009. By continuing to invest in product development and marketing we were able to successfully launch new products when many of our competitors waited for better economic times. New products, along with sales promotions and an effective sales team, helped our retailers feel a sense of excitement about our brand in a time when there was little good business news to be excited about. Also, we hired new high-level staff to both our sales and production teams to help the company economize our operations and be more progressive. Our investment in people helped us grow in 2009 and begin 2010 with momentum. Sales for 2010 are currently 33 percent above 2009 and 1 percent above our forecast.

Future Growth

West Paw Design continues to invest in our company growth and we plan to increase revenues by 11 percent in 2010. This comprises growth in pet specialty stores, along with continued growth with corporate customers. Our forecasted success is also partially based on a 140 percent projected growth in exports. This optimistic forecast is predicated upon three opportunities. First, we will introduce mainland Europe warehousing and logistics. By contracting with a company to warehouse our best-selling products and to fulfill orders to our European distributors, we can cut lead times and reduce transportation costs. Second, we have introduced multi-language packaging on our Zogoflex dog toys, which is anticipated to increase sales in German and French-speaking countries. Third, we anticipate future partnerships to materialize from a strong list of prospective distributors and plan to develop new distribution relationships at a large international trade fair in Germany.

Expansion

By March 2010 West Paw Design's production floor expansion will be complete. By doubling the size of our building to nearly 31,000 square feet, we will have the ability to grow. New production space will house much-needed inventory, along with our first in-house injection molding equipment for the production of Zogoflex toys in addition to a dedicated area for large order and export order staging and processing.

Simply put, West Paw Design is a small but mighty manufacturer that believes in making a positive impact, not only in the pet industry, but in the larger picture of our community and environment as well.

Export Sales History

During the last two years, we have realized growth in our export sales, which accounted for 16.9 percent of our 2009 revenue. Our export sales in 2009 represented a 133 percent growth over 2007 export sales. West Paw Design exports to 24 countries with the majority of sales going to Canada, the European market and Australia. Our growth has in part allowed us to promote one sales employee to a position in export sales and also to hire a sales director who will help oversee international sales.



Starting at Interzoo 2000, our first international trade fair, West Paw Design sought out international sales as a means for growth in future years. I had little understanding of the challenges involved with exporting and also I had no concept of how long it would take to realize success in exports. Marketing our product was difficult from the beginning because we had to compete with less expensive products made in Asia. Utilizing information we learned over the years we focused our efforts on a new product line introduced in 2004 — Zogoflex. This product line was an opportunity because it was very safe for dogs, as its material is FDA-approved. It was also recyclable and this is a bigger selling point in the European market than domestically. Finally, it was durable and backed up by a guarantee, even with our foreign distributors. Our branding focus was to utilize Montana and US-made quality, safety of materials and craftsmanship, recycled content and recyclable products, along with organic and non-toxic materials. This quality and environmentally safe brand positioning, along with the weakened dollar, opened up the opportunities that we see continuing to grow our sales.

By utilizing my fluency in German, I was able to make Germany our first strong market for export and it was good fortune that the world's largest pet trade fair was held in Germany. Utilizing both a good education and luck, we were able to finally pick a great distributor that serviced Germany in 2008 and our international sales took off. By being aware of the cultural and linguistic challenges to doing business in Europe, I was able to build strong relationships throughout 2008. In 2009 we added Australia and are working on identifying a strong distributor in Japan in 2010.

West Paw Design is unique in that we do export a larger percentage of our products than an average Montana manufacturer. In 2008 Montana manufactured \$10 billion in output value, of which \$750 million or 7.5 percent was exported. With 16.9 percent of our sales being to foreign companies, West Paw Design exports more than twice the amount of an average Montana manufacturer.

	2007	2008	2009
Total Sales Growth on Previous Year	4.0%	42.8%	1.3%
Export Sales Growth on Previous Year	70.2%	125.1%	3.8%
Percent of Sales to Foreign Companies	10.5%	16.5%	16.9%

Products Exported and Export Locations:

The majority of our exports are Zogoflex toys for dogs. These toys are uniquely differentiable from less costly Asian products because of durability, safety and environmental benefits. In addition to its US customer base, major markets for West Paw Design products include: Australia, Bermuda, Brazil, Canada, Cayman Islands, Czech Republic, Denmark, France, Germany, Hong Kong, Israel, Italy, Japan, Mexico, New Zealand, Puerto Rico, Singapore, Spain, Sweden, Switzerland, Taiwan, The Netherlands, United Arab Emirates and the United Kingdom.



Federal Programs Used

Small Business Administration – SBA 504 Loan Program

West Paw Design received SBA approval in 2009 on a 504 loan for the expansion of the existing building, in partnership with First Security Bank of Bozeman. The loan will close and fund this summer, once all phases of our building expansion are complete. According to an economic impact analysis completed by the Prospera Business Network, the expansion project is supporting 29 local jobs and will generate over \$2.5 million in total economic benefit to the community.

Our loan qualified for two benefits under The American Recovery and Reinvestment Act of 2009 (Recovery Act). We were eligible for the elimination of two program fees: 1) Third-Party Participation Fees and 2) Certified Development Company (CDC) Processing Fees. Both saved us a total of \$26,442. By not having to pay these fees, the monies were directed to other business investments. One investment of those savings was toward the down payment of a large machine to assist with production. The machine will be delivered to West Paw Design in early April. It is not only a taxable asset, but has allowed us to create 1.5 full time equivalent positions in our production team. These positions are not low wage positions, but rather mid-level positions with full benefits, including generous paid time off, health care, a 401k and profit sharing.

The compounding impact of the Recovery Act, the 504 loan and building expansion, along with the equipment purchase and the 1.5 FTE positions demonstrates the power of these programs and the way it is helping to support jobs and increase economic opportunity.

US Commercial Service – General

Through my experiences and in my discussion with others, I believe the the US Commercial Service is a great value and exceeds services that are available in the private market for small manufacturers. Montana's representative has worked with other third-party entities to assist companies with exports. These entities include the State of Montana, the Montana World Trade Center and the Montana Manufacturing Extension Center (MEP-Center). By collaborating to help West Paw Design grow, they each provide a necessary specialized service and utilize the US Commercial Services' diverse resources.

West Paw Design has taken advantage of research from the US Commercial Service including:

- how to export to Canada, which involved a discussion of duty charges, how to work out duty charges when the buyer uses their own broker, and how to cover duty and tax charges on shipments dispatched to Canada via courier services
- how to manage for risk via the proper selection of Incoterms
- how to manage for risk via export credit insurance
- how to find foreign duty rates and VAT charges
- identification of ocean freight rates for shipment to Denmark along with an introduction to a freight forwarder to facilitate this shipment



- identification of the proper Harmonized Tariff System (HTS) classification for display stands in connection with the dispatch of bamboo display stands to the Interzoo show
- the product exhibition at a catalog show in Taiwan, which resulted in one trade lead that was delivered to West Paw Design from a Taiwanese company interested in purchasing West Paw Design products

US Commercial Service — Gold Key

The desire to expand internationally was driven initially by my personal desire to work in a global community and to supply products to export markets. Unfortunately the decision was not based upon a market opportunity or vetted by market knowledge. The decision to expand internationally was naïve for us to undertake as such a small company. We had little understanding of the markets, their distribution models and how compatible our products would be to the consumers. In 2000 we attended our first trade show in Europe. It was a disaster because we did not understand where we would fit into the distribution model and how expensive it would be to get products shipped to the European market.

Because of our lack of success in 2000, we tried a different approach with the European market two years later in 2002. We sought advice from our Manufacturing Extension Partnership (MEP) engineer at the Montana Manufacturing Extension Center. We learned that the Montana Export Assistance Center could help us succeed and determined through conversations with our local representative that Gold Key would be the best service for us. Gold Key services arranges one-on-one appointments with pre-screened potential agents, distributors, sales representatives, association and government contracts, licensing or joint venture partners, and other strategic business partners in targeted export markets. Then, we looked at demographics of pet ownership and found that Germany and France were the biggest markets. With that we chose France for Gold Key. Our critical mistake with Gold Key was not looking deeper into the market and its distribution model before agreeing to proceed. What was later discovered was that France had a different distribution model than other countries and that our products did not fit well into that model. Consequently, nearly eight years later, we still have negligible sales in France.

We continue to exhibit internationally and find the trade shows to be very useful. As attested to by our growth internationally, export sales is a cornerstone of our success. As we look to other markets, we are very interested in utilizing more services from the US Commercial Service, especially the Gold Key services.

Gold Key Recommendations

I believe that the Gold Key service can be improved in two significant ways. First, I believe that the people who work for the US Commercial Service are the biggest asset in helping exporters and that more money and time should be spent on finding great people and training them. I believe this is important both in the US offices and foreign offices. This will help to ensure that the level of service is high and comparable across all offices. I also believe that with great people and strong training, the representatives will better know what questions to ask novice exporters to ensure that their first exporting experience is profitable. Second, I believe that the fee to use Gold Key should be eliminated. Other countries, such as Canada, provide a great deal of free assistance to their exporters. We should have the same, long-term approach to helping US companies succeed. I do believe in general that services are more highly valued when the participants pay for their participation. However, with Gold Key, the participants are still contributing money toward all the



related travel expenses to the foreign country, along with sample costs and staff time. These contributions are significant for small companies and do, I believe, fully commit the company to participating because they do have real costs involved.

