TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

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Testimony of Stephen Capp, Laserage Technology Corp.

U.S. House Committee on Small Business
Subcommittee on Economic Growth, Tax and Capital Access

"Pro-Growth Tax Policy: Why Small Businesses Need Individual Tax Reform"

November 3, 2011

Good morning, Chairman Walsh, Ranking Member Schrader, and members of the Subcommittee.

My name is Steve Capp, President and CEO of Laserage Technology Corp. (Laserage), and I am pleased to be here as a small business owner and member of the National Federation of Independent Business (NFIB) – the nation's leading small-business advocacy organization – to discuss the impact federal income taxation has on my company.

My father and I founded Laserage in 1979, which is now based in Waukegan, Illinois. When we started Laserage, we were just a tiny contract manufacturer with one laser, primarily working on ceramic components for the electronics industry. Over 32 years, we now have 135 employees and 65 lasers in 38 work centers processing many different types of materials. We specialize in laser processing of material for the medical device industry, but we also work with the electronics, LED, aerospace, and other industries. We also perform secondary operations such as finishing, testing, and packaging. Currently we export about 50 percent of the products we manufacture.

Like many small business owners, taxes are a major concern for us. The most recent NFIB Research Foundation's Small Business Problems and Priorities survey shows the challenges the tax code presents for small businesses. Four of the top ten issues identified in the survey are tax-related. Specifically, federal tax rates ranked third and tax complexity ranked fifth.[1]

I can assure you that small business owners are encouraged that Congress is considering tax reform. But, I am here to tell you that small businesses face unique tax challenges and need to be part of the tax reform debate. Like Laserage, which operates as an S Corp, the majority of small businesses – about 75 percent – are organized as pass-through businesses.[2] The pass-through business structure works to make small businesses competitive, and should continue to be supported by Congress, including recognition of the unique issues that impact pass-through businesses.

Choosing a Pass-Through Business Structure

An owner chooses a business structure for a variety of reasons. Avoidance of organization costs, liability protection and tax planning are generally the most common reasons to choose a pass-through structure. But, according to an NFIB Small Business Poll, of the small businesses that changed their business structure, 39 percent of them changed to avoid liability and 27 percent for tax planning reasons.[3]

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[1] William J. Dennis, *Small Business Problems and Priorities*, NFIB Research Foundation, Washington, DC series.

[2] 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.

[3] *Ibid*.

While a business structure like a sole proprietor or a partnership will protect the business from double taxation, the liability protection that a C Corp offers is not available for these business structures. If the business is liable for a debt, the business owner's personal assets are also at risk. Several changes made to the S Corps rule have increased the attractiveness of choosing the S Corp structure. This has led to a substantial increase in the number of S Corps. In 1985, 22 percent of all corporations were S Corps; by 1990, the figure has risen to 43 percent; and today, the majority of U.S. corporations are S Corps.[4]

Laserage is not unlike a lot of closely-held businesses in that we were originally organized as a C Corp, but changed to an S Corp. Ending the double taxation of profits and gains -- leaving us more after-tax profits to re-invest in our business -- was our primary reason for converting from a C Corp to an S Corp.

Ours is a capital intensive business, and historically, we have re-invested back into our business all of our after-tax profits (though we have occasionally bought back the stock of some shareholders when they asked us to and we could afford to). We made the decision to switch to an S Corp based on our need to retain as much of our profits for reinvestment as possible and for the benefit of our shareholders.

We have 34 shareholders -- double taxation as a C Corp made their investment in our company less attractive. As an S Corp, the distributions to shareholders have to be made to them pro rata to the percentage of the company they own. Our growth strategy is to distribute to our shareholders only that portion of our pre-tax profits that is required to furnish our shareholders with the taxes they will owe on the share of our profits they must each report on their personal income tax returns (we use the sum of the highest federal marginal tax percentage, plus the highest marginal state rate to make these calculations). We retain the rest our income almost entirely to fund modernization, growth and new investments (and only occasionally, to redeem shares of stock of a shareholder on his or her request).

