Testimony before the

Committee on Small Business

Subcommittee on Economic Growth, Tax and Capital Access

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Hearing on

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

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Chairman Walsh, Ranking Member Schrader, and distinguished members on the Subcommittee, thank you for the opportunity to testify today regarding the taxation of flow-through businesses and tax reform.

Flow-through businesses play an important role in the U.S. economy.[2] The vast majority of businesses in the United States have chosen to organize as flow-through businesses. Today, flow-through businesses comprise more than 90 percent of all business entities, employ more than 50 percent of the private sector work force and report more than one-third of all business receipts. Fifty-four percent of business net income is reported by individual owners of flow-through businesses, and these taxpayers pay 44 percent of business taxes when filing their individual tax returns.

With the prominence of flow-through businesses, it is important to carefully consider how the flow-through form fits into the U.S. tax system and how any particular tax reform might affect flow-through businesses.

There is considerable support for reform of the U.S. corporate income tax, especially by lowering the corporate income tax rate.[3] President Obama has called for a lower corporate income tax rate, combined with the elimination of special interest loopholes, to help restore competitiveness and encourage job creation.[4] Prominent members of Congress have also pointed to the importance of reforming the corporate income tax. House Ways and Means Committee Chairman Dave Camp (R-MI) has advocated lowering the top 35 percent corporate income tax rate to 25 percent. Senate Finance Committee Chairman Max Baucus (D-MT) has

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[2] "Flow-through" businesses refer to pass-through entities (S corporations, partnerships, and limited liability companies) and sole proprietorships whose income and expense is reported by the owners along with income received from other sources.

[3] For a discussion of the potential economic benefits of a lower corporate tax rate see Robert Carroll and Thomas Neubig, "The Economic Benefits of Reducing the US Corporate Income Tax Rate," An Ernst & Young LLP report prepared for the Reducing America's Taxes Equitably Coalition, September 2011.

[4] President Obama's State of the Union address, January 25, 2011.

emphasized the need for corporate tax reform, although without specifying a specific target for the corporate income tax rate. Most major tax and entitlement reform proposals have also included significant corporate rate reduction as a key element.[5]

This interest in corporate tax reform stems in large part from the substantial evidence that the U.S. statutory corporate income tax rate is out-of-step internationally and a growing consensus that the U.S. corporate tax rate should be lowered. Over the past several decades most other developed nations have reduced their statutory corporate income tax rates significantly leaving the United States with the second highest statutory corporate income tax rate among developed nations. At the same time, globalization amplifies the importance of differences in corporate tax rates across countries and there is increasing evidence that corporate income taxes adversely affect workers wages.

Elimination of business tax expenditures to finance a lower corporate rate, however, can raise substantial issues for flow-through businesses. Flow-through businesses could potentially lose the benefit of widely used business tax provisions without the benefit of the lower corporate tax rate. Attempts to separately allow provisions, such as accelerated depreciation and the production activities deduction, to flow-through businesses in a corporate-only reform would increase complexity and raise significant administrative issues.

The Internal Revenue Code (the "Code") provides businesses with considerable flexibility in how they organize and structure their business operations. Depending on their ownership and capital needs, businesses can choose between several different organizational forms. The flow-through form helps mitigate the economically harmful effects of the double tax on corporate profits, in which the higher cost of capital from double taxation discourages investment and thus economic growth and job creation. Moreover, double taxation of the return to saving and investment embodied in the income tax system leads to a bias in firms' financing decisions between the use of debt and equity and distorts the allocation of capital within the economy. As tax reform progresses, it is important to understand and consider all of these issues with an eye towards bringing about the tax reform that is most conducive to increased growth and job creation.

I have had the opportunity to consider the impact of taxation on flow-through businesses from a number of perspectives, inside and outside of government, in the context of broad reform of the Code and more narrow reform of the business tax system. I have analyzed the potential impact of tax reform on the flow-through sector on behalf of the S Corporation Association and have worked with other clients on various other aspects of tax reform. Today I will share my perspectives and experiences with the Subcommittee.

<u>Current tax treatment of flow-through businesses and the double tax on corporate profits</u>

Flow-through businesses – S corporations, partnerships, limited liability companies, and sole proprietorships – are subject to a single level of tax on the income earned. The income and

[5] For example, in December 2010, the President's National Commission on Fiscal Responsibility and Reform proposed lowering the top federal corporate income tax rate to 28 percent. In early 2011, Sens. Ron Wyden (D-OR) and Dan Coats (R-IN) proposed that the corporate income tax rate be lowered to 24 percent and a plan by House Budget Committee Chairman Paul Ryan (R-WI) included a top 25% corporate income tax rate.

expenses of flow-through businesses are reported by an entity's owners – hence the name "flow-through" or "pass-through" entities." An individual owner's flow-through income is combined with income they may receive from other sources and subject to individual income taxes. Losses, rather than accumulating within the business entity level, are also passed through to the owner where, subject to various limitations, they may, subject to various limitations, be used to offset income from other sources. Thus, it is the tax rates faced by individual owners of flow-through businesses that affect decision-making and the economic health of these businesses.