Export Barriers

Identifying Compatible Partners and Markets

As mentioned above, the US Commercial Service has been helpful in the search for compatible partners and markets. This is the biggest challenge for a small company where there is little time or money to waste on an export venture that is not successful and profitable. Because the risks of failure are high, the more that can be understood before exporting, the better the outcome. Because West Paw Design makes a consumer product that competes directly with much less expensive product, most often produced in Asia, we have to select a market where demand for the high-quality, US-made products exists. This often means that we can not simply select the most established, biggest and most successful partner. The search is complex and requires time and diligence. Many of the benefits of our product make it unique – for example the fact that our products and company are very environmentally friendly. Also, that our products are safe for use in the home and with pets and in fact many of our products are certified by a third-party organization to build confidence. West Paw Design needs assistance getting into new markets and help understanding the business models and cultures.

High Prices

Our prices have been affected most positively in recent years by the weaker US dollar. This has been among the most significant benefits to our international sales. While the complexities of currency rates are difficult to understand and predict, we are very thankful for the opportunity this has brought the company. However, our costs are still high on account of the benefits we provide to our staff and the safe work conditions we offer. Many competing products do not have the cost that we incur because they are made by companies without the same standards for employees.

Logistic Challenges

Our freight costs are relatively high, which is in part due to our location in Montana, but also due to the sheer distance to our markets in Europe and Australia. Our overseas distributors often order containers of product from China. They find it easy to consolidate shipments from various factories to reduce shipping costs. When they order from West Paw Design in Montana, there is no opportunity to consolidate locally and only occasional opportunities to consolidate in a US port. Because of the usual paperwork to ship products from the United States to foreign countries, along with payments and logistical issues, there is an increase in overhead costs to our foreign distributors that acts as a deterrent to ordering.

Intellectual Property

West Paw Design has invested significantly in product design, materials, packaging, and branding. These elements are worth protecting and we are diligent in doing so domestically. The cost to register trademarks and patents in foreign markets is high and has not been something we have done. However, I also see a role the US Government can play in helping to protect the innovation and intellectual property (IP) of small companies. Without strong and fair protection, IP infringement reduces the value of our innovation and can prevent us from expanding into countries where we perceive



there to be little protection. For example, I see the pet supply market in China as a rapidly growing opportunity. I am not comfortable selling into that country because I believe our designs and materials will be copied and used in the pet market.

Export Opportunities

Free Trade Agreements

Free trade is a benefit to both countries when the Free Trade Agreement is fair for both countries. As a proponent of FTAs in general, I look forward to benefiting from them as I have the opportunity to sell in those countries. However, I believe that although small companies like mine may know about the FTAs, many will not necessarily prioritize exporting to these specific countries with FTAs. My experience is that I first look toward the market, economic trends and sales opportunities. Small companies don't have the experience or staff to understand FTAs and will generally seek a larger sales opportunity before investing in a smaller market despite the FTA.

However, NAFTA is a tremendous advantage for us and we are very thankful for our sales to the Canadian market. Competing product coming from outside NAFTA has a 6.5 percent to 18 percent tariff, which is not applied to our products, which helps to keep them competitive in that market. Another example of an FTA that is benefiting us is with Australia. As mentioned above, our transportation costs to Australia are far greater than many of our competitors that ship from China. There is a General Rate tariff in Australia of 5 percent and yet it is 0 percent on our US products. This 5 percent is a real help in creating a more competitive marketplace for our products.

USA Brand Image

Over the last year I have heard some positive comments about the more open and cooperative position the US is taking in its view to the world community. I believe that the reemergence of a positive "Brand USA" is a great benefit to US exporters. When the US acts as a collaborative member of the global political and economic community, it reflects positively on US companies, products, and citizens. In all our business dealings we desire to support the positive image of the US and its people. It is a benefit to West Paw Design and small exporters that this positive image is also supported by our country's policies and actions.

Global Concerns that Impact Competitiveness

Protectionism

As a proponent of liberal trade, I believe that innovation is born out through quality education, a free business environment and strong competition. West Paw Design has great competitors in the United States and also in our export markets. When the onslaught of inexpensive plush dog and cat toys from Asia started to erode our traditional sales, we invested in something we had never done before — we developed a plastic moldable material called Zogoflex. Competition forced us to innovate and in doing so, opened the company up to a world of opportunity. Zogoflex is now our top revenue-generating product category.



I am reminded of the free spirit that accompanies the Winter Olympics Games that are currently underway. The competition pushes athletes, who come from all over the world, to develop new techniques to out-perform their competition. There are no barriers that create disadvantages for athletes from different countries. It is a quest for perfection and innovation that is at the heart of this competition. We should remember that American companies perform best when the competition is open and fair.

Human Rights and "Fair Trade"

I believe that we have a real opportunity to enhance trade while also enhancing the livelihoods of US citizens and also poorer world citizens. The United States needs to increase its efforts to enforce basic human rights initiatives that protect individuals who help make the products many Americans buy. To only talk about ending child labor, forced labor, and slave labor is to ignore the real cost of these dire conditions. We must demand that our trading partners and the products they provide have a higher and more consistent degree of regard for basic human rights. By doing so, we not only help to foster a more just and better world, but we also more fairly reflect the true costs of producing products. By encouraging more "fair trade" with our partners we will also be able to compete in a fairer and more just manner.

Global Pollution and the Environment

Pollution is an issue that also affects the cost of global trade. West Paw Design is known for going above and beyond regulations to help protect the environment. That is our choice and is how I have chosen to run the company. However, many products in the United States are made with less environmental impact than similar products produced in developing economies, such as China. Agreeing to global standards regarding the environment will not only benefit the Earth, but also help to better assess the impact of harmful manufacturing practices that keep competing products at an artificially low cost. The environmental costs impact all of us on the globe and also unfairly undervalue the true price of products.

Summary

The livelihoods of approximately six employees depend on our export sales. Those people depend on a well-functioning global marketplace, from which West Paw Design attains 16.9 percent of its revenue. By making the US Commercial Service an even better organization through great hiring and training and by providing more manufacturers access to its programs by eliminating fees, US small manufacturers can grow their exports and increase employment.

Closing

Chairman Baucus, Ranking Member Grassley, and Committee Members, thank you for this opportunity. I appreciate your time and interest in helping small and mid-sized manufacturers be more successful and create new jobs.

**Senate Finance Committee Hearing
Tax and Trade Issues Relating to Small Business
February 23, 2010
Responses to Questions for Spencer Williams, President, West Paw Design**

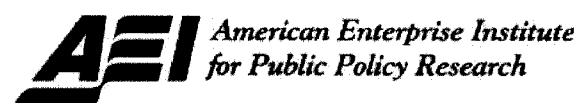
Questions from Senator Baucus

1. Exports have helped West Paw Design grow. They have generated new sales and created many new, good-paying jobs. And that is exactly what this economy needs right now. What are the most significant challenges you have faced in developing new export markets and increasing your exports? What steps could this Committee take to help you increase your exports?
 - a. The most significant challenge was knowing what made us “Export Ready.” That had less to do with the mechanics of exporting, such as transportation methods and marketing materials. Our challenges mostly centered around our products and sales systems. For example, I initially believed products that sold well in the United States would in turn sell well in Europe, which was not the case. We initially struggled to determine which products were well suited for specific foreign markets. Regarding our sales systems, we had not adequately researched pricing models for export to understand what the landed costs would be to the consumer. We also had not researched the distribution methods enough to know how unique they were relative to the US and relative to other foreign markets.
 - b. The Committee could take the following steps to help West Paw Design and small businesses like ours increase exports. First, increase funding to the US Commercial Service to accomplish two objectives: 1) increase the training of those responsible for market research and partner selection and 2) increase hiring as needed for additional high-quality and qualified professionals. With the goal of doubling US exports in 5 years, more staff will likely be needed to support the needs of US companies. Both of these objectives will ensure the greatest probability of a positive outcome for US exporters. Second, I believe that there needs to be more effort put toward the evaluation a company’s “Export Readiness” and assistance to quickly help small businesses become “Export Ready.” This could be accomplished through existing programs from the US Commercial Service and the Export Assistance Centers. It could also be further advanced through a relatively new program called ExporTech, which is a collaboration of many groups, including the US Commercial Service and the Manufacturing Extension Partnership.
2. Mr. Williams, you testified earlier about some of the challenges you face as a small business owner in reaching export markets. Have you used any of the federal programs designed to help small businesses overcome these challenges? Do you have any recommendations on how we can improve these programs?

