United States Senate
Committee on Finance

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Ranking Member

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Remarks of Sen. Chuck Grassley
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I'm glad to talk to you about tax policy for small and medium businesses. I was Chairman and am now Ranking Member of the Senate Finance Committee. I call it the quality of life committee, because we handle issues that affect Americans' quality of life, including health policy and taxes. I've always believe that the tax code should encourage the success of small and medium businesses. That's true now more than ever in these tough economic times. Small and medium businesses are engine of growth in this nation. We need them hitting on all cylinders to get the economy moving forward. That's why this conference is right on the money. Business owners should learn about the tax incentives meant for you. These incentives will help you hire more employees or improve or expand your business.

I'm glad we were able to get significant tax relief included in legislation responding to the financial crisis. These tax provisions include many important measures for Iowans and Iowa businesses. I know you've heard first-hand from my tax counsel, Jim Lyons, on the tax relief that was provided in response to the flooding, storms and tornadoes that affected Iowa and other Midwestern states. I'm pleased that we got this tax relief signed into law. It will provide real help to rebuild and revitalize these hard-hit areas. I was frustrated that it took the Congress so long to act. But after wearing out a few tables through pounding, my colleagues and I finally got the legislation moved forward.

The legislation provided a one-year patch for individual Alternative Minimum Tax. I would have liked to have done more. I would like to repeal AMT. But instead, we seem to continue to be kicking this can down the road. The legislation extends certain key provisions for business. For example, I know of great interest to you s that the Research Credit was extended for two years and was also expanded. The legislation also includes significant incentives for new sources of energy, renewable energy, and energy conservation. Included are the renewable energy production tax credit, including an uncapped wind energy credit, clean-renewable energy bonds, and cellulosic biofuels. There's a long list of tax provisions that provide much-needed tax relief to businesses and individuals. I've touched on only some of them.

What worries me is that many of you here, business owners and accountants, and even government officials, too often think these tax incentives for R and D, for energy, you name it – are just for the big guys. Nothing could be further from the truth. I can assure you I am not writing these tax laws to help only the Fortune 500. I'm writing these tax laws to help all businesses. The IRS reported recently that about 85 percent of the R and D Credit went to the largest companies in America. A key reason – the largest companies were much more active then small and medium companies in applying for the credit. Too often small and medium businesses are just simply not taking advantage of the R and D and many other tax incentives. A comedian once said that 90 percent of life is just showing up. The same is true in tax – small and medium businesses need to show up and take advantage of these benefits. So my message to you is, learn about the tax incentives that are available to you. These incentives can help your business succeed and thrive, especially in this down economy.

I know that many smaller businesses are not taking certain tax credits because they fear the IRS. This is of great concern to me. I was a member of the IRS Restructuring Commission in the late 1990s. I worked to put a real emphasis on the "Service" part of the Internal Revenue Service. I want to make sure the IRS maintains that focus. The IRS needs to help taxpayers pay the correct amount of tax – not a penny less, not a penny more than what they owe. I would say to the good employees of the IRS who are here, that they need to take this message back to the IRS. The IRS should work with businesses, making sure that businesses take advantage of the tax incentives provided and coming to the correct answer the first time. In doing so, the IRS needs to recognize the realities of a small or medium business – far too often the recordkeeping and other burdens placed on a small business are unreasonable. What may be tolerable for IBM is completely inappropriate for a local business here in Iowa. The IRS needs to understand that at all levels. IRS agents need to be fully informed and knowledgeable of the law. It's not fair to a business owner for the IRS to state that they owe thousands more in tax after a sub-par examination. That businessperson then has to spend a great deal of time and money to go to appeals or tax court and finally get a full and correct review. The IRS needs to do the job right the first time.

Next, I want to talk briefly about a couple items of tax policy in the next Congress. I hope we can look at a permanent resolution to the estate tax, which is more appropriately called the death tax. In addition, at the end of 2010, we need to work to prevent the bipartisan tax relief of 2001 and 2003 from expiring. If we don't, it will result in a huge tax increase on the American people.