In contrast, the income of C corporations is subject to two levels of tax, first when income is earned at the corporate level, and again when the income is paid out to shareholders in the form of dividends or retained and later realized by shareholders as capital gains. These two levels of tax are often referred to as the double tax on corporate profits.

The differential taxation of business income earned by C corporations and flow-through businesses is an important consideration in a firm's choice of organizational form. The double tax is also economically important and can distort a number of business decisions.[6] One important such distortion arises because the double-tax mainly affects business income generated by activities financed through equity capital within the C corporation form. Interest expenses are generally deductible by businesses, leading to a tax bias in favor of financing with debt rather than equity. The double tax thus raises the cost of equity financed investment by C corporations relative to debt financed investment and provides an incentive for leverage and borrowing rather than for equity-financed investment. Accordingly, the double tax contributes to the tax bias for higher leverage. Greater leverage can make corporations more susceptible to financial distress during times of economic weakness.

The current income tax also leads to a distortion between investment channeled through double-taxed C corporations and single-taxed flow-through businesses.The higher cost of investment in the corporate sector relative to the rest of the economy leads to a misallocation of capital within the economy. This in turn reduces the productive capacity of the capital stock and dampens economic growth. As noted before, the diversity of organizational forms can be seen as a useful choice for businesses to make in organizing themselves, but the impact of differential treatment should be recognized. Finally, the double tax raises the overall cost of capital in the economy, which reduces capital formation and, ultimately, living standards.[7]

Overall, the flow-through form provides an important benefit to the economy by reducing the economically harmful effects of the double tax.

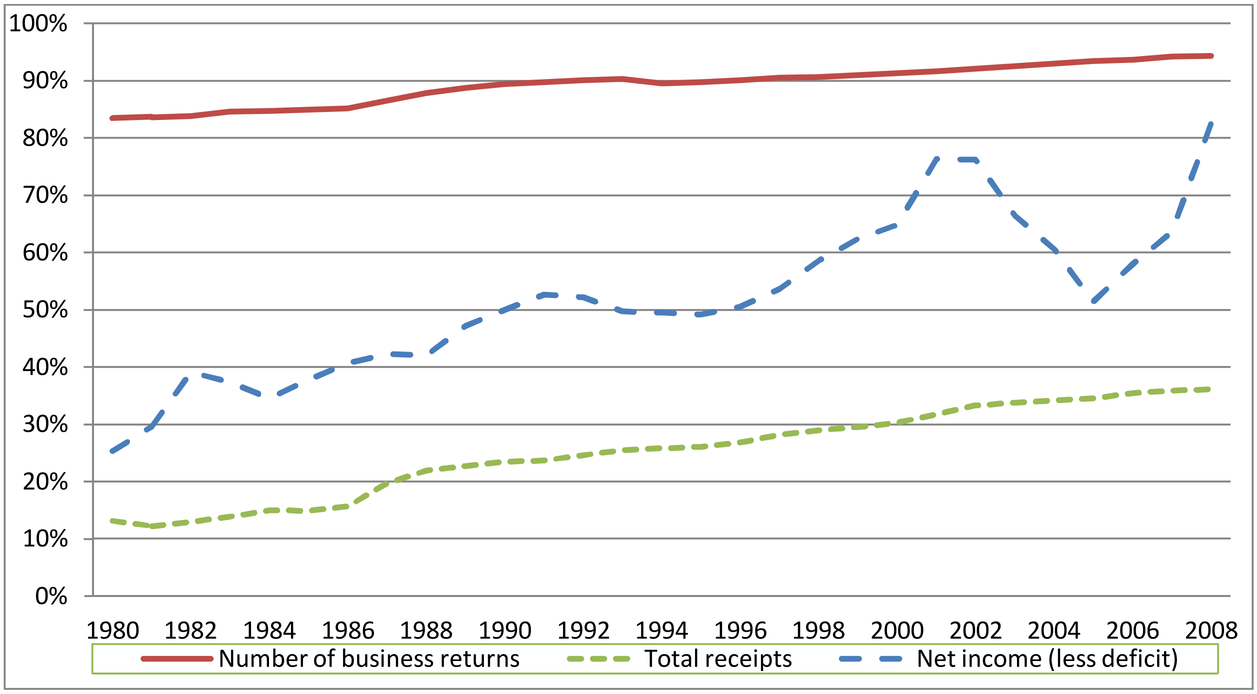
[6] For a discussion of these issues see Robert Carroll, "The Economic Effects of the Lower Tax Rate on Dividends," Tax Foundation Special Report No. 181, June 2010.

