AED Government Affairs Office
121 North Henry Street
Alexandria, VA 22314
Telephone: 703.739.9513
Facsimile: 703.739.9488
E-Mail: aeddc@aednet.org

SMALL BUSINESS TAX REFORM: GROWTH THROUGH SIMPLICITY

STATEMENT OF TIMOTHY WATTERS, PRESIDENT & CEO, HOFFMAN EQUIPMENT CO., PISCATAWAY, NEW JERSEY

ON BEHALF OF ASSOCIATED EQUIPMENT DISTRIBUTORS BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON SMALL BUSINESS

Chairman Graves, Ranking Member Velázquez, and other distinguished members of the committee, my name is Tim Watters, and it is my pleasure to appear before you today both as a small business owner directly impacted by tax reform, and in my capacity as vice chairman of Associated Equipment Distributors' (AED) Board of Directors.

I am the president and CEO of Hoffman Equipment Co., an 87-year old family-owned business headquartered in Piscataway, New Jersey. Hoffman sells, rents, and services Case, Liebherr, Terex, JCB, Grove, Manitowoc, and other leading brands of construction equipment from five locations in New Jersey and New York. We have 65 employees and our distribution territory includes New York's 12th congressional district.

AED is the trade association representing distributors of construction, mining, energy, forestry, industrial, and agricultural equipment. AED has more than 500 members, ranging in size from small dealerships with one location and a handful of employees to larger companies with thousands of employees and dozens of locations across several states. However, the overwhelming majority of AED's members are small, family businesses; AED's average member achieves about $40 million per year in revenues and employs 80 people.

I appreciate the opportunity to come before the committee to discuss how the small business-dominated equipment industry fits into the tax code and suggest ways to improve it to spur economic growth and job creation.

Tax Reform & the Construction Equipment Industry

AED recently conducted the most comprehensive tax survey the association has completed in years. The results provided a highly reliable industry sample and a compelling snap shot of the tax code's impact on our industry.

To put in perspective, it's important to understand where the construction equipment distribution sector fits into the overall economy. Survey respondents reported collective annual revenues of approximately $11.3 billion in 2011 and more than 20,000 employees. Average sales per employee were $562,108. Projected across AED's entire membership, the association estimates its U.S. dealer members earned $26.67 billion in total revenues in 2011 and employ close to 47,000 people.

Based on an earlier economic study conducted by Stephen Fuller, Ph.D., the Dwight Shar faculty chair at George Mason University (GMU) in Fairfax, Virginia and director of GMU's Center for Regional Analysis, which found that each dollar spent at an equipment distributorship creates $3.19

in direct, indirect, and induced economic activity, AED estimates its membership's total economic impact at $85 billion.[1]

The equipment industry is dominated by closely-held, pass-through entities. Consequently, it is vital that tax reform not just focus on C-corporations and publicly-traded companies. It must also benefit the pass through entities and smaller businesses that are the lifeblood of the economy. In total, two-thirds of survey respondents classified themselves as either S-corporations, Limited Liability Companies (LLCs), or Limited Liability Partnerships (LLPs), while 34 percent of AED dealer member companies are C-corporations. The respondents classifying themselves as either C or S-corporations had 5.5 shareholders on average; partnerships had an average of 2.4 owners.

Additionally, equipment distributors do more than just sell equipment. New and used equipment sales account for just less than half of the average survey respondent's revenues, while parts, service, and product support account for almost one-third of revenues. Dealers help make their customers more efficient by providing a wide range of equipment acquisition options. Congress should understand that AED members do more than just sell equipment. Tax laws and IRS rules must provide sufficient flexibility to allow our members to serve a diverse array of equipment markets and types of customers.

It should also be noted that AED's membership believes tax uncertainty is dragging the economy down and equipment distributors are open to comprehensive solutions. In AED's 2012 Government Affairs Survey conducted last spring, ninety-six percent of survey respondents agree or strongly agree that "the uncertainty surrounding the tax code is undermining the nation's economic vitality." Seventy-two percent of respondents agree or strongly agree that "balancing the federal budget will require a combination of spending cuts, entitlement reform, and across-the-board tax increases," and that "everyone should shoulder some of the burden." Fewer than one-third (only 32 percent) agree or strongly agree that "tax increases should be off the table as a way to address the budget deficit." But 63 percent disagree or strongly disagree that "high earners should be taxed at higher rates to prevent tax increases on low- and middle-income families.

Given the aforementioned, it is clear that my company and the broader industry have a significant stake in any changes to the tax code and are eager to participate in the process.

