



Testimony of Mr. Dennis Tarnay, CPA

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Chairman Tiberi, Ranking Member Neal and members of the Subcommittee, thank you for inviting me to appear before you today to discuss the issue of fundamental tax reform, particularly as it relates to small businesses. I am the Chief Financial Officer and a Minority Owner of Lake Erie Electric, a position I have held since 1987 and a former board member of The Ohio Society of Certified Public Accountants (OSCPA). I'm speaking today on behalf of both Lake Erie Electric and OSCPAs. Lake Erie Electric, based in Cleveland, Ohio, is an electrical contracting company that was first formed as a C Corporation in the 1950's to primarily serve industrial customers in the automotive and steel industries in the Midwest.

My company has seen many changes since its inception, both in terms of its corporate structure and business strategy. In 1987, we modified the corporate structure of the company to a pass-through Subchapter S-Corporation due to federal tax law changes that occurred at that time and because it was a better fit for us. When Cleveland's industrial base contracted, we transitioned our customer base to be more heavily weighted to commercial businesses and the health care sector. Both of these business decisions allowed Lake Erie Electric to continue to grow and to expand our workforce, even as other small businesses in the greater Cleveland area took the brunt of the current and prior recessions.

As you may know, Cleveland has one of the highest unemployment rates in the country. Small businesses in my area are working hard to find creative ways to reinvent and reinvest in themselves so that they may begin to hire workers again. Having a tax environment that doesn't punish higher income taxpayers – and therefore many, many small business owners -- is critical to not only survival in recessionary times, but having the ability to expand our workforce when times are better. That's the main message I want to deliver to you today: that simplifying the tax code for small businesses means creating jobs in places like Cleveland, Ohio.

Predictability and stability within the tax code provide businesses, particularly small businesses which typically have tighter profit margins, the necessary lens with which to make decisions regarding growth, investment or reinvestment of capital and expanding new employee job opportunities. Lower tax rates on small businesses mean that the money we do not have to pay in additional taxes instead can be reinvested in our businesses and workforce, spurring an

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economic recovery that in Ohio is slow at best. Further, a simpler tax code means small business owners can spend less time on costly and burdensome compliance activity and invest more of their time on innovation and growing their businesses. Simplicity also helps to minimize taxpayer confusion over exactly what liability is owed, and help with financial planning for the future. That simplicity could also prove beneficial to government as they seek to close the tax gap. Tax reform for small businesses is about one thing in America: JOBS for all business sectors.

Small Business and Tax Reform: You Can't Separate the Business Owners from the Business

Subchapter S Corporations are structured so that net income of or losses to the business are distributed to the shareholders of the company and are reflected on an individual's federal, state and even local income tax returns. The tax is assessed at their individual income tax rates, meaning legislators should be conscious that discussions of assessing the higher tax rates on individuals at \$200,000 and families at \$250,000 will have a direct impact on the ability of many small business owners to reinvest in their businesses, and to keep or grow their workforce.

In addition to Subchapter S corporations like mine, other forms of pass-through entities that will be similarly impacted are Limited Liability Companies, partnerships, Limited Liability Partnerships and sole proprietorships. Roughly 75% of small businesses are pass-through entities.¹ The primary reason there are so many pass-through entities is because double taxation is eliminated (first at the entity level as earnings, and then again at the individual level as dividend payments to shareholders) unlike businesses that operate as C Corporations. The largest percentage of small businesses are Subchapter S-Corporations like Lake Erie Electric.² This data leaves little doubt that in order for a robust economic recovery to take place, there must be a tax structure in place that incentivizes small businesses to hire and thrive.

Tax law does matter to small business pass-through entities, because they modify their business practices to adjust for law changes. In recent years, tax law changes have become a type of political tool, with revisions occurring far too often: sometimes more than once a year, and sometimes so late in the year that it is retroactive in impact, causing business owners to be confused and uncertain on how to proceed. . The frequency of tax law changes affect small businesses in particular because the unpredictability often slows or discourages the hiring or rehiring of employees, or investing in new equipment or other products and services . While certainly businesses of all sizes are impacted by the frequency of tax law changes, they have a far greater impact on small business decisions because so many of them operate on very tight profit margins. Predictability helps to keep costs down as fewer changes equate to fewer compliance costs associated to changing practices and procedures that in many cases are longstanding and

¹ *Business Structure – NFIB Small Business Poll*, NFIB Research Foundation, Washington, DC, Volume 4; Issue 7; 2004.

² *Id.* Subchapter S Corporations make up 31% of small businesses. *Id.*

successful from a cost/benefit standpoint. Lower costs equal greater ability to reinvest in the company and future growth.

Why pass-through entities should be maintained

The current structure of pass-through entities such as Subchapter S-Corporations provide flexibility and control to small business owners and should be maintained in any tax reform proposal.

Going forward, tax reform should help small businesses by reforming issues such as:

- Simplifying compliance rules regarding E-filing and E-verify
 - Shifting the burden away to be the watchdog for the government on the small business's employees -
 - Reforming the timing requirements for S-Corporation formation
 - Increasing the amount a small business may expense on the federal tax return
 - Reasonable independent contractor rules
 - The alternative minimum tax should be eliminated. If it can't be eliminated, enact a more reasonable and consistent threshold for the alternative minimum tax
- In a related matter, I applaud your efforts to address the expanded 1099 requirement currently on schedule to become effective Jan. 1, 2012. From a small business perspective, this is the classic example of a compliance cost on both business and the Internal Revenue Service outweighing the benefit derived.

The Bottom Line for Small Business and Tax Reform

In Ohio, in 2008 small firms made up 98.1% of the state's employers³, and nationally have generated 64% of net new jobs over the past 15 years⁴. To truly spur economic growth, rates should be set at a level that incentivize business owners to create the opportunity to hire additional workers, not punish them for being successful.

Meaningful tax reform that focuses on simplicity, predictability and fairness, and that includes an emphasis on the related cost and compliance burden to small businesses, is critically important so that we as small business owners, seek to do our part to grow the economy. On behalf of both Lake Erie Electric and OSCPA, I appreciate the opportunity to share my concerns and would welcome any questions you might have.

³ Small Business Administration Office of Advocacy, Small Business Profile; Ohio. www.sba.gov. Published Feb. 2011.

⁴ U.S. Small Business Administration,, "How important are small businesses to the U.S. economy?" , www.sba.gov.