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Small Business Legislative Council Statement for the Record
U.S. Senate Finance Committee
"Business Tax Reform" Hearing

September 19, 2017

Please accept the foregoing statement of the Small Business Legislative Council (SBLC) for the record in response to the U.S. Senate Finance Committee's September 19, 2017 hearing on "Business Tax Reform."

The SBLC is a 35 year old permanent, independent coalition of over forty trade and professional associations that share a common commitment to the future of small business. SBLC members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, and agriculture. SBLC policies are developed by consensus among its membership.

While the SBLC strongly supports efforts to make the tax system simpler and more manageable, it is critical that tax reform not come at the expense of small businesses and their employees. Already, in the House Blueprint and the President's outline, there have been proposals that are deeply concerning for small business and that could undermine small business' role as a critical driver of growth and job creation in this country. As discussed further below, the SBLC urges the Committee to reject these problematic ideas and use tax reform as a vehicle to help, rather than hinder, small businesses.

Tax Rates for Pass-Through Entities

Greater parity is needed between the tax rates for pass-through entities and C corporations. However, if a new system is created for taxing pass-through entities, the new lower rates should be available to all pass-through entities and the applicable rules should be clearly outlined in the legislation itself and structured to ensure that they do not have the unintended effect of disrupting the small business retirement plan system.

Under the current tax laws, pass-through businesses, which constitute the large majority of business enterprises and employ over half of the employees in the United States,[1] are at a disadvantage when compared to publically and privately held C corporations. Unlike pass-through

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[1] Drs. Robert Carroll and Gerald Prante, *The Flow-Through Business Sector and Tax Reform* at pg. 5, Appendix B, Ernst & Young (April, 2011).

entities, regular C corporations separately report their taxable income and pay income tax on that taxable income. Under current law, the top marginal rate for C corporations is 35%, whereas the top marginal rate for income earned through S corporations, partnerships and sole proprietorships is 39.6% (passive investors are also subject to an additional 3.8% net investment tax). ***This gap needs to be narrowed or eliminated. If the C corporation rate is going to be reduced through tax reform, the rate for income from pass-through entities must be as well.***

Both the President's outline and the House's Blueprint include proposals to reduce the tax rate for pass-through entities by creating a distinction between "active business income" and "reasonable compensation for services." This type of system would require owners of pass-through entities to take compensation for their services, which would be taxed at their personal income tax rate, and then allow them to receive other business income subject to a much lower tax rate. ***Provided that the reservations discussed below are adequately addressed, the SBLC strongly supports this concept.***

First and foremost, if a new structure, like the one noted above, is going to be introduced for taxing pass-through entities, it is essential that the rules for its application be clear and outlined in the legislation itself. While the concept of distinguishing between "active business income" and "reasonable compensation for services" sounds relatively simple, the rules for determining what constitutes reasonable compensation for services have the potential to become very complex. Small businesses do not have the same financial or administrative capacity to navigate complicated rules that their larger counterparts do. It is therefore important that the rules be clear and easily understood and applied. To ensure that this is the case, it is important that Congress clearly articulate the framework in the law itself rather than delegating the power to the IRS to do so. Even if the current Administration has given assurances that new tax regulations will not be overly complex, delegating authority to the agencies to add detail to a tax reform law leaves open the possibility (and we would argue makes it likely) that, over time, the law's goal of simplification will be lost amidst increasingly complex regulations.

Another consideration that the SBLC urges the Committee to address in considering a new tax system for pass-through entities, is the implications that a reduced tax rate for business profits could have on the small business retirement plan system. Most small business owners view the administrative costs associated with maintaining a plan and the meaningful contributions that they make for non-key employees as the price of being able to save in a qualified retirement plan for themselves. If the small business owner has the opportunity to take profits out at a rate that is significantly lower than his or her individual tax rate that would apply to retirement funds at the time they are withdrawn, the small business owner is going to take the money out of the business at the reduced rate and invest it elsewhere. In turn, if the small business owner has no financial motivation to save in a retirement plan, the small business is much less likely to create a new plan or continue to offer an existing plan. This would be a significant blow to employees and be counter to the goal of encouraging increased retirement savings. To avoid this problem, if a small business owner is going to be required to take a certain amount from the business as "reasonable compensation for services" before the reduced tax rate will apply, it is important that the contributions towards the retirement plan count towards reasonable compensation for services. Logically, this makes sense as the idea behind the distinction is to ensure that a certain amount of the business' income is being taxed at the business owner's standard individual rate and anything that is saved in a retirement plan will be subject to the individual rate when it is withdrawn. Additionally, it will continue to motivate small business owners to sponsor retirement plans that will allow them, and their employees, to save for the future.

Finally, if a new system is introduced to provide lower rates for certain pass-through income, that lower rate should be available for all pass-through businesses. Attempting to exclude certain types of pass-through businesses from a new lower rate would be unjust and would require the introduction of yet more complex tax rules that small businesses already struggle to navigate.

Business Interest Deduction

Small businesses rely on debt financing not equity to establish themselves and survive. The elimination of the business interest deduction would therefore be severely damaging to small business growth and success.

Both the President's outline and the House Blueprint have proposed to eliminate the business interest deduction in lieu of a move towards allowing full and immediate expensing. While the SBLC supports immediate expensing, eliminating the business interest deduction would result in dramatic loss of financing options for small businesses, making it much more difficult for new businesses to start and existing businesses to thrive.