But, avoiding double taxation of gains is another factor that greatly influenced Laserage's decision to be an S Corp. For many of our shareholders, their ownership is a significant part of their savings, and they look to the appreciation in Laserage's value culminating in its eventual sale.

Frequently business sales of closely-held businesses are structured as "asset sales" (unlike sales of public companies, which are usually "stock sales"); by being an S Corp, if Laserage is sold in an "asset sale," our shareholders' gain will only be taxed once. As a C Corp, an "asset sale" sale would first be taxed at the corporate level, and then a second time when the after-tax proceeds were distributed to the shareholders. As an S Corp, in an "asset sale" the sale only faces one layer of tax at the shareholder level. Obviously, this single layer of tax makes the investment in our company more attractive.

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[4] *SOI Bulletin*, Internal Revenue Service, U.S. Department of the Treasury, Selected Historical and Other Data - table 13, Winter 1999-2000.

While the conversion from a C Corp to an S Corp added complexity to our accounting and tax preparation, both Laserage and its shareholders have benefited from this decision -- allowing us to maximize our re-investment of our after-tax profits in our business without penalizing our shareholders. The choice to become an S Corps has allowed us to make the right decisions to grow and strengthen our business. Congress should continue to support pass-through business structures and they must be part of any tax reform debate.

Individual Rates and Small Business

Switching from a C Corp to an S Corp means that the individual tax rates are the rate at which we and our shareholders now pay tax on our business income. Keeping these tax rates low is important to our business and important to small businesses in general.

Small businesses fall into all of the current six individual income tax brackets. In 2001, the individual rates were lowered across the board providing all small business taxpayers with some tax relief. Since those tax rates became law, many agree that keeping rates low for some taxpayers is important. That is a step in the right direction to promoting a pro-growth tax policy and ensuring that many business owners will not see a tax increase. I encourage Congress to keep tax rates low for all small business owners. This is especially important as we continue to recover from the most recent recession.

Laserage's business would be impacted by higher tax rates and add to the economic challenges we are confronting. As I noted, we now export about half of the products we manufacture and this increase is driven by many of our customers. As our exporting has increased, Laserage has received ever-increasing pressure from some of our largest customers to begin production in a low-cost country.

To this point Laserage has successfully avoided taking this step, primarily by adopting what are known as "lean" manufacturing techniques and achieving productivity increases through improvements to our production methods. But, there is only so much that can be accomplished through those efforts, and at some point, if Laserage is to continue to be competitive and stay in business, it will either have to see its operating costs (including taxes) go down, or it will have to take additional steps such as relocating manufacturing overseas in order to avoid losing major customers.

Over the last few years, Laserage's operating costs have steadily increased. Illinois taxes were increased massively this past year. Last year, health insurance costs rose 21 percent. Materials and energy costs continue to increase. If federal income taxes increase, as well, it could well be the "straw that breaks the camel's back" and forces us to manufacture in an offshore business.

In candor, Laserage has already started looking into starting up manufacturing operations as a matter of self-preservation, and in doing so, we are certainly well aware that the corporate tax rate even in a well-developed county like Singapore is only 17 percent. A lower U.S. tax rate would make a difference in Laserage's product pricing thereby making it more competitive.

Raising the federal tax rate only makes the situation worse for Laserage and places greater pressure on its bottom line. I will continue to work to build Laserage's business here in the U.S. But, I must report to you that if the cost pressures become too great, given the rising demands of our customers for an overseas cost solution, Laserage will have no choice but to consider overseas options in order to survive and grow.

Tax Reform and Small Business

Because taxes are such a concern for small business owners, we support reforming the tax code. Any tax reform must consider the unique issues facing small businesses, including choosing a pass-through business structure. Tax changes that only focus on part of the tax code is not reform and may make the tax situation worse for small businesses.

Pass-through businesses, and the many small businesses that choose a pass-through structure, must be included in any reform of the tax code. Much of the debate surrounding tax reform has focused on eliminating deductions and closing loopholes to reduce rates. If that is the path for tax reform, the rate reductions must also include pass-through businesses or businesses like mine will be placed at a competitive disadvantage.

