Statement for the record of
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Committee on Ways and Means
U.S. House of Representatives

Hearing on
How Business Tax Reform Can Encourage Job Creation
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Chairman Camp, Ranking Member Levin and Members of the Committee, thank you for the opportunity to submit written comments on the need for business tax reform to encourage job creation.

I have been a tax professional for over 35 years. For most of that time, I advised clients on tax matters as a partner with a Big Four accounting firm. I also served as tax counsel to former Senate Finance Committee member John Danforth (R-MO), and I have remained closely involved in the tax policy process over the entire course of my career, including the period leading to enactment of the historic Tax Reform Act of 1986.

As this Committee and Congress consider how our Federal tax code can foster job creation and growth, I ask you to remain acutely aware of the impact of any proposed changes in the tax law on small businesses, which generate most of the new jobs in our economy. As more fully explained in the written comments that follow, I hope that you will give full consideration to how proposals to lower the corporate tax rate and broaden the income tax base will affect small businesses organized using a flow-through structure or as sole proprietorships. Flow-through entities encompass partnerships, limited liability companies and S corporations.

Background on the Kogod Tax Center

The Kogod Tax Center is a non-partisan research institute of the Kogod Business School at American University in Washington, D.C. The Kogod Tax Center promotes independent research and expands knowledge with respect to tax policy, tax planning and tax compliance for small and mid-size businesses, entrepreneurs and middle income taxpayers.

We work closely with the Kogod Business School's Masters of Taxation (MST) program. Under the leadership of Professor Donald Williamson, who is widely known among tax professionals nationwide, the Kogod MST program in advanced taxation for accounting students is one of the most highly respected graduate tax programs in the country.

Our goal at the Kogod Tax Center is two-fold: (1) to increase public understanding of critical tax policy, planning and compliance issues and (2) to advocate for tax policies that promote job growth and innovation. Specifically, we focus on the tax law's impact on three core groups of the American economy: small businesses, entrepreneurs, and middle-income taxpayers. Together these core groups serve as our nation's economic engine. We believe their success will help pave the road—as they have in the past—toward a stronger, more competitive American economy

The Critical Importance of Small Business to the Economy

Small businesses are central to our country's cultural and economic foundations; they symbolize and embody the values of entrepreneurship, upward mobility, and innovation.

The small business sector is also the growth engine of our economy. Today, small businesses employ about half the U.S. workforce, and created 65 percent of our net new jobs over the past 15 years. They are the core not only of our domestic growth, but increasingly a critical component to competing in the global marketplace.

In debating the swiftest path to job creation, economic growth and deficit reduction, policymakers from across the political spectrum are beginning to call for significant corporate tax reform. Indeed, President Obama's fiscal year 2012 budget calls for ''Congress to work with the Administration on corporate tax reform that would simplify the system, eliminate . . . special interest loopholes, level the playing field, and use the savings to lower the corporate tax rate for the first time in 25 years.''

Many agree our corporate statutory tax rate—soon to be the highest in the world—hinders our economic competitiveness. The reasons for reducing it are compelling. But current proposals for corporate tax reform that would lower the corporate statutory tax rate and eliminate many traditional business tax deductions or credits (that is, "broadening the tax base") could have unintended consequences for small businesses. That is because the vast majority of small businesses are not structured as traditional "C" corporations, and thereby not taxed at the corporate rate. Rather, they are organized as flow-through entities or as sole proprietorships.

Therefore, simply reducing corporate tax rates and broadening the tax base without addressing the needs of unincorporated businesses could have an unintended and serious negative consequence: it would increase the tax burden on unincorporated businesses. That is not the type of action that would be productive as our nation continues to struggle to emerge from a deep recession and looks to the small business sector as a vital pillar supporting job and economic growth.

Flow-through Businesses In the U.S. Economy

Structurally, most small businesses are organized as sole proprietorships or flow through entities—partnerships, limited liability companies and S corporations. These entities are not taxed at the company level; rather, they ''flow through'' to their owners any income or loss. Individual owners report these amounts on their individual tax returns—and these amounts are taxed at individual tax rates.

Currently flow-throughs comprise more than 90 percent of all business entities, and individual owners of flow through entities pay over 40 percent of all business taxes.

Small businesses in particular benefit from the flow-through structure, because they are able to avoid the double taxation that applies to corporate income. Often faced with limited cash flow, a flow-through structure can provide a small business with the opportunity to reinvest more capital, expand services, hire more workers, and develop innovative technologies and business processes.