[7] For example, a dynamic analysis of the lower tax rates on dividends and capital gains enacted in 2003 found that they would increase gross domestic product in the long-run by 0.4 percent and the capital stock by 1.2 percent if made permanent. See U.S. Department of the Treasury, *A Dynamic Analysis of Permanent Extension of the President's Tax Relief*, July 25, 2006.

The economic footprint of the flow-through sector

Flow-though businesses have grown steadily over the past several decades. As shown in Chart 1, the percentage of businesses choosing the flow-through form rose from 83 percent in 1980 to 94 percent in 2008.[8] The share of total receipts generated by flow-through businesses has nearly tripled since the early 1980s with the flow-through share of total receipts rising from 13 percent in 1980 to 36 percent by 2008. The flow-through share of net income also rose significantly, 25 percent in 1980 to 82 percent by 2008.[9]

Chart 1. Flow-through shares of all business returns, receipts, and net income, 1980-2008



Note: These data include some flow-through entities, primarily partnerships, which are owned by C corporations. Data focusing on individual owners of flow-through businesses are presented below in Chart 4.
Source: Internal Revenue Service, Statistics of Income, Integrated Business Data.

Two changes contributed to this growth.[10] First, the individual tax rate was lowered significantly relative to the corporate tax rate under the Tax Reform Act of 1986, which had the effect of making the flow-through form more attractive for many businesses. Second, in the late 1980s and 1990s limited liability companies (LLCs) combined flow-through tax treatment with limited

[8] The data presented here (Chart 1) also include RICs and REITs, which effectively are subject to a single layer of tax because of the deductibility of dividends. Note that RICs and REITs are included among C corporations in the Census data on employment, firms and establishments presented below due to data limitations.
[9] As discussed below, it is important to note that the line between business activity that is ultimately subject to the corporate tax or individual tax is blurred because some flow-through businesses, primarily partnerships and limited liability companies, can have corporate owners. Also note that the 82 percent of net income reported by all flow-through entities is for 2008, whereas the 54 percent of net income reported by individual owners of flow-through entities is the average from 2004 through 2008.
[10] Limited partnerships, which offer limited liability to the limited partners, along with flow-through treatment, were available.

liability for their owners[11] and the classification of businesses as LLCs was simplified in 1997 by allowing them to "check the box" on Form 1065-B to elect to be treated as a corporation or partnership (or sole proprietorship) for tax purposes.[12]

As shown in Table 1 below, the flow-through sector now comprises a large fraction of business activity not only based on number of firms and receipts/net income, but also based on the number of workers it employs. In 2008, the flow-through sector employed 54 percent of the private sector work force, with C corporations employing the remaining 46 percent.[13] S corporations employed 25 percent of the private sector work force, while partnerships employed 10 percent and sole proprietorships accounted for 19 percent.[14]

Table 1. Private economic activity of flow-through businesses and C corporations, 2008

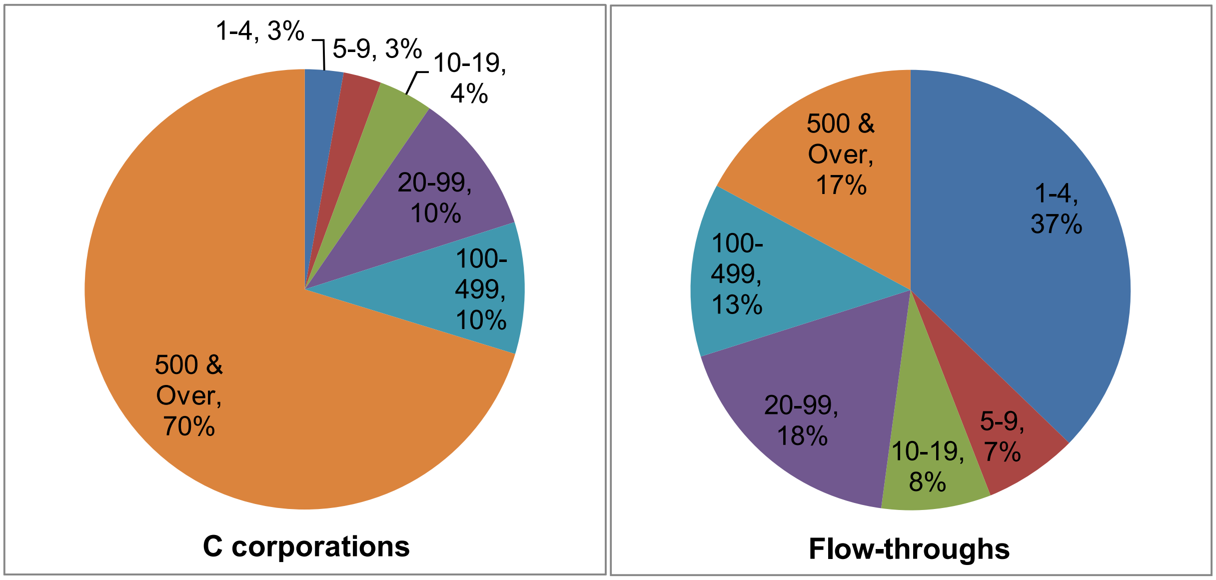
	Total Private Business Sector	Flow-Through Businesses				C corporations
		Total	S Corporations	Partnerships	Sole Proprietorships	
Employment	125.6	68.2	31.0	13.1	24.1	57.4
Firms	26.9	25.1	3.6	1.7	19.8	1.7
Establishments	28.4	25.6	3.9	1.9	19.9	2.8
Receipts	28.7	10.2	5.6	3.1	1.5	18.5
Percent Distribution						
Employment	100%	54%	25%	10%	19%	46%
Firms	100%	94%	13%	6%	74%	6%
Establishments	100%	90%	14%	7%	70%	10%
Receipts	100%	36%	19%	11%	5%	65%