Change Passive Income Rules

One of AED's top priorities in comprehensive tax reform is changing the Internal Revenue Service's (IRS) rules to ensure the Affordable Care Act's new 3.8 percent tax on passive income doesn't impact construction equipment distributors renting equipment.[2]

While contractors and other users traditionally purchased the equipment they used on construction projects, over the last 25 years there has been a significant shift towards rental. This trend has accelerated in recent years as a weak economy and uncertainty surrounding government

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1 Stephen Fuller, PhD., *Sales of Heavy Construction Equipment as a Percentage of Construction Spending and Related Economic Impacts* (2008) <http://www.aednet.org/government/pdf-2008/Fuller-Report.pdf>

2 Pub. Law 111-148.

infrastructure programs have made contractors more hesitant to buy new equipment. Equipment rental transactions take the form of a “rental with the option to buy” or a pure rental.

According to AED’s recent tax survey, equipment distributors earned $1.29 billion in total rental revenues in 2011, an average of $12.03 million per company. AED projects its members’ 2011 rental revenues were more than $3.3 billion.

While passive loss rules adopted in the 1980s were designed to prevent wealthy individuals from using losses from passive activities to avoid paying income taxes, due to anomalies in the Internal Revenue Code and IRS rules, the income and losses that equipment companies derive from renting bulldozers and other machines to contractors are considered “passive”.[3] The passive loss issue has long caused headaches for equipment companies, but the issue has taken on new urgency since the enactment of the Affordable Care Act, which imposes a new 3.8 percent tax on passive income, effective this year. In 2013, equipment dealers will become subject to a tax they were never meant to pay.

The tax was designed as an “unearned income Medicare contribution tax”. In the case of an individual (most equipment distribution companies are pass through entities, so the companies’ taxes are those of the individual owners), the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income over the threshold amount ($250,000 in the case of joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case).

In creating the new tax, Congress sought to limit its applicability and only ensnare a select group of individuals (financial traders and those deriving income from passive activities). Congress did not intend the law to apply to companies like equipment distributors. However, due to the complexity of the tax code and related regulations, companies that rent equipment have fallen into a trap and will be forced to pay a tax that was not meant for them. We are therefore asking Congress to do what it has done for other similarly-situated industries[4] and clarify that income from equipment rental is not passive income.

Preserve the Business Interest Deduction & Sec. 179 Expensing

Credit drives the equipment industry and is critical both to my customers’ ability to buy equipment and AED members’ ability to keep the doors open for business and finance rental fleets. Consequently, AED considers the business interest deduction to be critical to long-term growth.

According to AED’s tax survey, the combined interest expense deduction for 2011 reported by survey respondents was $92 million, an average of $872,000 per company. By contrast, the total interest expense deduction reported by respondents for 2007 was $163.19 million, an average of $1.75 million per company. The total projected interest deduction for all AED members in 2011 was

[3] Internal Revenue Code (IRC) Sec. 469(c)(2) provides that except as provided in paragraph (7) the term “passive activity” includes any rental activity.
[4] IRC Sec.469(c)(7) provides that paragraph (2) shall not apply to any rental real estate activity…..where the taxpayer is considered a real estate professional.

$232.05 million, while the total interest expense deduction in 2007 was $468.53 million. Congress must protect this important deduction when revamping the tax code.

Additionally, as proposed by Chairman Camp in his small business discussion draft, Congress should extend and expand Sec. 179 expensing levels. This capital investment incentive encourages growth, expansion, and purchases, which benefit the entire economy.

Find New Revenue Streams to Support Federal Infrastructure Investment

Transportation infrastructure is critical to America's economic growth and competitiveness. The surface transportation reform law enacted last summer (MAP-21) provides some near-term certainty. However, when it comes to highway, bridge, and transit investment, the job is far from complete. Gas taxes and other highway user fee revenues are insufficient to support even the current inadequate level of transportation investment, let alone the additional construction needed to rebuild America's crumbling infrastructure. Without new revenues, the highway program is in true jeopardy.

In fact, according to College of William & Mary researchers, over the next 23 years, as Corporate Average Fuel Economy (CAFE) standards rise, gasoline consumption will decline.[5] This will lead to a drop in gas tax payments to the federal Highway Trust Fund (HTF), the highway program's primary funding source. Failing to change the existing tax structure while maintaining current investment will cause the HTF's account to incur a $365.5 billion deficit over the next 23 years, the study concludes.