- a. West Paw Design has taken advantage of federal programs that were designed to help us with the challenges of export. A specific program we have used is the US Commercial Service's Gold Key Matching Service in France. We have also used the Export Assistance Center to connect us with Foreign Commercial offices in Germany, Singapore, Taiwan and Japan. We have used the extensive reporting found at Export.gov to better understand market potential and trends. Through the Commercial Service we have exhibited our products at a catalog show in Taiwan, researched foreign duty rates and VAT charges, identified Harmonized System (HS) classifications, learned about managing risk with export credit insurance and International Commercial Terms (INCOTERMS).
 - b. My recommendations for these are first to promote them to other manufacturers because they are very helpful and difficult for small companies to obtain in the private sector. Second, I have heard different US Commercial Service staff members mention that the quality of work can differ depending on location. This seems to be a well-known issue. In my personal experience the staff member who used to serve Germany was not as willing to help small companies, like mine, as compared to the representatives I was working with in France. Therefore, I would also recommend that there be a greater focus on quality so that all the contacts in the world-wide operations of the US Commercial Service deliver great results. This focuses on training and hiring, as mentioned in my response to the first question.
3. Yesterday the Senate passed the Hiring Incentives to Restore Employment (HIRE) Act. One provision included in that legislation would keep the Section 179 expensing limits at the same levels as 2008 and 2009. In addition to the higher thresholds, we have also heard a number of businesses asking that we expand the types of property that may be expensed to include buildings and structural components, air conditioning and heating units, and leased property.
 - How would expanding the types of property that may be expensed under Section 179 help businesses create jobs?
 - a. First, I'm very supportive of the HIRE Act's inclusion of the Section 179 limits at 2008 and 2009 levels. This is a real benefit to companies because it encourages investments that can improve efficiency and open new markets. I do not believe that expanding the types of property under Section 179 would help to create jobs as many jobs as continuing to focus on the current property types under Section 179. The equipment that is purchased should be closely related to the production of goods and services.
 - How would you rank these additional types of property in order of effectiveness in helping to expand jobs?
 - a. I would rank them as follows: buildings, air conditioning and heating units, and leased property.

4. I also have a few questions about what incentivizes people to start new small businesses.
- What tax provisions might motivate people with good ideas to start businesses?
 - a. Allow for faster deduction of startup-related costs.
 - b. Provide greater deductions on the cost of health insurance for startup companies for 1-3 years. Many potential business owners fear the cost of health care because they are small enterprises and do not qualify for group discounts. If the cost of health insurance were able to provide for greater tax deductions, the benefits would be two-fold: first, the startup business would be more likely to provide insurance, helping to ensure that the individuals and their few employees would be healthier and second, they would save taxes.
 - c. Easy R&D tax credits. The paperwork is complex for companies and accountants, that many businesses don't take advantage of them. Easing the process of obtaining R&D tax credits will also help to encourage more investment in good ideas, knowing that their would be a reward for that investment. Assuming that investment is marketable, the business would likely grow quicker.
 - Would increasing business start-up deductions encourage people to start businesses?
 - a. Yes, I believe that this would provide an incentive, as noted above.
 - Would creating tax-free savings accounts to allow people to save to start businesses encourage people to start businesses?
 - a. I don't know a lot about this idea, but it seems like it may help in the long term. However, because saving money takes time, I do not believe it would have a big impact on our current economic climate. However, as a believer in the concept of saving and trying to encourage Americans to save more, I am supportive of this idea.
 - How quickly do new businesses begin to hire employees once they begin?
 - a. My trade experience is based around the observations I've had of the US Pet Market after the early 2000 recession during the years 2001 through 2003. During that time I saw individuals start many new, innovative and successful pet retail operations. Often they had started with only employed ownership and within a period of 6 months to 2 years they had hired staff to help them run the business. In general I believe that on average startup companies do not hire staff within the first year, but then do so starting in the second year.

COMMUNICATIONS



Statement for the Record

Senate Committee on Finance

February 23, 2010 Hearing, "Trade and Tax Issues Relating to Small Business Job Creation"

Statement Submitted March 9, 2010

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The views expressed in this testimony are those of the author alone and do not necessarily represent the views of the American Enterprise Institute.

Chairman Baucus, Ranking Member Grassley, and Members of the Committee: Thank you for the opportunity to submit this statement to the Committee regarding tax issues pertaining to small businesses and job creation. This statement draws heavily on an article that we recently published on the taxation of big and small business.¹

We laud the Committee's interest in job creation, but urge the Committee to broaden its focus beyond small businesses. Economic policy should focus on creating jobs at firms of all sizes.

Favoritism toward small business is gaining additional momentum in the debate over how to avoid the jobless recovery that we experienced in the previous two recessions. Policies directed toward small businesses are at the heart of President Obama's plan to revive the economy, as outlined in his State of the Union address and his fiscal 2011 budget. The president proposed a credit for business hiring that would be limited to \$500,000 per firm (thereby preventing large firms from reaping its full benefit) and a program to increase lending to small businesses. As discussed in more detail below, the president has also proposed the elimination of capital gains tax on certain stock in small businesses and the extension of expanded Section 179 expensing. These policy changes, if enacted, would add to the long list of policies that favor small firms.

In this statement, we describe some of the current and proposed policies that favor small over big businesses and then critique the arguments that have been offered in support of such favoritism. We conclude by advocating that policy encourage job creation at firms of all sizes.

The Policy Tilt toward Small Business

Numerous tax and spending measures are rooted in the misperception that small businesses play a unique role in job creation in the U.S. economy:²

- On the spending side, the Small Business Administration (SBA) offers contract preferences, loan guarantees worth nearly \$28 billion, and other assistance to small firms.³ The stimulus package passed last year provided \$730 million in additional

¹ Alan D. Viard and Amy Roden, "Big Business: The Other Engine of Economic Growth," *AEI Tax Policy Outlook*, June 2009, available at <http://www.aei.org/outlook/100051>.

² For more complete discussions, see Jane G. Gravelle, "Federal Tax Treatment of Small Business: How Favorable? How Justified?" *NTA Proceedings of the 100th Annual Conference (2007)*, available at www.ntanet.org/images/stories/pdf/proceedings/07/017.pdf (accessed June 10, 2009); Eric Toder, "Does the Federal Income Tax Favor Small Business?" *NTA Proceedings of the 100th Annual Conference (2007)*, available at www.ntanet.org/images/stories/pdf/proceedings/07/018.pdf (accessed June 10, 2009); and Andrew B. Lyon, "Tax Reform and Small Business" (testimony, Committee on Small Business, U.S. House of Representatives, April 10, 2008), available at www.house.gov/smbiz/hearings/hearing-04-10-08-tax/testimony-04-10-08-lyon.pdf (accessed June 1, 2009).

³ Ben R. Craig, William E. Jackson III, and James B. Thomson, "Are SBA Loan Guarantees Desirable?" *Federal Reserve Bank of Cleveland Commentary*, September 15, 2004, available at www.clevelandfed.org/Research/Commentary/2004/0915.pdf (accessed June 10, 2009); and Emily Maltby, "\$700M for Small Business in Obama's Budget," *CNNMoney.com*, March 3, 2009.

funding for the SBA's emergency lending activities, and the president's fiscal 2011 budget allocates almost a trillion dollars for the agency's yearly operations, a 21 percent increase over the agency's 2010 funding.⁴

- Smaller firms have greater ability to avoid the corporate income tax because they can more easily organize as sole proprietorships, partnerships, or limited liability companies, which are not subject to corporate income tax. Even if a small firm organizes as a corporation, it can still choose subchapter S status and thereby avoid corporate income tax if it has one hundred or fewer stockholders and meets certain other conditions. In contrast, large, publicly traded firms have no choice but to pay corporate income tax. Their income is then subject to double taxation, with corporate tax imposed at the firm level and dividend and capital gains taxes imposed (at a preferential 15 percent rate) at the stockholder level.
- Even among firms that are subject to the corporate income tax, smaller firms face lower tax rates. While large corporations pay a 35 percent rate on their taxable income, small corporations pay 15 percent on the first \$50,000 of taxable income and 25 percent on the next \$25,000. Also, corporations with gross receipts of less than \$5 million are exempt from the corporate alternative minimum tax.
- The net operating loss carryback relief offered by the 2009 stimulus legislation was initially limited to firms with gross receipts of less than \$15 million. Although legislation enacted in November 2009 extended some relief to larger firms, small firms continue to enjoy more favorable treatment than large firms.
- Tax discrimination against large firms has been particularly conspicuous in the oil industry. A tax break known as percentage depletion is available to independent oil producers, but not to integrated, generally larger, producers that refine as well as drill. Small oil producers also get more generous tax treatment for intangible drilling costs.

A few provisions deserve special mention because changes to them are now being considered:

- Section 179 of the Internal Revenue Code gives small firms more generous tax treatment on their equipment and software investments. For 2008 and 2009, this provision, as expanded by the 2009 stimulus legislation, allows firms with less than \$800,000 of such investments to deduct immediately the first \$250,000 when they are made rather than depreciating the costs over time. For big firms, however, the amount that can be immediately deducted is reduced dollar-for-dollar as equipment and software investments rise above \$800,000, until the provision completely phases out at \$1.05 million. President Obama has proposed that these higher values be extended through 2010.

⁴ "Small Business Administration." The Budget for 2011 Fiscal Year available at <http://www.whitehouse.gov/omb/budget/fy2011/assets/business.pdf>.

