

Mark Smetana – House Committee on Ways and Means, March 7, 2012

Good morning Chairman Camp and Ranking Member Levin and members of the committee. It is an honor and privilege to be invited to testify at today's hearing regarding the treatment of privately-held businesses in the context of tax reform.

This hearing comes at an important time as America's businesses continue to struggle with lingering economic uncertainty. This proves especially true for the thousands of privately-held and family-owned businesses across the United States.

My name is Mark Smetana and I am Chief Financial Officer for Eby-Brown Company, a 100 year old family-owned broadline distributor to the convenience store industry. The current family ownership is in its second generation and employs about 2,500 people. The longevity of the company has largely resulted from the family's reinvestment of its earnings into the business coupled with traditional bank financing.

I am also an active member of Financial Executives International (FEI). FEI's 15,000 members represent companies from every major industry, half of which are privately-held companies. As part of my involvement with FEI, I have previously served as Chairman of the FEI's Committee on Private Company Policy. This committee has helped Congressman Peter Roskam and Congressman Jason Altmire form the *Privately-Held and Family-Owned Business Caucus*.

America's privately-held businesses are the backbone to our economic success story. Forbes Magazine estimated that the 223 largest private companies in the United States employ 4.4 million people and account for \$1.3 trillion in

revenues.<sup>1</sup> Recognizing the importance of private companies is vital since any workable tax reform must address businesses regardless of their form of organization.

All forms of business use GAAP based financial statements to measure financial performance and the financial position of the business. However, there are fundamental differences between privately-held businesses and corporations in that holders of privately-held companies are typically limited in number and have longer term investment horizons – years, decades, generations – whereas investors in publically-held corporations are short-term renters of the securities they own, frequently trading them for cash. Capital used to finance privately-held businesses post start up are after-tax cash earnings and traditional forms of debt borrowings. Public corporations raise capital via offerings of debt and equity-traded securities to the public. The owners of privately-held businesses typically measure the value of their business in terms of the cash flows the business generates – EBITDA, or earnings before taxes, interest, depreciation and amortization – times a market multiple. Whereas public companies measure valuation in terms of market capitalization, price to earnings ratio and earnings per share. Most privately-held corporations evaluate investment opportunities on an after tax cash flow basis whereas public companies evaluate the impact on the price of its stock.

Tax policy plays a material role in evaluating those investment decisions for privately held businesses. The recent framework for business tax reform released jointly by the Obama Administration and the Department of Treasury strongly

---

<sup>1</sup> DeCarlo, Scott, Andrea D. Murphy and John J. Ray, *America's Largest Private Companies*, Forbes Magazine, Nov. 3, 2010.

implies that those organized as pass through entities are advantaged in the current tax code over corporations. This is simply not the case. According to a report from Dr. Robert Carroll and Gerald Prante of Ernst and Young, America's pass-through businesses reported 36 percent of all business net income but paid 44 percent of all federal business income taxes.<sup>2</sup> Furthermore, the pass-through tax regime recognizes that there is a fundamental difference between closely-held business enterprises and corporations, especially publically-traded ones. Among them are:

- Owners of pass through privately-held companies are taxed on business income whether distributed or retained in the business at one level of taxation whereas corporations pay taxes on all income and their owners pay a second tax on after tax earnings that are distributed to its owners creating a double tax event.
- Pass-through entities are flexible, allowing a disproportionate allocation of earnings to its owners based on the agreed upon equity contribution among them. Corporations are inflexible in the allocation of earnings to its stockholders.

In order to fairly treat all businesses and provide a consistent policy with which businesses can operate in the US economy, tax reform must address both forms of organization. The stated goal of providing a competitive business tax environment is important, however, it should not result in discriminating against closely-held businesses by: widening the amount of marginal taxes they pay on

---

<sup>2</sup> Carroll, Dr. Robert and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young, April 2011.

Mark Smetana – House Committee on Ways and Means, March 7, 2012

business sourced income; forcing them into an inappropriate investor/owner relationship with their business; double taxing their business income as if they were merely an investor trader of the business; or forcing them to pay a second level tax on the sale of their business.

Financial professionals are already making decisions based on increases in marginal rates set for January 2013, expiring AMT fixes and increases in the tax rates on investment income. Certainly none of these prospects can be welcomed at a time when our economy desperately needs increased private sector investment.

As I close, it is vital that private companies are recognized as critical for America's economic future. When tax reform does take place, I hope that their importance to our economy is understood and not penalized.

I want to thank the Chairman and Ranking Member for giving me the opportunity to speak before the committee today. I am happy to discuss these issues further and answer any questions you may have.