Note: Units in millions, dollars in billions.
Source: U.S. Bureau of the Census, Statistics of U.S. Businesses and Non-employer Statistics; receipts are from Statistics of Income Division, selected sources.

Private sector employment within the flow-through sector is sizable and more concentrated among smaller firms than C corporations (see Chart 2). About 37 percent of workers within the flow-through sector were with firms with four or fewer employees. About 52 percent of workers in the flow-through sector held jobs in firms with fewer than 20 employees. In contrast, among C corporations 70 percent of workers held jobs in firms with more than 500 employees and 90 percent of workers held jobs in firms with more than 20 employees.

[11] In 1988 the IRS issued a revenue ruling indicating that it would treat LLCs established under Wyoming state law as partnerships for tax purposes. Other states subsequently enacted similar LLCs statutes.
[12] In 1995, there were 118,559 LLCs in the United States. By 2008 the number had grown to 1,898,178. Internal Revenue Service, *Partnership Returns, 2008*, Statistics of Income Bulletin, Fall 2010.
[13] These tabulations exclude the non-profit and government sectors. RICs/REITs are included among C corporations due to data limitations. U.S. Bureau of the Census, Center for Economic Studies, 2008.
[14] Sole proprietors are counted as one "employee." A summary of the data and methodology used for these tabulations is provided in Appendix A.

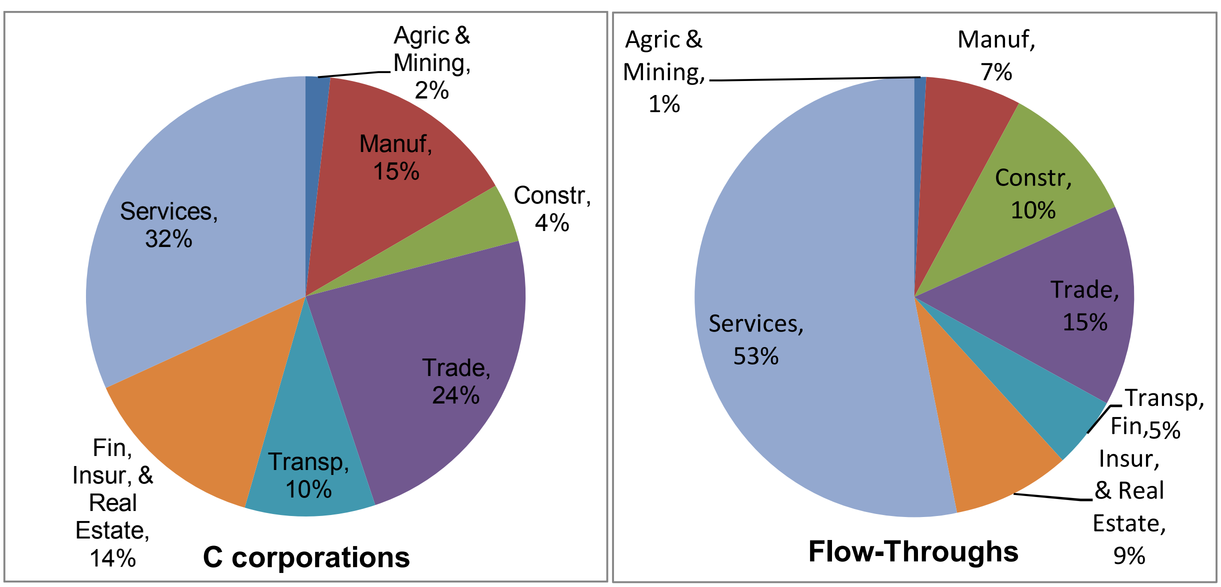
Chart 2. Employment by size of firm, C corporation and flow-through sectors, 2008



Source: U.S. Bureau of the Census, Statistics of U.S. Businesses and Non-employer Statistics.