- Investors are also allowed to exclude from taxable income 50 percent (75 percent in 2009 and 2010) of capital gains on stocks in businesses that have less than \$50 million of assets, if the stock is originally issued and is held for at least five years. President Obama has proposed that the exclusion be increased to 100 percent.

The critical question is whether the preferences for small business, either in current law, or in the new proposals, are warranted. As discussed below, economic theory and evidence clearly call for neutral treatment of firms of all sizes.

Is Small Business Special?

Despite the extensive favoritism for small firms, there is no economic rationale for most of the preferential provisions. To begin, there should be no illusion that a preference for small business over big business is a way to provide tax relief to people with lower incomes. In fact, the bulk of small business income goes to high-income households; in 2006, households in the top two income tax brackets received 72 percent of all income from noncorporate firms and S corporations.⁵ Indeed, an advantage of large firms is that their ownership shares can be publicly traded on stock exchanges, making it easier for ordinary workers and investors to buy shares, either directly or through pension funds and mutual funds.

The most common argument for preferential treatment of small business--its uniquely powerful role in job creation--does not stand up under scrutiny. To begin, the statement that small firms create the majority of jobs does not imply that they play a unique role in job creation. No matter how jobs are distributed across firm sizes, one can always find some threshold size such that firms smaller than that size account for a majority of jobs.

Careful statistical studies do not assign any special role to small firms. Instead, such studies have largely reaffirmed Gibrat's Law, formulated by Robert Gibrat in 1931, which holds that there is no relationship between a firm's employment size and its growth rate of employment.⁶ As Federal Reserve Bank of Cleveland economists Ben R. Craig and James B. Thomson and University of North Carolina professor William E. Jackson III noted in 2004, "economic studies find little evidence to support" the claim that small businesses are an important source of employment growth.⁷ In their authoritative book on job creation and destruction, Steven J. Davis

⁵ U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness" (background paper, July 23, 2007), 15, available at www.ustreas.gov/press/releases/reports/07230%20r.pdf (accessed June 11, 2009). See also Jane G. Gravelle, "Federal Tax Treatment of Small Business: How Favorable? How Justified?"; and Gene Steuerle, "When Is It Best to Tax the Wealthy? (Part 2 of 2)," *Tax Notes*, December 19, 2005, available at www.taxpolicycenter.org/UploadedPDF/1000858_EP_121905.pdf (accessed June 10, 2009).

⁶ For further explanation and evidence of Gibrat's Law, also known as the Law of Proportional Effect, see John Sutton, "Gibrat's Legacy," *Journal of Economic Literature* 35, no. 1 (1997): 40-59.

⁷ See Ben R. Craig, William E. Jackson III, and James B. Thomson, "Are SBA Loan Guarantees Desirable?"

of the University of Chicago and AEI, John C. Haltiwanger of the University of Maryland, and Scott Schuh of the Federal Reserve Bank of Boston dismiss what they call the “small business job-creation myth,” concluding that “conventional wisdom about the job-creating prowess of small businesses rests on statistical fallacies and misleading interpretations of the data.”⁸

Davis, Haltiwanger, and Schuh, along with other authors, emphasize the “regression fallacy” that arises from temporary changes in firm employment. Most of the studies computing job gains between two dates classify firms as big or small based on their size at the earlier date, a practice that inflates job gains at small firms.⁹ When a firm that has temporarily become small due to a recent setback regains its former position, a job gain for a small firm is recorded; when a firm that has temporarily become large due to a recent expansion falls back to its prior position, a job loss at a large firm is recorded. Opposite results are obtained if the firms are classified as large or small based on their employment at the later date.¹⁰

It is also important to look at net, rather than gross, job gains. For any category of firms and time period, gross job creation is the sum of job gains at those firms that added jobs during the period. Conversely, gross job destruction is the sum of job losses at those firms that reduced jobs during the period. Net job creation is equal to gross job creation minus gross job destruction. As Davis, Haltiwanger, and Schuh--and others--document, smaller firms have proportionately higher rates of gross job creation than larger firms. Unfortunately, small firms’ high gross job creation is offset by high gross job destruction. Davis, Haltiwanger, and Schuh conclude that “[i]n a nutshell, net job creation in the U.S. manufacturing sector exhibits no strong or simple relationship to employer size.”¹¹

Recent research by Giuseppe Moscarini of Yale University and Fabien Postel-Vinay of the University of Bristol finds that small firms tend to report stronger employment growth than large firms during periods of economic weakness but weaker employment growth during upturns, with little net difference across the overall business cycle.¹²

⁸ Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction* (Cambridge, MA: MIT Press, 1996), 57, available through www.aei.org/book/824.

⁹ Véronique de Rugy, “Are Small Businesses the Engine of Growth?” (Working Paper 123, AEI, December 8, 2005), available at www.aei.org/paper/23537.

¹⁰ Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, 66-70. For a vivid illustration of the regression fallacy, see Cordelia Okolie, “Why Class Size Methodology Matters in Analyses of Net and Gross Job Flows,” *Monthly Labor Review* (July 2004): 10, available at www.bls.gov/opub/mlr/2004/07/art1full.pdf (accessed June 10, 2009).

¹¹ Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, 10-11, 60-62; and Véronique de Rugy, “Are Small Businesses the Engine of Growth?”

¹² Giuseppe Moscarini and Fabien Postel-Vinay, “Large Employers Are More Cyclically Sensitive” (Working Paper 14,740, National Bureau of Economic Research, Cambridge, MA, February 2009), available at www.nber.org/papers/w14740.pdf (accessed June 10, 2009).

While there may be no strong pattern of differences in net job creation between large and small firms, one difference is well established: jobs at large firms tend to feature higher wages and other desirable attributes. In the words of Davis, Haltiwanger, and Schuh, “A large body of empirical research documents that, on average, larger employers offer better wages, fringe benefits, working conditions, opportunities for skill enhancement, and job security.”¹³

Distorting the Economy

Even if small firms play no unique role in job creation, one might think that tax policies that favor small firms over big ones are harmless. Unfortunately, that is not true. Preferences for some firms over others interfere with the market’s allocation of resources and disrupt the efficient workings of the economy.

Consider a simple example in which the profits of small firms are taxed at a 20 percent rate and those of large firms are taxed at a 50 percent rate. (These numbers are purely illustrative and do not correspond to actual tax rates.) Investors are willing to invest in any project that provides at least a 4 percent after-tax rate of return. Thus, they will invest in all small-firm projects that yield at least 5 percent before tax and all large-firm projects that yield at least 8 percent before tax.

The good news is that this tax system does not end up treating anyone unfairly. Although investors in large firms are taxed more heavily, they are compensated by a higher before-tax return. Since all investors clear 4 percent after tax, no one can complain about unfair treatment.

The bad news is that this tax system wastes resources and causes inefficient production, reducing the amount of output that can be produced from the total investment funds available. All large-firm projects with before-tax returns below 8 percent fail to go forward because they cannot provide a 4 percent return after paying the 50 percent tax. Yet, small-firm projects that yield as little as 5 percent go forward. Output would be higher if funds were reallocated away from small-firm projects that yield 5 or 6 percent to large-firm projects that yield 7 or 8 percent.

With neutral tax treatment, the market would produce an efficient allocation of resources. If both sectors were taxed at 33 percent, all projects yielding more than 6 percent before tax would go forward in both sectors, while all projects yielding less than 6 percent would not. There would then be no way to reallocate funds to achieve higher total output. Uneven tax treatment blocks this efficient outcome. Furthermore, neutral tax treatment would still be appropriate even if small firms really did create more jobs than large firms. If small firms have a competitive advantage in job creation, they will be able to exploit that advantage in a neutral tax environment.

¹³ Steven J. Davis, John C. Haltiwanger, and Scott Schuh, *Job Creation and Destruction*, 170-71.

In one respect, placing heavier taxes on large firms is worse than other types of uneven tax treatment because it imposes a built-in penalty on growth. For example, Section 179 puts a penalty on increasing equipment and software investment above \$800,000 because each additional dollar invested reduces the amount that can be immediately deducted.

There is no reason for tax and spending policy to tilt the scales between big and small firms.¹⁴ There is nothing inherently bad about being big.

Conclusion

Small business has played, and will continue to play, an important role in the American economy. But the role of big business is equally important. Public policy should protect firms of all sizes from unnecessary taxes and regulation. And, job creation efforts during the current recession should apply to firms of all sizes. We urge the Committee to heed the testimony offered by Chris Edwards at the hearing:

“Congress should focus on creating a simple, neutral, and pro-growth tax structure for all American businesses, large and small ... A new job at a multinational computer chip maker is certainly as valuable as a new job at the corner restaurant, and probably more durable.”¹⁵

In particular, we urge that incentives for the hiring of new workers not be capped per firm. There is no reason why the benefits of the incentive should be limited at big firms. Also, as Eric Toder of the Urban Institute noted in his testimony, limiting the credit in this manner means that large firms continue to receive a credit, but have no direct incentive to hire more workers.¹⁶

As policymakers continue to honor small business as an engine of economic growth, they should give equal recognition to big business, the other engine of economic growth.