Small businesses rely heavily on traditional debt financing. Unlike equity financing, debt financing allows small business owners to maintain their ownership of, and control over, their businesses. Moreover, many alternative or creative funding options aren't available to small businesses, particularly in their early years. Eliminating the business interest deduction would result in a double tax on the interest itself. Without the business interest deduction, before being paid as interest, the amount would be taxable to the business, but then would still be taxed as income to the lender. As the result of this treatment, and the increased costs and decreased gains that it will cause, those lenders that traditionally service small business clients, like community banks, are likely to reduce their borrowing options. This will make it more difficult for small businesses to get the debt financing they need and will strike a significant blow to the small business economy on which a huge part of the national economic stability depends.

Last In First Out (LIFO)

The last in first out method of inventory accounting (or LIFO) allows businesses in industries that face rising prices to most closely match the cost of goods sold with the cost of replenishing inventory. In other words, LIFO helps businesses maintain the status quo. Without LIFO, by allowing businesses to avoid being taxed on the portion of their sales

attributable to inflation and instead use that money to acquire or produce inventory to replace that which was sold.

The majority of the businesses using the LIFO inventory method are organized in the form of pass-through entities, such as partnerships or S corporations and are therefore taxed at the individual rate. Proposals to fund a reduction in the corporate tax rate by repealing LIFO would leave pass-through entities shouldering most of the burden of a rate reduction while receiving none of the gain.

Moreover, looking to prior proposals to eliminate LIFO, most of the revenue would be raised by a one-time recapture tax. This is a short sited approach that would be devastating for a wide range of businesses. Specifically, not only will the long term revenue stream created by a LIFO repeal be significantly smaller than the one-time recapture, but the one time recapture will also result in an unprecedented retroactive tax on businesses using LIFO. These businesses, have relied on existing tax laws, including the availability of LIFO, to manage their revenue streams, inventories and expenditures. Requiring them to go back and pay taxes on the past benefits that they received from the use of LIFO would wreak havoc on cash flows, capital reserves, expansion opportunities and job creation for American businesses using this method of accounting.

Health Insurance Premium Deduction/Exclusion

The current system which allows employers to deduct health insurance premiums and employees to exclude health insurance premiums from their income, has the very positive effect of encouraging employers to contribute towards health insurance premiums, and should be maintained.

Under the current system, an employer contribution towards an employee's health insurance premium provides a win for both the employer and the employee. The contribution helps the employee get health insurance and can be excluded from the employee's income. In turn, the employer gets to deduct the contribution, so, although it is providing a huge benefit to its employees, it is able to do so at a lower cost.

If the tax laws are changed in a way that would eliminate or reduce the benefit that employers get from contributing towards employee health insurance or reduce the benefit of these contributions to employees by making them taxable, it would cause many small business employers to give second thought to making such contributions. Employer contributions towards health insurance premiums are critical to helping many Americans afford health insurance and any change that would deter employers from making these contributions would be a move in the wrong direction.

The Small Business Retirement Plan System

The qualified retirement plan system, has been very successful in providing retirement security for a significant number of Americans. It is important that those provisions that have encouraged plan sponsorship among small businesses and saving by small business employees are not negatively impacted by tax reform.

As noted above, most small business owners are motivated to establish plans, and make contributions for their employees, by a desire to save for their own retirement. If the tax laws are changed to reduce the ability or appeal of saving in a retirement plan, small business owners will be much less likely to continue an existing plan or start a new plan.

Accordingly, so as not to disturb the current successful small business retirement system, the SBLC urges Congress to:

- Reject attempts to decrease the amount that can be saved in a qualified plan. If the amount that small business owners can save in a qualified plan is reduced, small business owners will be motivated to freeze or terminate plans once they themselves have hit that cap. This will mean that less small business employees will be offered a plan.

- Avoid changes that would quickly force saving out of a plan after the owner's death or otherwise do anything to make owners fearful of saving too much in a retirement plan. If small business owners are concerned that at their descendants who inherit their plans will be forced to take the money out over a short period of time and therefore face negative tax consequences, the owner will save less in the plan. This means that retirement savings overall will decrease, as will plan sponsorship.

- Protect the deductibility of employer contributions. As with health insurance, under the current tax system, when an employer contributes to an employee's retirement plan it is a win-win because the employer gets a deduction and the employee grows his or her retirement plan balance. If the deduction for the employer contribution is eliminated, employers will be far less likely to contribute towards an employee's retirement savings.

- Reject proposals to try to limit how much can be saved in a defined contribution plan pre-tax or subject existing defined contribution plan balances to taxes now, rather than at the time of their withdrawal (*i.e.* to move the bulk of the defined contribution retirement plan system towards Roths). Again, if small business owners don't see a tax benefit for themselves to save in the plan, they will be less likely to sponsor a plan. Moreover, if employees are taxed on contributions to a plan, they will be less likely to save, which, given that people are far more likely to save in employer-sponsored retirement plans than in any other vehicle, would reduce retirement savings overall.

Conclusion

As Congress tackles the challenge of tax reform this fall, we urge the Committee to consider how each proposed change could impact small businesses and their employees. Tax reform that pursues a lower corporate rate at the cost of eliminating the critical provisions that small businesses rely on to grow and succeed will be a move in the wrong direction. We look forward to working with this Committee to achieve meaningful tax reform that will benefit businesses of all sizes.

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