I'd like to also discuss how Senator McCain and Senator Obama's tax plans will affect small business. There's been a lot of controversy over the years about the effects of marginal rate increases on small business. It first arose in 1993. At that time, President Clinton and the Congressional majority Democrats pushed through legislation that retroactively raised the top marginal income tax rate. The rate was 31 percent. Under the 1993 bill, two new higher rates went into effect, the 36 percent and 39.6 percent rates. One of the criticisms of the higher marginal rates was that these rates would harm small business. In 2001, Chairman Baucus and I crafted a bipartisan package of marginal rate reductions. Part of that package brought down the top rate from 39.6 percent to 35 percent. Another part of the package lowered the 36 percent rate to 33 percent. The non-partisan congressional Joint Committee on Taxation concluded that the legislation improved the progressivity of the tax code. However, the top marginal rate reductions remained controversial. Many on the left said the rate reductions were tax cuts for the wealthy. They defined the bipartisan broad-based tax relief as "the Bush tax cuts for the rich." These critics failed to examine the data on the whole bill. The fact that the Democratic Presidential candidate is embracing most of the policy from the bipartisan deal should give these liberal critics pause. Senator Obama's campaign tax plan confirms what I said many times here over the last seven years. It confirms that the bill Chairman Baucus and I crafted was a bipartisan plan that would stand the test of time. Since the top rates of 35 percent and 33 percent drew opposition, there was a lot of debate about their merits.

Aside from the general economic benefits of increased incentives or work and investment, Chairman Baucus and I focused on the benefits to small businesses. In August 2001, Chairman Baucus and I released a statement on a Treasury Department analysis. I'd like to quote from part of that press release:

Quote: "{o}wners of sole proprietorships, partnerships, S corporations, and farms – will receive 80 percent of the tax relief associated with reducing the top income tax rates of 36 percent to 33 percent and 39.6 percent to 35 percent.... Experts agree that lower taxes increase a business' cash flow, which helps with liquidity constraints during an economic slowdown and could increase the demand for investment and labor..." End quote.

Today, seven years later, we find ourselves in the same debate. Senator McCain's position is that we should not raise those rates, especially in a slow economy. Senator Obama insists that we raise those top rates. This is a sharp difference between the two potential Presidents on tax policy. My constituents have a right to be informed, in an intellectually honest way, on this important question. So let's take a look at this small business issue.

What is a small business? Some on the other side have said the only small businesses that matter are those with owners who earn less than $200,000 to $250,000. To those people, the local hardware store, if one of the owners or the sole owner earns over $250,000, no matter how many folks it employs, is the same as Home Depot or Lowe's. Those of us from the Heartland know that the definition of small business is not limited to those whose owners make $250,000 or under. For us, it depends on whether the business is locally-based. It depends on whether the business finances its growth from its own earnings, not through the stock market. So, when we talk about small business, we should not use any artificially low level of income. We should use a common sense definition of small business. There's too much at stake to demagogue the definition.

For most Federal policy, the Small Business Administration says a small business is privately held with 500 or fewer employees. Small business has generated 60 percent to 80 percent of the net new jobs annually over the last decade. Where are tomorrow's jobs going to come from? The lion's share will come from small business. The small business sector accounts for more than half of the net business income in our nation. The small business owner pays the tax. The individual tax rate, at the owner's level, is the rate paid by small business. These businesses are described as flow-throughs because the business income and tax burden flows through to the business owner. If a business makes a profit, the profit is taxed at the owners' level. It flows through to the owners. At that point, the Federal Government takes its share. The after-tax profit is available to the owners.

Currently, the top two Federal tax rates are 33 percent and 35 percent. Senator McCain wants to keep the rates there. Senator Obama wants to raise the statutory rates to 36 percent and 39.6 percent.

Senator Obama also wants to restore the hidden marginal rate increases known as "PEP" and "Pease." For small business-owning families, their real marginal rates would go up to 40 percent and 41 percent respectively. Let's take a look at how small businesses that are organized as regular corporations would be affected. These businesses are not flow-through entities. Since the top two rates, as proposed by Senator Obama, would rise by 21 percent and 17 percent, respectively, the salary income would be taxed at those higher rates. For that same group of taxpayers, Senator Obama proposes to tax dividend income at 20 percent instead of the 15 percent rate that applies now. That is a 33 percent tax increase. So, for these regular, non-flow-through small business owners, the amount of tax owed on their business income would rise at a range of 17 percent to 33 percent.

