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TESTIMONY OF THERESA KERN

President of MA Steel Erectors, Inc. in Chicago, IL

On Behalf of Women Construction Owners & Executives USA

Before the Committee on Small Business

Subcommittee on Economic Growth, Tax and Capital Access

United States House of Representatives

On

“Adding to Uncertainty:

Small Businesses Perspectives on the Tax”

September 13, 2012



Women Construction Owners & Executives USA

“Consequences of Tax Uncertainty for Small Businesses Structured as Corporate Pass-through Entities

Good morning Mr. Chairman and Members of the Subcommittee. My name is Theresa Kern and I am the Owner and President of MA Steel Erectors, Inc. headquartered in Palos Heights, IL. We are a union-signatory specialty trade subcontractor that provides labor to install reinforcing steel in commercial, industrial, heavy and highway construction projects. MA Steel is incorporated as a Subchapter S, pass-through corporate entity and I am the sole shareholder.

I am testifying today as both a small business owner and in my capacity as Immediate Past President of Women Construction Owners & Executives USA (WCOE), a 30 year old organization whose mission is simply to create contracting opportunities for our members – women who have chosen to build a career and a business in the non-traditional construction industry.

Thank you for giving me the opportunity to testify before you today at this very important hearing.

As you know, the lingering economic recession has significantly damaged the construction industry and most small businesses in our industry have been hit disproportionately hard. Yet, WCOE members are optimistic about the future as the construction industry economy begins a slow recovery.

The future tax policy of the United States will have a profound effect on our members' ability to stabilize and then grow their businesses. MA Steel is a labor intensive business as are most construction companies, and business growth has a direct correlation to creating badly needed jobs to help the American economy grow and prosper.

While media headlines blare “Corporations don't pay their fair share”, let me assure you that small business corporations not only pay their fair share, but are a major contributor to the

economy as well as the tax base of this country and have often been referred to as the “life blood of the US economic growth engine”.

Ernst & Young is reporting that 90% of all US businesses are corporate pass-through entities and employ more than 50% of the private sector workforce while representing over a third of all US business receipts. Pass-through entities are Subchapter S Corporations (S Corps) and Limited Liability Corporations (LLC’s) that have specific limits as to the number and type of shareholders. IRS reports there are over 4.5 million Subchapter S corporations alone. It is often said that small businesses are the cornerstone of the American economy and corporate pass-through entities are the cornerstone of America’s small business community.

Generally, entrepreneurs are advised by their CPA or attorney to incorporate using one of these Congressionally-chartered tools in order to separate her business from her household assets without the onerous paperwork and reporting requirements of a “C” Corporation.

Congress also decided in 1958 that these special privately held, corporate entities would not be taxed as a corporation, but rather because the owner/entrepreneur was investing her own money into the enterprise to get it started and often to keep it running, the income or loss generated by the Sub S/LLC corporation would be reported by the owner(s) on their individual tax returns as earned income or loss. The pass-through corporation, whether a Sub S or LLC, is therefore not liable for income tax, but the shareholder is: the businesses entire profit (or loss) is passed through to the individual(s) who report it on their household tax return at the rate for their total household tax bracket. (Conversely, profit distributions to “C” Corporation owners are treated as dividend income to the shareholders and currently taxed at up to 15%.)

When the media trumpets headlines like “90% of corporations pay no taxes” – they may be statistically correct. But these are not corporations as the general public defines corporations – these are mostly small business owners who have been advised to protect their household assets by incorporating, and to use an LLC or Sub S corporate structure to eliminate the requirement for big corporate boards of directors, annual meetings, elections, expensive audits, and activist shareholders. With the 2002 passage of Sarbannes-Oxley which mandated even more rigorous reporting requirements for “C” corporations, pass-through entities are even more attractive.

What is critically important to understand is that profits in a business incorporated as a Sub S or LLC entity does not translate to cash in the pocket of the owner. But, a loss in a

business nearly always requires the owner to either forgo her own salary, or even invest more of her own money into the firm. There is one other thing that all corporate pass-through entity owners know – while the company may show a profit in the financial statements, there may be no cash in her corporate or personal bank accounts. Further, there is no relationship between the amount of profit a Sub S or LLC entity shows on a financial statement and the amount of money an owner has actually withdrawn.

Please let me also explain one of the anomalies about the construction industry. Unique to construction is the issuance of a surety bond which is a guarantee of performance on a project that the owner of a construction company must collateralize with her business's balance sheet and personal assets. Nearly all construction projects require a surety bond performance guarantee from all of the contractors and subcontractors working on a project.

Because construction company balance sheets have taken a severe hit during the last 4 years, banks and bonding companies are insisting that balance sheets be strengthened by keeping profits in the company.

It is important to note here that the surety bond on a specific project cannot be released until the final retention is released at completion and acceptance by the owner. My ability to begin a new project is restricted by my balance sheet which remains encumbered until those assets are released when the bonded work is accepted and final payment received – a process that often takes many months after project completion. If I want to take on another project prior to the release of the retention money in order to keep my crews busy, I need to have sufficient assets available to secure a bond.

Let's assume I'm lucky enough for MA Steel to make a nice profit this year. My bank and bonding company will require that I not only pay myself only a minimal amount but that I leave the profits in the business in order to show a stronger financial position. As a Subchapter S corporation, however, all of that nice profit will be reported as income to me and I will have to pay tax on it, even though I may not have one penny of it in my personal checking account.

When we are talking about an average contract value of \$500,000, and dozens of projects a year, it is not unrealistic to expect annual business profits to exceed \$250,000 all of which is reported as retained earnings in the business and as income to me – yet the majority of that profit stays in the business and never makes it into my personal checking account for my own use.

I am liable for payment of the income taxes due on this phantom income at the individual tax rate. Increasing the rate of this tax by even 10% will have a significant deleterious effect on my ability to grow my business. I have to keep the profits in the business per demands of the bank and bonding company if I want to grow; yet I have to take the profits out of the business to be able to pay the taxes.

The members of WCOE fully support simplification of the tax code and closing tax loopholes that are beneficial only to the most sophisticated financial analysts. We also support efforts to decrease the Federal budget deficit, but to do it on the backs of America's robust entrepreneurial community will be counter-productive.

I would like to give you one more relevant example of what the current uncertainty with the tax code means to small business owners like me.

I have finally located a reinforcing steel fabrication plant that I would like to buy to expand my business by being able to provide the rebar that we install. My CPA is telling me that unless I could close escrow before the end of this year, I would be foolish to proceed because there is no certainty about tax policy in just 4 short months. Something as simple as the current Section 179 tax law which would allow me to write off a major portion of this investment instead of depreciating it over dozens of years makes the project financially feasible. It is impossible to get an SBA 504 loan, close escrow and finish capital and equipment improvements before the end of this year. So for now, I am forced to sit and wait while the economy sputters along and factory workers remain unemployed because there is no productive tax policy in place that will give me the confidence I need to make this investment.

In summary, these last 4 years have been very difficult for the construction industry. We have lost many women owned construction companies who could not find a way to survive. Those of us who have hung on and managed to create profits, albeit small, are looking to rebuild our communities by growing our businesses and creating jobs.

We are encouraged that this House Subcommittee is working on the issue of taxation for small business owners and how the current uncertainty is holding back investment and the natural job creation that comes from that investment.

Thank you for the opportunity to talk with you today. I would be happy to answer any questions.