The Potential Impact of Corporate Tax Reform for Many Small Businesses

There is widespread agreement that the federal tax code is too complicated. The number of deductions, credits, phase-outs, alternative calculations, and more has reached mind-numbing proportions.

So far, most of the proposals for corporate tax reform discussed in the media rely primarily on eliminating some business deductions, preferences, and credits to increase the amount of income subject to tax, i.e. broaden the tax base, and then apply a lower corporate tax rate to that broader income base. In most of the proposals, under discussion, the base-broadening changes would apply to all businesses, including those that are flow-through entities and sole proprietorships.

If corporate tax reform moves forward in this way, small businesses will shoulder an increased tax burden because they would be subject to the base broadening effort but they would not benefit from the rate reduction benefits. This would happen at a particularly inopportune time as many small businesses are already struggling to stay afloat. This approach seems to make little sense if we are interested in growing our economy.

Comprehensive Business Tax Reform, Not Just Corporate Tax Reform

Congress faces three strategic alternatives with respect to reforming our business tax system. I would like to share my views on how each of these three strategic alternatives would affect small businesses that are sole proprietorships or organized using a flow-through structure such as a partnership, limited liability company or S corporation.

I would also like to comment generally on how each alternative advances the cause of good tax policy in the areas of sound tax administration, business competitiveness and jobs growth.

Alternative 1: Eliminate Certain Deductions, Preferences, and Credits Only for "C" Corporations, Lower Corporate Tax Rates, and Leave Current Rules Intact for Flow-through Entities.

This alternative would allow small follow-throughs to continue to benefit from current tax incentives, and to continue to be taxed under the current rules.

While this would seem fairer to small flow-throughs, this approach would create two tax systems, and add immense complexity to the Federal tax code, which most agree is something to avoid. This alternative also has a notable shortcoming: It would exclude flow-through entities from the economic and other benefits that come from simpler rules and lower rates.

Alternative 2: Eliminate Certain Deductions, Preferences, and Credits for All Businesses and Only Lower the Corporate Tax Rate.

This alternative would result in an increase in taxes for flow-through entities unless individual income tax rates are lowered simultaneously with corporate tax rates. However, lowering individual rates across the board would result in a significant reduction in revenue. Further, since individual tax rates are part of an integrated system, simply lowering the rates at which individuals are taxed without making concurrent changes to other individual tax rules is impractical. This raises the specter of having to reform the individual tax rules to reform business tax rules.

While the tax rules for individuals are every bit as much in need of reform as the business tax rules, there is a third alternative for Congress to consider that would allow reform of business taxes to move forward without having to reform the entire Internal Revenue Code.

Alternative 3: Eliminate Deductions, Credits and Preferences, and Apply the Same Reduced Corporate Rate—a Business Rate—to All Businesses Regardless of the Structural Entity by Which They Choose to Conduct Business

This alternative would be relatively simple to administer. Income from flow-throughs already appears on separate schedules on individual tax returns. Income from sole proprietorships is reported on Schedule C, and income from both partnerships and S corporations is reported on Schedule E of the individual tax return (Form 1040).

Under this alternative, all that would be required would be for a taxpayer who is an owner of a flow-through entity to add his or her income on those two schedules (C and E) together and subject the total to a reduced ‘‘business tax’’ rate schedule. This is what happens today for individuals who have qualifying dividend income and capital gains on schedules B and D. The remaining income on an individual’s return would be subject to tax under the individual income tax rules.

Conclusion

The Kogod Tax Center thanks the Committee for permitting us the opportunity to share our insights about how business tax reform can encourage competitiveness and job creation.

As you move forward on this extremely important undertaking to reform the Federal tax code, we ask you to give close examination to how changes might affect the vitality and competitiveness of small businesses, especially those organized as sole proprietorships or flow-through entities such as partnerships, limited liability companies and S corporations. Tax costs are often the largest expenditure of these businesses, and tax burdens have a direct impact on the ability of any business, especially a small business, to expand its operations and its payroll. We are not asking that you give special benefits to this vital sector of the economy but rather you not create any obstacles to its ability to grow.

The third alternative that we discuss above, namely eliminating deductions, credits and preferences, and applying the same reduced corporate tax rate (a business tax rate) to all businesses regardless of the structural entity by which they choose to conduct business, offers a sound approach that advances all of the Committee's goals and the goals of good tax policy overall.

A major advantage to this approach is that it would help to level the playing field for corporate and non-corporate entities. It would move us toward a single, comprehensive business taxation system—one that applies to all businesses equally across the board. If done right, it could ease compliance and increase simplicity and fairness. And ultimately, that could provide small businesses with the certainty they need in order to compete, thrive and create jobs.