¹⁴ There is one legitimate reason for tax policy to distinguish between small and large firms. The cost of complying with tax and regulatory provisions is often proportionately greater for small firms than for large firms, which can put small firms at a competitive disadvantage and can justify offering them relief from some compliance burdens. But, this rationale has little relevance to the job-creation measures now under consideration.

¹⁵ Statement of Chris Edwards before the Senate Committee on Finance “Tax Issues Related to Small Business Job Creation,” February 23, 2010 (<http://finance.senate.gov/hearings/testimony/2010test/022310cettest.pdf>), p.1.

¹⁶ Statement of Eric J. Toder before the Senate Committee on Finance, “Tax Issues Related to Small Business Job Creation,” February 23, 2010 (<http://finance.senate.gov/hearings/testimony/2010test/022310tetttest.pdf>), p. 5.

Senate Finance Committee

February 23, 2010

“Tax and Trade Issues Related to Small Business Job Creation”

**Statement for the Record from
The National Venture Capital Association
1655 Ft. Myer Drive, Suite 850
Arlington, VA 22209**

The National Venture Capital Association (NVCA) appreciates the opportunity to submit a statement on important tax issues related to small business job creation. The NVCA represents the interests of approximately 425 venture capital firms in the United States which comprise more than 90 percent of the venture industry’s capital under management.

Company formation and job creation is fundamental to the venture capital business model. A venture capitalist’s job is to find, invest in and nurture new businesses with the goal of growing these companies exponentially over the long term. Last year, the venture capital industry invested more than \$17.6 billion into nearly 2400 start-up companies in the United States. Companies that were founded with venture capital and grew to become publicly-traded entities today account for 12.1 million US jobs. We estimate that more than half a million Americans are employed at private venture-backed start-ups today. Venture capitalists invest consistently in both bull and bear markets – and remain committed to finding the best and brightest ideas and transforming them into thriving companies and employers.

NVCA has a long history of supporting policies that foster a vibrant entrepreneurial ecosystem and reward long term, high risk investment in small, emerging growth businesses. One such policy has been the Qualified Small Business Stock (QSBS)

incentive program enacted in IRC Section 1202 in 1993 under President Clinton. The program was designed to reward long term (5 years or more) investors in small businesses by excluding from gross income 50 percent (and in the case of investment in empowerment zones, 60 percent) of the gain recognized on the sale or exchange of qualified small business stock. In enacting that policy, Congress sought to address one of the critical challenges for small, emerging growth companies – access to capital. During the economic downturn in the early 1990s, high-growth entrepreneurial companies helped pull our country towards economic recovery and put us on a path toward the growth and innovation that we experienced for the balance of the decade. From 1990 to 1993, firms employing between 100 and 499 people – the category that includes most emerging high growth companies – created new jobs at twice the rate of larger companies.ⁱ

Unfortunately, in practice, the QSBS program has never really worked as intended. The provisions of the program have been too onerous and require a high degree of technical knowledge to which most investors in small businesses do not have access. As a result, the majority of investors do not even apply for consideration. Furthermore, while this exclusion appears advantageous at first blush, it currently offers at most only a one percent tax savings. Both the Taxpayer Relief Act of 1997 and the Jobs and Growth Tax Reconciliation Act of 2003 lowered capital gains rates generally, without providing for a similar reduction in the rates applicable to Section 1202. As a result, Section 1202 produces an effective tax rate of 14 percent (*i.e.*, 50 percent of Section 1202 gain is excluded from tax while the remaining 50 percent is taxed at a 28 percent rate), as compared to the 15 percent capital gains rate that applies generally. In addition, the alternative minimum tax (“AMT”) has further reduced the benefit of Section 1202.

Recent proposals from the Administration would expand that exclusion to 100 percent, effectively eliminating the tax on any long term capital gains. Equally important, last year Senator Kerry along with Senator Snowe introduced S. 78, the “Invest in Small Business Act.” to amend the QSBS rules and thereby bolster desperately needed financing for our country’s small, entrepreneurial companies. We applaud in particular

Senator Kerry's unwavering efforts to recognize the value of long-term investment and to address many of the long-standing concerns with the statute. We believe strongly that there is an opportunity to strengthen the positive impact of the program and realize the benefits that Congress intended with legislation that addresses the major challenges of the current policy. A detailed description of the problematic provisions and potential fixes are included in this statement as Addendum A.

When enacting QSBS, Congress and the Administration recognized that certain investing activity has positive economic externalities beyond those directly received by the company and the investor. Providing additional capital gains tax incentives was seen as a way to encourage an activity that has broad community implications and national economic importance in the area of company formation and job creation. We find ourselves with a similar opportunity today, except that we are facing proposals that - in the venture context - are directly contradictory. While changes to QSBS would increase the capital gains incentive for early stage investing, current carried interest legislation would move in the opposite direction, stripping away the capital gains benefit for venture capitalists. A change to carried interest tax policy would supersede QSBS tax incentives for venture capitalists and undermine long term investment in small businesses

Carried interest is the portion of profits that a venture capitalist shares in when the companies in which they invest with their partners become successful and go public or become acquired for a gain. It is earned over a long period of time - if at all - and has motivated the venture capital industry for decades. When venture capitalists earn carried interest it is because an asset - a company - was created from scratch and has grown to the point that it is a thriving employer, with ongoing growth potential and worthy of a return to investors. It is what Congress intended when enacting capital gains tax legislation.

By rescinding the capital gains tax incentive for the venture community, Congress would jeopardize the job creation and investment in small business it is trying to support through increasing the QSBS capital gains tax incentive. Without adequate incentives to

take long term risks, there will likely be a steady reduction of venture capitalists, a lower risk threshold of existing venture capitalists, and overall fewer companies funded. The NVCA's position on this issue is publicly available from previous hearings and we continue to welcome the opportunity to work with lawmakers to better understand the implications of this policy.

At a time when Congress is looking to create jobs – as evidenced by this hearing – we should be doing all we can to support venture investment in new businesses. By revising the QSBS program requirements and working toward a carried interest tax policy that supports venture capital investment in emerging growth companies, Congress will not only be sending a clear signal of support to the job creators but will be solidifying the incentives necessary to ensure that company formation and job creation continue to thrive within the venture capital ecosystem.

The NVCA is eager to work with this Committee to enact rational tax policies that support job creation and motivate investors to build businesses. We are available to answer questions and discuss further these issues as we move forward.

ⁱ *The State of Small Business: A Report of the President*, 1998. Table A2, page 184.

SMALL BUSINESS STOCK INCENTIVES—TIME FOR A FRESH APPROACH

By Lisa D. Sergi, Scott S. Jones and Mary B. Kuusisto

Given the current economic upheaval as well as the impending rise of capital gains tax rates at the end of 2010 (or possibly sooner under a new administration), the time has come to re-examine tax incentives for investments in small businesses. The case for using tax incentives in this way—particularly in light of the federal government’s willingness to use enormous amounts of taxpayer funds to combat the financial crisis—is quite compelling from an economic perspective.

To cite just a few relevant statistics, the Small Business Administration reports that small businesses have generated 60 to 80 percent of all new jobs each year for the last decade.¹ Furthermore, in 2005, small businesses hired 40 percent of all high-tech workers, comprised 97.3 percent of all identified exporters and produced 13 times more patents per employee than large firms.² In addition, venture-backed companies employed over 10.4 million Americans and generated \$2.3 trillion in revenue in 2006, corresponding to 9.1 percent of U.S. private sector employment and 17.6 percent of the nation’s GDP.³

Unfortunately, the existing tax incentives for investments in small businesses—including a 50-percent exclusion for gains under Section 1202,⁴ tax-deferred rollover of gains under Section 1045 and ordinary loss treatment under Section 1244—have never really provided the intended incentive to invest in small businesses because the provisions are too limited and contain technical drafting issues. With relatively few changes, however, these provisions could be fixed to provide the incentives that Congress originally intended and that may be needed now more than any time in recent history.

This article examines the existing incentives (and their inherent problems), discusses recent proposed legislation to correct these provisions and suggests some additional fixes.

EXISTING SMALL BUSINESS STOCK INCENTIVES UNDER SECTIONS 1202 AND 1045

Section 1202

For non-corporate taxpayers, Section 1202 excludes from gross income 50 percent (and in the case of investment in empowerment zones, 60 percent) of gain recognized on the sale or exchange of qualified small business (“QSB”) stock (as defined below) held for five years or

¹ For an in-depth look at employment dynamics by firm size from 1989 to 2005, see www.sba.gov. The SBA’s definition of a small business is complex and based upon different factors, including NAICS classification, number of employees and annual receipts.

² See www.sba.gov.

³ *Venture Impact: The Economic Importance of Venture Capital Backed Companies to the U.S. Economy* by Global Insight, revised for 2006 data. This report is available at www.nvca.org.

⁴ Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder.

more.⁵ As discussed below, however, there are numerous additional limitations that apply to both issuers and shareholders in order to qualify for this exclusion. Unfortunately, these limitations have rendered Section 1202 largely inapplicable.