There are also considerable differences in the employment within various industies for these two sectors, with significantly greater respresentation of flow-through employment in the services and construction industries (see Chart 3). In contrast, C corporation employment is more dominant in the manufacturing, wholesale and retail trade, and transportation industies.

Chart 3. Employment by industry, C corporation and flow-through sectors, 2008



Source: U.S. Bureau of the Census, Statistics of U.S. Businesses and Non-employer Statistics.

It is important to point out that these employment estimates are influenced by the presence of large employers, particularly among C corporations. For example, while only 7 percent of flow-through employment is within the manufacturing sector, more than 81 percent of all manufacturers are organized as flow-through businesses.

Flow-through businesses are well represented in all areas of the country, representing more than one-half of the private sector work force in every state except for Delaware (49 percent) and Hawaii (48 percent) (state-by-state data is presented in Appendix B). Flow-through employment exceeds 60 percent of the private sector work force in six states: Idaho (65 percent), Maine (62 percent), Montana (69 percent), South Dakota (63 percent), Vermont (63 percent) and Wyoming (62 percent).

While the foregoing data provides a picture of the economic footprint of flow-through business entities, the owners of some flow-through businesses (primarily some partnerships[15]) are corporations, not individuals. This distinction is important because individual owners of flow-through businesses are taxed under the individual income tax. A significant amount of partnership income flows through to corporate owners.[16] This income is often associated with various types of joint ventures between corporations.

Another important factor that makes comparisons of business entities and the flow-through income received by individual owners difficult is that a considerable share of flow-through income takes forms other than allocated net income reported on an owner's Schedule C or Schedule E. For example, individual owners of flow-through businesses can also receive allocated income in the form of capital gains, rents and royalties. This income is reported separately from allocated net income reported on the Schedule C or Schedule E in order for it to maintain its character and receive special tax treatment under the Code (e.g., the special lower tax rate on long-term capital gains and the limitations on passive activity losses).

As shown in Chart 4, after accounting for all of the income allocated to individual owners of flow-through businesses, individual owners received 54 percent of total business income from 2004 through 2008.[17] The taxes paid on this income by individual owners of flow-through businesses averaged $232 billion annually (44 percent) from 2004 through 2008, as compared to an average of $290 billion for C corporations over this period.[18]

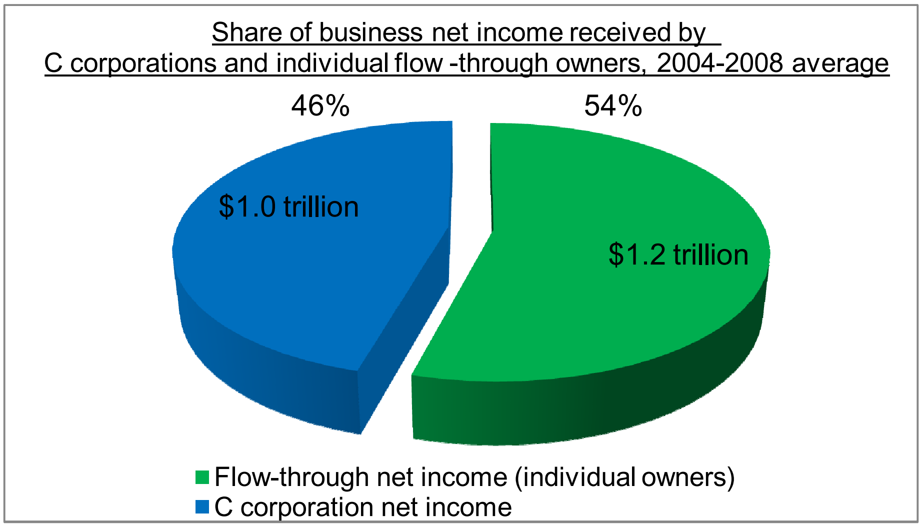
[15] Sole proprietorships are, by definition, owned by individuals and the ownership of S corporations is generally restricted to individual shareholders.

[16] In 2007, about 30 percent of partnership income was allocated to corporate partners. Wheeler and Nina Shumofsky, *Partnership Returns, 2008,* Statistics of Income Bulletin, Fall 2010.

