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Statement of Senator Chuck Grassley  
Senate Finance Committee Hearing, “C, K, or S: Exploring the Alphabet Soup of Small  
Business Choices in Advance of Tax Reform”  
Thursday, June 5, 2008

Taxpayers have a wide variety of entities to choose from when starting a small business. These small business owners can operate as a limited liability company, an S corporation, a partnership, a limited liability partnership, a sole proprietorship, or a farm sole proprietorship. The abbreviations for these entities, such as LLCs, LLPs, and LPs, look like they might be found in a bowl of alphabet soup rather than in our tax laws.

However, over the years, the number of entities keeps increasing. The tax laws relating to small businesses have also grown increasingly complex over time. For example, the partnership tax statutes and regulations are one of the most complex set of rules found in our tax laws. Considering how complex the rest of our tax laws are, that’s saying something. Some of this complexity exists because we give partnerships a lot of flexibility when allocating income, losses, and deductions to their partners. However, a lot of the complexity found in the partnership tax rules arose in response to abuse by partnerships that were trying to unfairly take advantage of these rules.

Similarly, the tax rules for S corporations have grown more complex over the years. In response to this complexity, a lot of taxpayers’ gut reactions are that the tax system should be simplified. However, taxpayers usually want the tax system simplified unless it means they have to pay more taxes. Another thing taxpayers care about is having the freedom to conduct their business the way they want. The wide variety of entity choices currently available allows small business owners much freedom in deciding how to structure their business.

One of these choices, the limited liability company, has become increasingly popular. The LLC offers the best of all worlds – limited liability, a single level of tax, and great flexibility in allocating income, deductions, and losses. Even though an LLC provided these attractive features, people were originally hesitant to form an LLC, because the caselaw relating to LLCs was not as developed as the case law relating to S corporations or partnerships. However, as this case law has developed, small business owners have used the LLC with greater legal certainty. Similarly, the LLP has been utilized to a greater degree in recent years. I should also note that the S corporation remains a very popular entity choice for new businesses.

With the growing number of entity choices comes growing complexity. This complexity

imposes large administrative costs to hard-working small business owners that must comply with these complicated tax laws. Also, the complexity means small business owners can't be confident that they've received all the benefits coming to them, or that they haven't paid more than they owe. When looking at simplifying our tax laws for small businesses, we must also consider the fact that taxpayers like having choices and flexibility in arranging their business affairs, and they don't want to get hit with a tax increase just for the sake of simplification.

While we all agree something should be done and we should be open-minded about what reform would look like, I'd like to remind everyone that if we allow the bipartisan tax relief plans of 2001 and 2003 to expire at the end of 2010, it will result in a huge tax increase on small businesses. According to the Treasury Department's publication titled Topics Related to the President's Tax Relief that was released last week, about 74 percent of the tax returns that will benefit this year from lowering the top tax rate from 39.6 percent to 35 percent are flow-through business owners. Also, about 82 percent of the 29.2 billion dollars in tax relief this year from lowering the top tax rate will be received by flow-through business owners.

If we fail to act to prevent this bipartisan tax relief from expiring at the end of 2010, we will be taking money from the pockets of small business owners. This is money these small business owners could use to hire more workers or spend in our economy on goods and services. According to the U.S. Small Business Administration, small businesses employed over 58 million workers in 2005, which is more than all other firms combined. Our small business owners, including our farmers, are the backbone of our economy. We should not break our economy's backbone by hammering it with a dramatic tax increase.

Another reason we should prevent the bipartisan tax relief plans of 2001 and 2003 from expiring is that the top individual rate and the top corporate rate are currently the same. When the top rates are different, taxpayers frequently attempt to unfairly take advantage of this difference.

I look forward to the testimony from our distinguished panel. We have an accomplished cross-section of witnesses that includes professors, CPAs that have spent many years in the private sector working for small businesses, and a member of a think tank who has held high-level tax positions in the federal government. I appreciate all four witnesses' dedication to the debate about small business tax reform. I look forward to their testimony.