Furthermore, while this exclusion appears advantageous at first blush, it currently offers at most only a one percent tax savings. Both the Taxpayer Relief Act of 1997 and the Jobs and Growth Tax Reconciliation Act of 2003 lowered capital gains rates generally, without providing for a similar reduction in the rates applicable to Section 1202. As a result, Section 1202 produces an effective tax rate of 14 percent (*i.e.*, 50 percent of Section 1202 gain is excluded from tax while the remaining 50 percent is taxed at a 28 percent rate), as compared to the 15 percent capital gains rate that applies generally. In addition, the alternative minimum tax (“AMT”) has further reduced the benefit of Section 1202.

Definition of QSB Stock

Both the partial gain exclusion of Section 1202 and the gain rollover election of Section 1045 (as discussed below) apply only to QSB stock.⁶ Stock of a corporation is treated as QSB stock only if all of the following criteria are met:

- The stock was originally issued after August 10, 1993, the date of the enactment of Section 1202;⁷
- The issuer satisfies the “C corporation requirements;”
- The stock satisfies the “original issuance requirement;”
- The issuer satisfies the “QSB requirement;” and
- The issuer satisfies the “active business requirement.”

For a company to meet the “C corporation requirements,” it must be a domestic C corporation,⁸ and must have been a C corporation during substantially all of the shareholder’s holding period of the stock.⁹ Today, however, many small businesses are organized as S corporations or as limited liability companies (“LLCs”) since, within the last 10 years, all 50 states have adopted LLC statutes. LLCs and S corporations can provide the same limited liability as a C corporation, but with pass-through tax status. Because of this changing trend in organizational form, many interests in small businesses do not qualify as QSB stock.

Stock satisfies the “original issuance requirement” only if the shareholder acquires the stock at its original issuance for money, property or services provided to the company.¹⁰ Neither stock of another corporation nor underwriting qualify as property or services for this purpose.¹¹ In addition, the original issuance requirement provides extensive rules regarding when a

⁵ IRC Section 1202(a)(1).

⁶ IRC Sections 1202(c) and 1045(b)(1).

⁷ Revenue Reconciliation Act of 1993, P.L. 103-66, Section 13113.

⁸ IRC Section 1202(d)(1).

⁹ IRC Section 1202(c)(2)(A).

¹⁰ IRC Section 1202(c)(1)(B).

¹¹ IRC Sections 1202(c)(1)(B)(i) and 1202(c)(1)(B)(ii).

redemption by the company will void the original issuance.¹² These rules further the intended policy of infusing capital into small businesses themselves rather than working to provide early liquidity to owners. While there may be the need for some revision to the redemption rules to account for founders that need additional financing to bring their start-up companies to viability, the original issuance requirement generally is satisfied by owners of venture-backed companies. Venture capitalists typically invest their capital directly into companies alongside the companies' founders early on (rather than purchasing stock from prior owners) in order to achieve the long-term appreciation attributable to the growth of a company.

A company satisfies the "QSB requirement" only if it meets two separate gross asset tests. First, the aggregate gross assets of the issuer must not have exceeded \$50 million at any time on or after the enactment of Section 1202 (August 1993) and before the issuance of the QSB stock.¹³ Second, immediately after the issuance, the aggregate gross assets of the issuer—including any amounts received by the issuer in the issuance—must continue to be no more than \$50 million. There are several problems with this test. First, in certain cases, aggregate gross assets may be hard to measure, which makes compliance uncertain. While the assets are generally measured at their adjusted tax basis, this is not true for contributed property, which must be measured at fair market value upon contribution. Often small businesses are initially formed by their founders with little business or record-keeping experience. While it might seem odd that a start-up company could have \$50 million of aggregate gross assets, the founders likely would have contributed intangible assets such as patents or other know-how at the company's inception. In hindsight, if the intellectual property is found to have been the driver of a very successful company, the fair market value of that contribution could be challenged if not documented properly upon original contribution.

In addition, the measurement dates and dollar limitation can discourage follow-on investments and investments in capital-intensive businesses. While future growth of a company in excess of \$50 million does not disqualify previously issued QSB stock, it would prevent follow-on investments in that issuer from qualifying as QSB stock. These provisions, therefore, work to discourage the type of long-term commitment to a start-up company that is necessary to support growth throughout its life cycle and until it achieves financial success for its owners and the economy. For example, the aggregate gross assets of an alternative energy company or a biopharmaceutical company can be quite significant because of the capital-intensive nature of the business, and the company might need even more capital infusions in order to bring the product to market and become profitable. For this reason, follow-on investments should be measured only by reference to the investor's original investment in the company (assuming that interest is still held), and the \$50 limitation million should be increased. In both cases, this will help bring companies in many industries to economic success.

An issuer meets the "active business requirement" if, during substantially all of a shareholder's holding period, (1) it uses at least 80 percent of its assets (by value) in the active

¹² IRC Section 1202(c)(3)(B) and Treasury Regulations Section 1.1202-2.

¹³ IRC Section 1202(d)(1)(A). The \$50 million gross assets limit generally is determined with regard to the tax basis of the issuer's assets. Thus, an issuer may be deemed to have less than \$50 million in gross assets even though the fair market value of those assets exceeds \$50 million. Unfortunately, assets that are contributed to an issuer generally are required to be valued at their fair market value (rather than tax basis) as of the contribution date, which can create significant uncertainty for hard-to-value assets, such as intellectual property.

conduct of one or more “qualified trades or businesses,” and (2) the issuer is an “eligible corporation,” which generally is any domestic C corporation other than certain enumerated specialty corporations.¹⁴ Valuation of assets to comply with the first prong of the active business requirement can be problematic, particularly with respect to working capital and, as discussed above, contributed intangible assets. Furthermore, excessive holdings of portfolio securities or real estate will disqualify a corporation from meeting the active business requirement; holdings of greater than 10 percent are considered excessive.¹⁵ In addition, specific guidelines apply with regard to certain activities and particular assets, including start-up and research assets, working capital and computer software royalties.¹⁶ Finally, it may be very difficult (and burdensome, given the various special rules) to determine whether the active business requirement has been satisfied during substantially all of a shareholder’s holding period, as this requires constant measurement during that holding period. This complexity would be greatly reduced, without significantly affecting the policy of encouraging investment only in active businesses, by instead requiring that a company must be engaged in a trade or business under the general rules of Section 162 (and which trade or business is otherwise a qualified trade or business) in order to have its stock qualify as QSB stock.

A “qualified trade or business” generally is any trade or business other than the following: (1) one involving the performance of certain enumerated services (*e.g.*, law, health, engineering) or one where the principal asset is the reputation or skill of one or more of its employees; (2) any banking, insurance, financing, leasing, investing or similar business; (3) any farming business; (4) any business involving the production or extraction of minerals; and (5) any operation of a hotel, restaurant or similar business.¹⁷ Although there are valid policy reasons for excluding certain of the enumerated businesses from the QSB incentives, others that are excluded require the incentives that QSB stock may provide. For example, healthcare services is a burgeoning start-up field that can greatly enhance the economy and quality of our healthcare system. Engineering, consulting and financial services also seem too broad to be included in a blanket exclusion.

Section 1202 Limitations

Even if an investor holds stock that otherwise meets the definition of QSB stock, other requirements and limitations apply, which as mentioned above, have largely eliminated the benefits of Section 1202.

First, an investor must hold QSB stock for more than five years to be eligible for the exclusion.¹⁸ Certain rules for including the holding period of previously held stock and limitations apply with regard to the QSB stock holding period. For example, if a partner receives QSB stock from a partnership, the partner includes the partnership’s holding period only if the partner received his or her partnership interest prior to the partnership’s purchase of the QSB

¹⁴ The following corporations are not eligible corporations: a DISC or former DISC, a corporation for which a Section 936 election is in effect, a regulated investment company, real estate investment trust or real estate mortgage investment conduit or a cooperative. IRC Section 1202(e)(4).

¹⁵ IRC Sections 1202(e)(5)(B) and 1202(e)(7), respectively.

¹⁶ IRC Section 1202(e)(2).

¹⁷ IRC Section 1202(e)(3).

¹⁸ IRC Section 1202(a)(1).

stock.¹⁹ From a business perspective, the five-year holding period requirement is simply too long, especially if each follow-on round of investment in a company must have its own five-year holding period. Small businesses are funded over their entire life cycle to minimize losses, but incentives to invest over that entire life cycle are legitimate.

Second, the gain realized by an investor with respect to a particular issuer that is subject to the Section 1202 exclusion is limited to the greater of (a) \$10 million (reduced by the aggregate amount of gain taken into account by the investor under Section 1202 with respect to that issuer in any prior year); and (b) ten times the aggregate adjusted basis of QSB stock of that issuer disposed by the investor during the taxable year.²⁰ Many small businesses are capitalized by venture capital funds that invest a pool of capital in 10 to 25 companies. Very often, the great majority of these companies lose money or nearly break even. It is the expectation of a disproportionate reward that drives venture capitalists to invest in “dry wells.” Eliminating the incentive for high risk/high reward investments would seem counter to supporting truly successful companies.