[17] The net income and taxes paid by individual owners of flow-through businesses and C corporations are not directly comparable because the labor compensation of owners of C corporations are generally paid as wages and deductible to the business, while the labor compensation paid to owners of partnerships and sole proprietorships is generally included as part of business entities' allocable net income. S corporations, in contrast, are generally required to pay owners actively involved in a business a reasonable level of compensation, which, similar to C corporations, is a deductible expense by the business. Taking into account the amount of labor compensation paid to owners of partnerships and sole proprietorships as allocable net income could have a significant effect on these calculations.

[18] This comparison only takes into account the taxes related to the net income of flow-through businesses and C corporations. Investor level taxes on corporate earnings are not taken into account.

Chart 4. Individual owners of flow-through entities receive 54% of business net income, 2004-2008 average



Source: Internal Revenue Service, Statistics of Income, Corporate Source Book and Individual Tax Returns (publication 1304), selected years; computations by Ernst & Young LLP.

Economic decisions of flow-through businesses affected by the tax system

Research has found that individual income tax rates affect various economic decisions of flow-through business owners. For example, tax rates have been found to affect the entry and exit from flow-through form as individuals decide whether to open up their own business or work for another firm.[19] Tax rates have also been found to deter these businesses from hiring workers and investing and affect the rate at which flow-through businesses grow.[20] The effect of the individual tax rates on these types of economic decisions is one reason the tax treatment of flow-through businesses has figured prominently in recent discussions of changes to these tax rates.

Increases in the cost of capital resulting from higher individual income tax rates was found to reduce the investment spending of entrepreneurs and the probability that they invested at all.[21] A 5-percentage point increase in the individual marginal tax rate was found to reduce the

[19] Donald Bruce and Tami Gurley-Calvez, "Federal Tax Policy and Small Business," In Overcoming Barriers to Entrepreneurship, Rowan and Littlefield Publishers, forthcoming; William M. Gentry and R. Glenn Hubbard, "'Success Taxes, Entrepreneurial Entry, and Innovation," Working Paper No. 10551, National Bureau of Economic Research, June 2004.

[20] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351; Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147; and Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.

[21] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Entrepreneurs, Income Taxes, and Investment," In *Does Atlas Shrug? The Economic Consequences of Taxing the Rich*, Joel Slemrod, ed., Russell Sage Foundation and Harvard University Press, NY, 2002, pp. 427-455.

percentage of entrepreneurs who made new capital investments by 10.4 percent and the mean amount of investment by 9.9 percent.

Lower individual tax rates were found to increase the probability that entrepreneurs hired workers and, for those with employees, the total amount of a firm's wages.[22] A 10-percent increase in the net-of-tax share (i.e., 1 minus the marginal tax rate) was found to increase the mean probability of hiring workers by 12 percent, and for those firms with employees, increase the median wage bill by 3.7 percent. Finally, a 10-percent increase in the net-of-tax share was found to increase business receipts by 8.4 percent.[23]

The concern over higher individual tax rates has, in part, been the result of the fact that the flow-through sector plays an important role in the U.S. economy and the recognition that higher tax rates on these firms' owners may result in less hiring and capital investment of businesses within the flow-through sector. These issues will arise again in 2013 due to the scheduled increase under current law in the top tax rate imposed on flow through businesses through the individual income tax income from 35 percent to 39.6 percent and the Medicare tax from 2.9 percent to 3.8 percent.

Tax reform can have significant consequences for flow-through businesses

Some have suggested that tax reform focus first on reform of the corporate income tax before focusing on reform of the individual income tax. With the flow-through sector representing more than half of all business activity, as measured by employment (in 2008), and paying 44 percent of total federal business income taxes (between 2004 through 2008), tax reform could have significant consequences for flow-through businesses.

One approach to tax reform that has been suggested, for example, is lowering the corporate tax rate and paying for this change by eliminating or limiting business tax expenditures. Many of these expenditures are long-standing provisions that are available to and widely used by both C corporations and flow-through businesses.