The highway program is already in dire straits. Although it has been self-sustaining for many years thanks to the gas tax and other user fees, declining revenues have made transfers from the general budget necessary to prevent road and bridge spending cuts. Many studies have shown that merely maintaining current spending is insufficient to build the infrastructure our growing economy needs. One report by the Texas Transportation Institute found that traffic congestion, largely resulting from inadequate capacity, costs the country more than $100 billion per year in wasted time and fuel.

The William & Mary study offers a few possible solutions. The gas tax was last increased - to 18.4 cents per gallon - in 1993. The research team determined that restoring the gas tax's 1993 spending power by raising it to 25 cents and indexing it for future inflation would raise $167 billion above current baseline spending requirements over the next two decades. The study also examined ways to implement a vehicle mileage-based user fee.

We must create new Highway Trust Fund revenue streams through a gas tax increase, a vehicle miles traveled tax, or some other innovative solution. These could and should happen (as they have in the past) as part of a broader budget and tax reform deal. AED and its members are committed to working with you to build public and political support for these policies.

Oppose LIFO Repeal

LIFO (which stands for "last in, first out") is an inventory accounting method that has been used by companies in a range of inventory-intensive industries since the 1930's to manage inflation's impact.

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[5] *The Impact of Fuel Use Trends on the Highway Trust Fund's Present and Future* (2012) http://www.aednet.org/government/pdf-2013/WM-HTF-Report.pdf

LIFO takes into account the greater costs of replacing inventory, providing a more accurate measure of the financial condition of the business and the income to which tax should apply.

LIFO is an accounting method, not a tax loophole. When inventory costs are rising, using the LIFO method will mean less tax liability in a given year than under the FIFO ("first in, first out") method. However, if prices fall, the taxpayer would repay the LIFO benefit through greater tax liability. Moreover, taxpayers may not change between LIFO and FIFO without Internal Revenue Service (IRS) approval, thus once a company elects to use the LIFO method, it assumes the risk of artificially increased tax liability if inventory costs should fall.

Proposed in President Obama's budget proposals, repealing LIFO would have a devastating impact on both large and small companies alike - particularly members of the equipment industry. Thirty percent of AED members reported using the LIFO inventory accounting method and 28 percent use first in, first out (FIFO). The average reported LIFO reserve was $8.16 million. Survey respondents reported combined LIFO reserves of $220 million. AED projects that its members have approximately $588 million in combined LIFO reserves and repeal would mean close to $200 million in retroactive tax liability.

While Hoffman Equipment Co. doesn't use LIFO, many of my industry colleagues have expressed a great deal of concern about the impact repeal would have on their ability to grow and even remain in business.

Repeal the Estate Tax
As AED has documented in study after study, the federal estate tax takes an enormous toll on the capital-intensive, family business-dominated construction equipment industry. Earlier this year, the Taxpayer Relief Act permanently fixed the top estate tax rate at 40 percent and the personal exemption rate at $5 million, indexed for inflation. Restoring predictability to the estate tax was a good start, but Congress needs to do more.

Forty-four percent of AED tax survey respondents said that their company had purchased life insurance for the current owners to protect the company from the federal estate tax. The total expended by survey respondents on estate tax-related life insurance was $11.3 million, an average of $221,100 per company. Similarly, 45 percent reported having hired attorneys and accountants to create estate plans to protect their business from the federal estate tax. The total spent by respondents on estate planning lawyers and accountants over the past three years was $2.83 million, an average of $54,000 per company. AED projects that its members spend a combined $31.82 million on estate tax-related insurance premiums annually and that over the past three years equipment distributors have spent a combined $6.69 million on estate planning lawyers and accountants.

AED maintains that the tax is fundamentally unfair because it disproportionately penalizes family businesses and amounts to double taxation. It should be repealed in its entirety. However, in the alternative, Congress must come up with a simple way to mitigate the negative impact on family companies, for example, by only taxing assets at sale, allowing them to pass from generation to generation without being taxed.

Conclusions

AED members overwhelmingly believe that the uncertainty surrounding the tax code is dragging down the economy. Equipment distributors understand the situation is complicated and are open to a comprehensive solution to our tax and fiscal problems. The majority of our members agree that balancing the federal budget will require a combination of spending cuts, entitlement reform, and tax increases. However, tax reform should be fair, support business risk-taking and investment, and everyone should share in the burdens and benefits.

For the results of the reform debate to be credible and widely acceptable, the process must be bipartisan and stakeholders from all sides must be part of the dialogue. We also believe that restoring balance to our nation’s fiscal structure is a prerequisite to resuming robust economic growth, rising employment, and improving standards of living for all Americans.