Third, AMT further reduces any potential benefit of Section 1202. Under existing rules, a portion of the gain excluded from gross income under Section 1202 is treated as a preference item and added back to the taxpayer’s income for purposes of computing his or her alternative minimum taxable income.²¹ Currently, only 7 percent of the gain excluded under Section 1202 is added back for AMT purposes, but 28 percent of such gain generally will be added back beginning in 2011.²²

For example, if QSB stock were sold at a gain of \$400, then \$200 generally would be excluded from gross income, but 7 percent of that excluded gain (or \$14) would be added back for AMT purposes (and 28 percent, or \$56, would be added back as of 2011). Given that the current long-term capital gain rate is 15 percent, if the \$400 gain were attributable non-QSB stock, it would bear a tax liability of \$60. Under the AMT regime, \$214 would be taxed at the AMT rate of 28 percent for a tax liability of \$59.2. As of 2011 under the AMT regime, \$256 would be taxed at 28 percent for a tax liability of \$71.68. Obviously, a *de minimis* tax savings currently and a higher tax burden after 2011 provides no incentive at all.

Fourth, Section 1202 is not elective. If an eligible investor disposes of QSB stock, the disposition will be subject to Section 1202 if the other requirements are met. Therefore, an investor who does not want Section 1202 to apply (*e.g.*, in order to avoid falling within the AMT regime) must intentionally fail one of the Section 1202 requirements.

Finally, only non-corporate taxpayers may take advantage of Section 1202.²³ As a result, corporations that wish to invest in small businesses cannot receive the benefits of the 50 percent exclusion. From a tax policy perspective, corporate taxpayers should be encouraged to invest in small businesses in the same way as non-corporate shareholders.

¹⁹ IRC Section 1202(h)(2)(C).

²⁰ IRC Section 1202(b).

²¹ IRC Sections 57 and 55(b)(2)(B).

²² IRC Section 57(a)(7).

²³ IRC Section 1202(a)(1).

Section 1045

Enacted in 1997, Section 1045 was intended to allow investors that sell QSB stock²⁴ to defer gain recognition by reinvesting the sales proceeds in new QSB stock within 60 days (*i.e.*, a 60-day rollover). Gain on the sale of QSB stock qualifies for roll-over treatment only if all of the following conditions are met:

- The investor is not a corporation;²⁵
- The investor sells the stock;²⁶
- The stock is a capital asset in the hands of the investor;²⁷
- The investor has held the QSB stock for more than six months;²⁸ and
- The investor makes an election to apply the Section 1045 provisions.²⁹

Unlike Section 1202, the Section 1045 election allows an investor to sell the QSB stock before the five-year holding period has elapsed, as long as the investor has held the stock for more than six months and is willing to re-invest the proceeds in another QSB. As originally enacted, the rollover was available only for QSB stock held by individuals. The IRS Restructuring and Reform Act of 1998, however, extended rollover treatment for QSB stock held by any taxpayer other than a corporation (*i.e.*, non-corporate partners of partnerships and S corporations).

The QSB issuing the replacement stock must meet the “active business requirement” (as discussed above) for the six-month period following its purchase.³⁰

If a Section 1045 election is made, gain from the sale is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement QSB stock purchased by the investor, reduced by any portion of the cost of the replacement QSB stock that was previously taken into account under Section 1045.³¹ The replacement QSB stock, however, must be acquired during the 60-day period beginning on the date of sale of the original QSB stock.

To the extent that capital gain is not recognized, the deferred gain will reduce the basis of the replacement QSB stock. The basis adjustment is applied to the replacement QSB stock in the order such stock is acquired.

A Section 1045 election must be made on or before the due date (including extensions) for filing the income tax return for the tax year in which the QSB stock is sold. If an investor has more than one sale of QSB stock in a tax year that qualifies for the Section 1045 election, the

²⁴ Under IRC Section 1045(b), QSB stock has the same meaning as provided in IRC Section 1202(c).

²⁵ IRC Section 1045(a).

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ IRC Section 1045(b)(4)(B).

³¹ IRC Section 1045(a).

investor makes a Section 1045 election on a case-by-case basis and can elect Section 1045 for all or only a portion of the shares held.

Applicability of Section 1045 to Partnerships and Partners

On August 13, 2007, the IRS and Treasury adopted final regulations providing rules regarding the application of Section 1045 to various situations involving partnerships and their partners. In general, the regulations broadly allow QSB stock gain rollovers to be accomplished through partnership structures, but place very strict limits on rollovers of gain attributable to “carried interest” to which venture capitalists are entitled.

Before the new regulations were issued, it generally was understood that (1) a partnership could sell original QSB stock and purchase replacement QSB stock, (2) a partnership could sell original QSB stock and one of its partners could purchase replacement QSB stock, or (3) the partnership could distribute original QSB stock to a partner, who sells the original QSB stock and purchases replacement QSB stock.³²

The new regulations, however, clarify that if a partnership sells original QSB stock and allocates the corresponding gain to one of its partners, then that partner may acquire replacement QSB stock through another partnership and qualify for Section 1045 rollover treatment. Similarly, if a partnership distributes QSB stock to a partner and that partner sells that QSB stock, then that partner may acquire replacement QSB stock through another partnership and qualify under Section 1045.³³

This clarification is beneficial for venture capitalists and other investors. Since venture capital and other private investment funds typically make all of their stock purchases during a limited investment period, the only practical way for a venture capitalist or other investor to obtain replacement QSB stock may be through a successor (or other) private investment fund.

Under Section 1045, a partner is entitled to rollover benefits in respect of QSB stock acquired by a partnership only to the extent that the partner held an interest in the partnership at the time of the initial QSB stock acquisition and throughout the period during which the QSB stock was held by the partnership. Prior to issuance of the new regulations, it was unclear how to measure a partner’s “interest” in a partnership, where allocations of profit and loss reflect a carried interest held by the general partner.

Unfortunately, the new regulations define “interest” in a partnership in a manner that prevents the rollover of QSB stock gain attributable to a general partner’s carried interest. Specifically, the new regulations provide that the amount of gain a partner may roll over in respect of QSB stock held by a partnership cannot exceed (i) the partner’s smallest percentage interest in partnership capital from the time the QSB stock is acquired until the time the QSB stock is sold, *multiplied by* (ii) the partnership’s realized gain from the sale of that QSB stock. In addition, the new regulations provide a corresponding rule to limit the rollover amount with respect to QSB stock that has been distributed by a partnership and sold by the recipient

³² See IRC Section 1045(b)(5) referencing IRC Section 1202(g).

³³ Treasury Regulations Section 1.1045-1(c)(1)(i).

partner.³⁴ Applying QSB treatment to carried interest holders would be a significant incentive to provide targeted relief for venture capitalists that invest in start-up companies. So long as carried interest is provided for at the inception of a venture capital fund, extending the incentive to carried interest holders should not be viewed as abusive.

CURRENT LEGISLATIVE PROPOSALS

Kerry/Snowe Bill

On April 25, 2007, Senators John Kerry and Olympia Snowe introduced Senate Bill 1214, the “Invest in Small Business Act of 2007,” to increase the exclusion for gain under Section 1202 and make other modifications applicable to certain small business stocks. As currently drafted, S.1214 amends Section 1202 as follows:

- Increases the exclusion of gain from the sale or exchange of QSB stock from 50 to 75 percent;
- Reduces the required holding period for QSB stock from five to four years;
- Provides for a 100 percent exclusion of gain from such stock sold by a business in an empowerment zone (currently such exclusion is 60 percent);
- Permits corporate taxpayers the exclusion, denying it only for QSB stock held by a 25 percent controlled corporate group, which are those corporations filing consolidated tax returns; and
- Revises the definition of a QSB to mean a C corporation with aggregate gross assets not exceeding \$100 million, adjusted for inflation after 2007 (currently, the limit is \$50 million with no inflation indexing).

S.1214 also provides certain additional amendments to other provisions of the Internal Revenue Code to enhance the benefits of Section 1202, including a repeal of the AMT preference for QSB stock and repealing the 28 percent capital gains rate on QSB stock. Although S.1214 is an important step in the right direction, some additional changes (as discussed below) would further encourage investments in small businesses. At this time, the status of S.1214 is uncertain. Upon its introduction, the bill was read into the record and referred to the Committee on Finance, but there has been no further action since that time.

Childers Bill

On July 16, 2008, Congressman Travis Childers introduced House Bill 6507, the “Invest in Small Business Act of 2008,” to modify Section 1202. The provisions of this bill are nearly identical to S.1214, with two additional improvements. First, unlike S.1214, which provided a 75 percent exclusion from gain, H.R.6507 would exempt all gain on the sale of QSB stock that met the holding period requirement. Second, H.R. 6507 would shorten the holding period

³⁴ Treasury Regulations Section 1.1045-1(d)(2).

requirement from five to three years. The bill was referred to the House Committee on Ways and Means on July 16, 2008, and no further action has been taken.

SOME SUGGESTED FIXES TO SECTIONS 1202 AND 1045

The following are some recommendations regarding Sections 1202 and 1045.