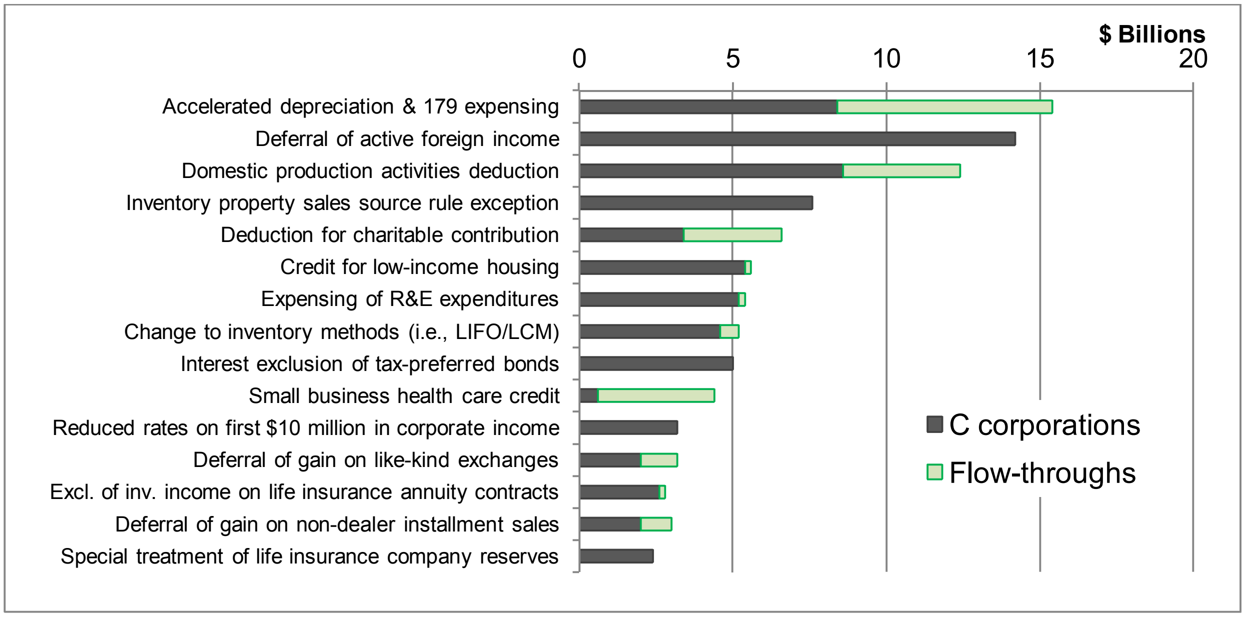
Curtailing business tax expenditures would raise the taxes paid by owners of flow-through businesses, even though these businesses would receive no tax benefit from the lower corporate tax rate and could even face a higher tax rate if individual income tax rates increase after 2012.[24] For example, if accelerated depreciation was eliminated to help finance a lower corporate tax rate, flow-through businesses would lose the benefit of this tax provision without receiving the benefit of a corresponding reduction in the corporate tax rate.

As shown in Chart 5, flow-through businesses make extensive use of a number of broadly available business tax expenditures such as accelerated depreciation, the deduction for

[22] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Income Taxes and Entrepreneurs' Use of Labor," *Journal of Labor Economics,* April 2000, 18(2), pp. 324-351.
[23] Robert Carroll, Douglas Holtz-Eakin, Mark Rider and Harvey Rosen, "Personal Income Taxes and the Growth of Small Firms," *Tax Policy and the Economy*, NBER, Vol. 15, 2001, pp. 121-147.
[24] For a similar analysis that considers the effects of revenue neutral business tax rate reduction financed by repeal of all business tax expenditures see Gerald Prante, Robert Carroll, and Thomas Neubig, "Lowering Business Tax Rates by Repealing Tax Expenditures: An Industry Analysis," *Bureau of National Affairs Daily Tax Report*, Vol. 2011, No. 34, February 18, 2011.

domestic production activities, and the deduction for charitable giving. In total, flow-through businesses benefited from 23 percent of the approximately $116 billion in annual business tax expenditures between 2010 and 2014.[25]

Chart 5. Largest business tax expenditures in US, Annual average, 2010-2014[*]



[*]The value of the tax expenditure for tax-exempt bonds includes only the benefit to the corporate investors, not the benefit of lower interest rates to the issuers.
Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), December 15, 2010, and Ernst & Young LLP calculations.

Repeal of these provisions could entail substantial tax increases for flow-through businesses that could negatively impact employment and growth in the flow-through sector. To gauge the potential impact on flow-through businesses of a "corporate only reform," the percentage change in income tax liability associated with elimination of all business tax expenditures was calculated for flow-through businesses. The analysis takes into account all business tax expenditures permanently in effect from 2010 through 2014 and as estimated by the Joint Committee on Taxation.[26]

The starting point for this estimate is computing the income taxes paid on flow-through income earned and allocated to individual owners of flow-through businesses. As shown in Table 2, based on simulations using the Ernst & Young LLP Individual Tax Simulation Model, individual income taxes on flow-through business income received by individual owners will average $346 billion during 2010 through 2014 period.[27] About 38 percent of these taxes are paid by flow-

[25] Includes only permanent, positive tax expenditures.
[26] Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014," (JCS-3-10), December 15, 2010.
[27] The procedure for estimating the income tax paid on flow-through business income estimated the income tax liability of owners of flow-through businesses with and without their flow-through business income. This approach, described in greater detail in Appendix A: Data sources/simulations, assumes flow-through business income is a taxpayer's last dollar of income earned. The income and associated taxes for RICs/REITs are excluded for purposes of this calculation.

through businesses in the finance, insurance, and real estate industry, followed by services (25 percent) and manufacturing (11 percent).