The current tax rates for pass-throughs are similar to a C Corp. If the rates were to go down for C Corps but remain unchanged for my S Corp, or stay at current rates for my C Corp competitors but increase for me and my fellow Laserage shareholders, it would put Laserage at a distinct disadvantage. At the very least, the tax rate paid by pass-through businesses should be the same rate that applies to C Corps. Reducing the taxes for both S Corp and C Corp manufacturers would make us both more competitive relative to goods made elsewhere in the world.

In addition, losing deductions without corresponding relief by lowering tax rates would similarly place Laserage at a competitive disadvantage. As a manufacturer, Laserage operates a capital intensive business, and therefor relies on the deductions it was entitled to take for its capital expenditures to help fund its modernization, growth and competitiveness. Last year, we purchased $1.1 million in capital equipment, though I should tell you that this included an additional $350,000 in investments, because of the uncertainty over whether the same expensing of capital expenditures would be extended to 2011. This year, we will purchase about another $850,000 of equipment, which we will also deduct as an expense. In addition, as a manufacturer we rely on the Section 199 domestic production deduction.

Losing the benefit of these deductions without corresponding relief in the form of rate reductions would be harmful to Laserage. On top of the inordinately large price increases Laserage has endured in state taxation, health insurance, commodities and other areas, any tax increase will make it even more difficult for Laserage to compete.

Tax reform must also include simplifying the tax code. The current code is cumbersome and requires us to spend too much time and money to ensure we comply. The tax return Laserage filed with the IRS last year was 416 pages long. This is simply an information return, since as a pass-through, Laserage is not a taxable entity. Yet, even with the massive internal accounting personnel costs Laserage incurred to generate all of the necessary information required to be included in the return, the return itself was so complex we had to pay more than $9,000 to have our independent auditors simply prepare it for filing. Last year, my personal tax return, which includes my share of Laserage's taxable income, was 28 pages and cost me about $2,500 to have my personal accountant prepare.

Any changes to the tax code must make it simpler and less expensive for businesses to comply with the code.

One simple step that Congress can take is to end the many expiring and short-term tax provisions. A simple example is the current individual rates. With those rates set to expire at the end of 2012, pass-through business owners like mine are left wondering what the following year's tax rates will be.

In addition, the short-term and one-time provisions promoted as tax incentives also provide little certainty for small business owners. We simply cannot plan and make business decisions with constantly changing tax laws "hanging over our heads." Business owners need certainty and clarity about the tax rules and to be freed of fear of constant and\or harmful changes.

Conclusion

Tax reform can be an effective tool for economic growth. This is particularly true for pass-through and small businesses. The tax code is an impediment to growth, and reforming the tax code so that we can make business decisions, rather than tax decisions must be part of any tax reform.

The majority of private sector employees – 54 percent – work for pass-through businesses.[5] Small businesses, in particular, account for the vast majority of new jobs. But the current economic conditions have kept small businesses from growing and creating new jobs. The trends in the most recent NFIB Small Business Economic Trends (SBET) survey demonstrate this. While this month saw a slight increase in small business optimism, the survey had been negative for the previous six months.[6]

Two of the biggest concerns in the SBET are taxes and government regulations. Congress has the opportunity to address those concerns, but I urge Congress to focus on

[5] Carroll, Robert and Gerald Prante, *The Flow Through Business Sector and Tax Reform: The Economic Footprint of the Flow-Through Sector and the Potential Impact of Tax Reform,* April 2011.
[6] Dunkelberg, William C. and Holly Wade, *NFIB Small Business Economic Trends,* October 2011.

long-term solutions, so that businesses are able to plan and make sound investments in their future.

Tax reform and more certainty can be an effective tool for economic growth and job creation. Businesses like mine struggle every year with complicated and expiring tax provisions. The Congress has the opportunity to reform our complicated tax code, but you must make sure to do it right. Tax reform must address the concerns of both pass-through and corporate businesses.

Thank you for the opportunity to appear before the committee on this important issue.