- *Extend the benefits of Sections 1202 and 1045 to investors in Subchapter S corporations and other forms of legal entities, such as LLCs and partnerships, which otherwise meet the requirements of Sections 1202 and 1045.*

Currently, the benefits of Sections 1202 and 1045 are available only for investors who purchase and hold domestic C corporation stock. These tax provisions, however, should encourage investments in all small business, regardless of their legal forms.

- *Increase the gross asset test to \$150 million, and thereafter index for inflation.*

Under the current provisions, the issuer must not have aggregate gross assets in excess of \$50 million at any time after August 1993 and before the issuance of the QSB stock. \$50 million no longer reflects the size of small businesses in America, and the limitation needs to be indexed to inflation or it may quickly become ineffective again even if the gross asset test is increased.

- *There should be a total exclusion for all capital gains on QSB stock if the required holding period is met.*

Although it may be difficult in the current fiscal environment, particularly in light of the pay-go rules, all capital gains ideally should be eliminated on the sale or exchange of QSB stock if held for the required holding period to encourage the necessary investment in small businesses.

- *The holding period for QSB stock should be shortened.*

A shorter time frame than the current requirement of a five-year minimum holding period would encourage more investors to make capital investments in small businesses, but could still be longer than the one-year requirement for long-term capital gain treatment generally, in order to promote a stable capital base for small businesses.

- *Eliminate the \$10 million/10x basis limitation on gains subject to Section 1202.*

This limitation does not promote investments in small businesses. Investors should be encouraged to invest in small businesses that are high risk and similarly offer the potential for a high return multiple. Unfortunately, many small businesses fail, and therefore venture capitalists and other investors often rely on a small number of big “winners” to compensate for losses on other small business investments. Tax incentives should not discourage this portfolio approach by placing limitations on the amount of excludable gain.

- *Elimination of AMT preferences for the excluded amount under Section 1202.*

This avoids the current “zero sum game” of granting exclusions and then recapturing those benefits of exclusion through the AMT, thereby eliminating the incentive effects of Section 1202.

- *Allow all corporate investors (other than corporations included in the same consolidated returns) to take advantage of the benefits of Sections 1202 and 1045.*

Corporate taxpayers should be encouraged to invest in small businesses.

- *Require the aggregate gross asset test to be satisfied only one year prior to the stock issuance date and provide an exception for follow-on investments where the investor still holds stock that originally qualified as QSB stock. In addition, allow contributed property to be valued based upon tax basis, rather than fair market value.*

The aggregate gross asset test is difficult to apply and results in too much uncertainty. There should be a single measurement date prior to the issuance of the QSB stock, and an exception should apply to QSB stock holders who make follow-on investments, since additional investments typically are required for a small business to prosper, even if that business has outgrown the technical definition of “small.” Furthermore, contributed assets should be valued at tax basis, as many small businesses require the contribution of hard-to-value assets, like intellectual property.

- *Redefine the active business requirement to mean any trade or business under Section 162, other than accounting, legal, actuarial, farming, insurance, banking or hospitality businesses, and remove the 80 percent asset requirement.*

The active business requirement is too complicated. Other than the enumerated businesses listed above, the requirement for an active business should comport with Section 162, which is the provision that governs the definition of an active business for income tax purposes generally. In addition, the 80 percent asset value test is too difficult to measure and should not be required if the company is engaged in a business for Section 162 purposes.

- *The 60-day rollover requirement under Section 1045 should be increased.*

The current 60-day period is too short. Although some time limit is appropriate, a longer period would give venture capitalists and other investors more time to find suitable qualified replacement QSB stock while encouraging re-investments in small businesses.

- *Amend Section 1045 so that the rollover would apply to a partner who receives a disproportionate profits share of QSB stock gain (or distributions of QSB stock) and obtains replacement QSB stock (whether directly or indirectly through another partnership).*

The rollover benefit of Section 1045 should not be limited to a partner’s capital interest in a partnership, but rather to that partner’s share of partnership profits (including any carried interest) as agreed to among the partners through the partnership agreement.

SECTION 1244

Section 1244, which was originally enacted in 1958, is the oldest of the three small business tax incentive provisions. It provides ordinary loss treatment to individuals who recognize a loss on “small business stock” (directly or indirectly through partnerships) that was originally issued in exchange for money or property by a “small business corporation” (“SBC”). As is the case for Sections 1202 and 1045, significant limitations apply to both the issuer and the investor in order to qualify for the ordinary loss treatment under Section 1244. These limitations are discussed below.

Definition of SBC Stock

Unfortunately, Section 1244 uses different definitions than Sections 1202 and 1045. A sale of stock qualifies for ordinary loss treatment under Section 1244 only if it is SBC stock³⁵ (not QSB stock as required under Sections 1202 and 1045). In general, to qualify as SBC stock, the following requirements must be met:

- The stock may be common or preferred stock (but, if issued before July 14, 1984, it must be common stock);³⁶
- The issuer must be a domestic corporation;³⁷
- The issuer must be a SBC (discussed below);³⁸
- The stock must be issued for money or property (other than stock or securities);³⁹ and
- At the time the loss is incurred, at least 50 percent of the corporation’s gross receipts must have been from an active trade or business for the five most recent tax years ending before the date on which the loss arose.⁴⁰

The definition of an SBC is extremely limiting. To qualify as an SBC, the corporation’s receipt of equity investments up through the time of the stock’s issuance must be no more than \$1 million.⁴¹

Limitations on Investors and Other Shareholders

Section 1244 provides ordinary loss treatment only to shareholders that:

- Are individuals who invest directly or through partnerships;
- Recognize a loss on SBC stock;
- Where such stock was originally issued to them;

³⁵ IRC Section 1244(a).

³⁶ IRC Section 1244(c)(1).

³⁷ *Id* and IRC Section 7701(a)(4).

³⁸ IRC Section 1244(c)(1)(A).

³⁹ IRC Section 1244(c)(1)(B).

⁴⁰ IRC Section 1244(c)(1)(C).

⁴¹ IRC Section 1244(c)(3)(A).

- For money or property;
- By a domestic SBC; and
- Not in excess of the annual limit.

Only individuals and partnerships⁴² may utilize Section 1244.⁴³ Individual partners may benefit only if they were partners at the time the SBC issued the stock to the partnership.⁴⁴ In addition, the ordinary loss deduction is limited to the lesser of (1) the partner's proportionate share of profits/losses at the time of the issuance of the stock, and (2) such share at the time the loss is sustained.⁴⁵

Furthermore, the benefits of Section 1244 are available only to individuals and partnerships that acquire the stock at original issuance.⁴⁶ An individual or partnership that acquires the stock from a shareholder by purchase, gift, devise or in any other manner is not entitled to an ordinary loss under Section 1244.⁴⁷ Various other provisions define the original issuance requirement.

For purposes of Section 1244, a loss transaction includes a sale or exchange of stock, worthlessness and liquidation of an insolvent corporation.⁴⁸

In any single taxable year, the amount of loss that an individual may treat as an ordinary loss under Section 1244 is limited, whether or not the Section 1244 stock was issued by one or more corporations, to \$50,000 (or \$100,000 in the case of a joint return).⁴⁹

Some Suggested Fixes to Section 1244

Although changes to Sections 1202 and 1045 are of primary importance, the following are some recommendations regarding Section 1244 that, in conjunction with the previously recommended changes, would further encourage investments in small businesses.

- *Adopt the definition of a QSB used under Sections 1202 and 1045.*

The current \$1 million limitation on all prior receipts of equity capital is far too low and does not include an adjustment for inflation. It would be more appropriate to use the definition of a QSB (as amended per the recommendations above) for both simplicity and, more importantly, to encourage investments in businesses that are small by modern standards.

- *Eliminate the yearly limitation on the amount of ordinary loss an investor can deduct under Section 1244.*

⁴² Despite the pass-through nature of an S corporation, S corporation shareholders are not entitled to report ordinary loss as a result of a corporate sale of SBC stock. *Rath v. Comr.*, 101 T.C. 196 (1993).

⁴³ IRC Section 1244(a).

⁴⁴ Treasury Regulations Section 1.1244(a)-1(b)(2). This provision is identical to the provision for Sections 1202 and 1045 and is used to prevent selling the benefits of Section 1244.

⁴⁵ *Id.*

⁴⁶ IRC Section 1244(a).

⁴⁷ Treasury Regulations Section 1.1244(a)-1(b)(2).

⁴⁸ Treasury Regulations Section 1.1244(a)-1(a).

⁴⁹ IRC Section 1244(b).

Currently, in any single taxable year the amount of loss that an individual may treat as ordinary loss under Section 1244 is limited to \$50,000 (or \$100,000 in the case of a joint return). To encourage investments in high-risk small businesses, there should be no limitation on ordinary loss treatment for small business investments.

CONCLUSION

In light of the worldwide financial crisis and imminent U.S. tax rate increases, Congress should move quickly to fix the existing tax incentives for investors in small businesses. With relatively few changes, Sections 1202, 1045 and 1244 can be amended to work as originally intended and encourage investments in small business which in turn will create new jobs and spur American innovation, technology and economic growth.