Table 2. Average annual tax increase on flow-through businesses from elimination of business tax expenditures, by industry, 2010-2014

Industry	Current Tax ($billions)	Share of Taxes (current law)	Tax increase ($billions)	Percent change in tax
Agriculture and mining	14	4%	3.0	22%
Utilities	2	1%	0.2	8%
Construction	26	8%	2.3	9%
Manufacturing	37	11%	3.0	8%
Wholesale trade	21	6%	1.0	5%
Retail trade	12	3%	1.1	9%
Transportation	8	2%	0.5	6%
Information	10	3%	0.4	4%
Finance, insurance, and real estate	130	38%	9.9	8%
Services	86	25%	5.6	7%
All industries	346	100%	27.0	8%

Source: Ernst & Young LLP calculations based upon multiple data sources, primarily JCT and IRS.

Based on Ernst & Young LLP estimates, eliminating all businesses tax expenditures would increase the income taxes paid by individual owners of flow-through businesses, on average, by 8 percent or $27 billion annually from 2010 through 2014.[28] Flow-through businesses in the agriculture and mining industry would experience the largest increase in individual income taxes (22 percent) primarily due to the elimination of timber-related provisions. Flow-through businesses in the finance, insurance, and real estate industry would face an 8 percent increase in taxes due to the loss of the benefit of the tax expenditures for the deferral of gains on non-dealer installment sales, amortization of business start-up expenditures, the charitable giving deduction, as well as accelerated depreciation for certain rental property and the low income housing tax credit. In contrast, flow-through businesses in the information industry would only have a 4 percent increase in taxes, below the 8 percent average across all industries because flow-through businesses within this industry tend not to receive much benefit from business tax expenditures.

A corporate tax reform that lowered the corporate tax rate paid for by eliminating or limiting business tax expenditures only for C corporations would, in effect, hold flow-through businesses harmless from the reform, but would add substantial complexity to the Code. New tax rules would be needed to, in effect, partition provisions off for just flow-through businesses. Moreover, it is unclear how these rules would operate in a number of circumstances. For example, in the case of a joint venture between a C corporation and a pass-through business, it is unclear how

[28] This estimate includes the higher taxes on ordinary income reported by flow-through businesses, as well as taxes paid on other flow-through income reported on individual tax returns, such as capital gains, rental income, and royalty income.

tax expenditures available to one business form, but not the other would be allocated. The creation of additional differences in the tax treatment of C corporations and flow-through businesses might also cause additional shifting between these business forms. Differences in tax treatment have caused shifting between the C corporation and flow-through business forms in the past,[29] but in this case the shift between organizational forms would result from the various tax expenditures being available only to businesses in the flow-through sector.

This type of complexity, which could arise in a number of circumstances across many business tax provisions, would not be in the spirit of tax reform. Rather than a simpler tax system, such a reform would have the potential to add considerable complexity to the Code.

Summary

The current focus on reform of the tax system has also drawn attention to how flow-through businesses might be affected by tax reform. Corporate tax reform is clearly an important component of an overall approach to improving the current tax system. The high US corporate income tax rate relative to most other developed nations may adversely affect the competitiveness of the United States. Difficult choices also arise in reforming the US corporate income tax in an increasingly global economy where most other developed nations have shifted to territorial tax systems.

As with any such endeavor, however, policy makers should keep in mind the potential for undesirable side effects. Corporate reform that eliminates business tax expenditures could have the unintended impact of raising the cost of capital for businesses organized using the flow-through form. Such firms are a large part of the U.S. business sector and important contributors to the vitality of the US economy.

This sector has grown rapidly over the past several decades to the point where flow-through businesses now employ 54 percent of all private sector workers and pay 44 percent of all business taxes. The expansion of the flow-through sector provides the important benefit of reducing the scope of the double tax on corporate profits, as well as providing additional flexibility in the ownership structure of businesses that may provide a better match to their management needs and capital requirements.

The path towards tax reform will need to take into account many features of our tax system and strike a balance between a number of sometimes conflicting and competing objectives.

Thank you and I would be pleased to address any questions you may have.

[29] See, for example, Robert Carroll and David Joulfaian, "Do Taxes Affect Corporate Financial Decisions? -- The Choice of Organizational Form," U.S. Treasury Department, Office of Tax Analysis, Working Paper 73, October 1997; and Austan Goolsbee, "Taxes, Organizational Form, and the Deadweight Loss of the Corporate Income Tax," *Journal of Public Economics,* 69(1), 1998, pp. 143-152.