July 27, 2011

The Honorable Max Baucus
Chairman
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Orrin Hatch
Ranking Member
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Dave Camp
Chairman
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

The Honorable Sander Levin
Ranking Member
United States House of Representatives
Committee on Ways and Means
1101 Longworth House Office Building
Washington, DC 20515

Dear Senators Baucus and Hatch and Representatives Camp and Levin:

Thank you for holding this joint hearing on the tax treatment of debt and equity. The current tax code is an immensely complex and burdensome system that directly affects how small businesses access, invest, and retain capital. An optimal tax code is one in which business decisions are based upon the underlying economics and not on the tax implications. We are far from an optimal tax code. Given the mammoth scope and complexity of the tax code, there is a tendency for most of the analysis surrounding taxes to focus on aggregate numbers and big businesses, while overlooking small business investors.

As you review your options for improving the tax code, it is critical to recognize that the economics of accessing capital for small businesses can often be profoundly different than for large or publicly traded businesses. The Joint Committee on Taxation's report is an expansive review of the tax treatment of debt and equity, but it is not focused on small business although the U.S. Small Business Administration's Office of Advocacy cites that over the past 15 years, small companies have created 64% of new net jobs[1]. I strongly encourage the Committee to specifically examine how changes to the code, particularly removing the deductibility of interest and raising capital gains taxes on equity investments, will affect the ability of investors to provide capital to small businesses.

[1] SBA Office of Advocacy (2011).

Large businesses have greater flexibility in setting their preferred capital structure. They can easily access capital via the equity markets, debt markets, or use complex structures not readily available to smaller businesses. Small businesses are often unable to create an optimal capital structure because they cannot access capital the way large businesses can. There are many small businesses that would rather attract equity investments and reap the benefits of long term capital. But small businesses are not able to attract equity investment like a public traded company, nor can small businesses access low cost debt like big businesses. These Large businesses can issue long-term, low-interest bonds, but small businesses cannot. While large businesses have access to large financial institutions and to new and complex financial instruments, small businesses are limited primarily to debt and occasionally equity. Small businesses investment is very different from other types of investing and changes to the tax treatment of debt or equity can affect these key job creators differently.

To oversimplify a bit, equity investments provide liquid capital on which the issuer of the equity generally has no requirement to pay interest. Investors taking equity stakes in large businesses view the investments as relatively low risk and fairly liquid investments. Further, because many are publicly traded it is relatively easy to assess market valuations.

None of the aforementioned are true for small businesses investors thus small businesses often have significant challenges accessing all types of investment, particularly equity. Small businesses do not have the balance sheets to withstand market shocks that large businesses can endure. Investors must also deal with the fact that market information is much harder to obtain and to assess when dealing with small businesses. Additionally, equity investments in small business are often illiquid, unlike publicly traded enterprises, therefore requiring more patience and an additional premium to account for this illiquidity.

Equity investments are important, but hard to come by for small businesses. Early stage companies that have not yet matured to produce a significant profit need equity investments as a source of capital because they do not yet have the cash flows to pay off debts. However, equity investors in small businesses generally invest with a relatively short term exit strategy to sell or redeem their equity in order to recover their principal and to realize a profit. Therefore, small businesses that are not going to be sold have a very difficult time accessing equity investments. Many great, job-creating small businesses are never going to go public. Good equity investors will bring significant business acumen and expertise to the business, but many entrepreneurs fear losing total ownership and control. For these reasons, equity alone is not likely to be the only source of capital.

Too much debt can be destructive to any business, but debt is a key component in a healthy capital structure. Debt is often critical to small businesses' ability to survive and thrive because it is the only form of investment the small business can access. Debt has the advantage of allowing the business owner to retain control of their business. Debt can also be refinanced, thereby letting businesses take advantage of changing economic conditions. For the investor, debt instruments are often collateralized, and thus reduce the risk. Debt valuations can be easier to ascertain and therefore can make it easier for an investor to approve the transaction. Investors can, but do not need to, sell their position to make a profit and can often retain the option to sell or transfer the note. These advantages offered by debt instruments are exceptionally important to small business investors who supply this type of capital.

As Congress reviews tax reform and the tax treatment of debt and equity, it will be critical to recognize that any action with the potential to increase the cost of capital must be reviewed with a specific focus on small businesses. Removing the deductibility of interest would be particularly detrimental to small businesses' ability to access and afford their primary lifeline to capital. Further, raising capital gains taxes on equity investments or changing the treatment of carried interest for small business investors would create new barriers to investment.

Tax reform and relief is needed. Good reform can facilitate investment in small businesses, resulting in growth that will create jobs and tax revenues. However, if this discussion is limited to aggregate numbers with large businesses as the sole model, jobs will be lost as small businesses perish.

Sincerely,

Brett T. Palmer
President

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Submission for Record

Joint Hearing on Tax Reform and the Tax Treatment of Debt and Equity – July 13, 2011

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