How much small business activity would be affected by the increased rates Senator Obama proposes? The answers have been controversial. People who are hostile to marginal rate reductions have pointed to one statistic. They cite a statistic from the Tax Policy Center that concludes that 1.9 percent of filers with business income pay the top two marginal rates. According to the analysis, that percentage is roughly three times the percentage of tax filers in the general population. Indeed, Senator Obama made this point in Wednesday's debate with Senator McCain. For the opponents of marginal rate relief, the discussion ends there. The statistics show small business owners are three times more likely to be in the top two brackets, but that does not matter to the opponents. They say the rates must go up and the revenue must be spent on expanding government. The political point of the opponents boils down pretty simply. This small group of filers is well off, so, other than them, who cares if their rates go up.

There is a huge assumption that makes this argument dangerous. The assumption is that since the number of filers is limited to roughly two percent, the business activity is likewise limited. The assumption is dangerous economic policy. It understates the number of small businesses affected. And it discounts any negative effect of removing resources from small businesses. Small businesses are more vulnerable to the good and bad years of business cycles. Two-thirds of small businesses survive for at least two years. Forty-four percent of small businesses survive for at least four years. We're dealing with a moving target when we talk about the 2 percent figure.

The assumption about business activity is even more dangerous. Let's go through an example. A taxpayer files jointly, owns a small business, and earns $500,000 of business income. Let's assume all of this taxpayer's income comes from the small business. The small business owner pays $146,700 under current law. Senator McCain's plan leaves this level in effect. Under Senator Obama's proposal, the small business owner's taxes would go up by about $20,000. That's a tax increase of roughly 13 percent. Can the business owner grow enough sales to pay the extra tax? Maybe. Maybe not. Can he or she replace a $20,000 machine? Maybe. Maybe not. Can he or she maintain payroll? Maybe. Maybe not. How about the future? Any good business person has to project how their investment is working. Higher taxes negatively affect the net income from an investment. A small business owner is less likely to make future investments in the business. My point is the tax increase Senator Obama is proposing has a very real cost to the small business owners.

Let's look at data from the National Federation of Independent Business ("NFIB"). Its latest survey shows that 40 percent small business owners of firms with 20 to 249 employees would be hit by Senator Obama's tax increase. Here's the scariest part. As the percentage of small business owners hit by Senator Obama's higher taxes goes up, the number of employees goes up. So, it's fair to say these figures probably understate the impact of the higher marginal rates on the remaining small businesses, those between 250 and 500 employees. With small businesses alternately running gains and losses, over time, the higher rates will hit a larger number of small business owners. Every year, the Small Business Administration prepares a report to the President on the small business economy. The last report covers data for 2006. For 2006, the entire private sector workforce growth occurred in small businesses with 500 or fewer employees. For 2006, more than half of America's private sector employees worked in these firms. For 2006, these small businesses accounted for over half of the nation's private sector gross domestic product. There's clearly a link between tax relief, economic growth and jobs. We've seen the evidence of that link in years past. Tax relief kicked in, the economy started growing, and jobs started coming back. Why would we want to go in reverse gear? Senator McCain and Senator Obama agree on the policy objective of growing jobs. Why would you aim a 17 percent to 33 percent marginal tax rate increase at the businesses that grew all the jobs in the most recently-studied year? Senator McCain's plan recognizes this job-loss risk. Senator Obama plan goes in the opposite direction. Let me conclude with a challenge to the proponents of raising marginal rates on small business. When I say critics I'm referring to politicians, pundits, and some in the media. I think the data I've presented speaks for itself. Those who insist that higher marginal rates won't affect small business should take another look. If they're intellectually honest, they will exclude small business from the 17 percent to 33 percent marginal rate increases they support. Thank you. Now I'll be glad to take your questions.

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